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Forward

The "Wednesday Seminar" is annually published book, containing the research paper, discussion paper and working papers presented at the Islamic Economics Institute (IEI) weekly seminars. These seminars have been going on since 1985, though the book series started in 2007.

I am pleased to present to the readers the seventh book of the "Wednesday Seminars' that were held during the academic year 2011-2012, which is also electronically available on the IEI website http://ierc.kau.edu.sa/Pages-A-NHiwar.aspx.

In this year, 2012, the Islamic Economics Institute presents this book in a new format. Where a separate section is assigned for papers written in English. These papers are the outcome of the monthly seminar held by the "Chair for Ethics and Financial Norms". This Chair has been created in collaboration between IEI and University Paris 1 Pantheon Sorbonne.

I hope the respected reader of the "Wednesday Seminar" book finds it beneficial and useful.

Dean

Dr. Abdullah Qurban Turkistani

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Presentation: 3rd Seminar held on September 4th 2011

ISLAMIC APPROACH TO RISK*

Sami Al-Suwailem
1432H–2011

I. Risk in Islamic Economics

More than 670 years ago, *Ibn Taymiah* (728H-1328G) wrote:

> Risk falls into two categories: commercial risk, where one would buy a commodity in order to sell it for profit, and rely on Allah for that. This risk is necessary for merchants, and although one might occasionally lose, but this is the nature of commerce. The other type of risk is that of gambling, which implies eating wealth for nothing (أكل المال بالباطل). This is what Allah and his Messenger (peace be upon him) have prohibited. ([2]; pp. 700-701.)

This phrase shows that Muslim scholars were aware of the dual forms of risk. Although there might be cases where it is difficult to distinguish between the two, the overall framework nonetheless is clear. The above statement shows that there are two types of risk:

1. Risk associated with normal economic transactions, i.e. value-adding and wealth-creating activities.
2. Risk associated with "eating wealth for nothing", or zero-sum activities, where no net additional wealth is created.

* Adopted from sections 4 and 5 of the author's paper: *Hedging in Islamic Finance,* IRTI, 2006.

Economic Risk

If we define risk as possibility of loss, then it becomes clear from an Islamic perspective that risk as such is not desirable. Islamic principles clearly call for the preservation and development of wealth. Exposing wealth to loss cannot be a goal in itself. In fact, al-Qarafi clearly states that i.e. protection of wealth, is desirable for rational agents (cited in al-Suwailem [10]).

This is the same position towards hardship (مشقة). Although many Islamic deeds involve hardship of some sort, such hardship is not desirable in itself. According to Ibn Taymiah ([4]; pp. 10:620-622):

> Reward of deeds is based on their usefulness, not their hardness. A good deed might be hard, but its goodness is for a reason other than being hard. Reward may be larger if involved hardship is larger, not because hardship is the objective of the deed, but because the deed implies hardship.

In other words, hardship is secondary in determining the value of the deed. The primary factor is its usefulness. Accordingly, value would reflect its hardness, but only to the extent that it is useful.

The same reasoning applies to risk, as it is a form of hardship. Risk as such is not desirable, although it is intrinsic to virtually all economic activities. However, the value of an economic decision is not determined primarily because of risks it involves; rather, it is determined according to wealth it creates and value it adds. Risk is reflected in value accordingly, but not that risk in its own determines the value.

Whenever taking risk is praised it is because of the added value and created wealth that follows, not that risk as such is desirable. This represents a vital difference between legitimate and undesirable risk: Risk is legitimate when it is necessary for value creating. But when no value is added, it is a form of gambling.

Hedging

Hedging is used generally to denote neutralizing and minimizing risk. In this respect, it naturally belongs to Islamic economic objectives. As such, this is not an issue and should not raise any concerns. The issue, however, is how to reach this goal, and what means is used to meat this end. If the means involves pure speculation and gambling-like activities, it would be illegitimate, even if the objective is. Ends do not justify means (Ibn al-Qayyim [6]), and thus noble ends necessitate noble means. Obaidullah (2005) rightly notes, “the provision of hedging facility is hardly an adequate rationale for tolerating *qimar* and *maysir*. The Shari’ah does not disapprove of hedging, since it brings in some It is the zero-sum nature of the game that the Shari’ah finds objectionable, as in it lie the roots of social disharmony and discord.” (p. 176.)

To achieve legitimate hedging without *maysir* therefore is a challenge that both Islamic and conventional finance are facing. The objective of this paper is to explore and highlight milestones of the Islamic approach through which legitimate means can be developed to reach this essential goal.

Tolerable Risk

Muslim scholars discussed the conditions under which risk can be tolerated, and those under which it is not. Generally, they point that risk is tolerable if it satisfies the following conditions:

1. It is inevitable.
2. It is insignificant.
3. It is unintentional.

(See al-Dharir [12], pp. 587-612, and Hassan [7], pp. 464-469).

The first condition implies that the same level of added value of the concerned activity cannot be achieved without assuming risk of loss or failure.

The second condition concerns the degree of this risk. It states that likelihood of failure shall be sufficiently small. Scholars were clear that likelihood of failure should be less than that of success in order for involved risk to be acceptable (al-Dharir, op. cit.). We shall see later how this condition distinguishes the Islamic approach from conventional, Neoclassical approach.

The third condition follows from the first two. The objective of a normal economic activity is the value it creates, not the risk it necessitates. This risk therefore cannot be the intended part of the transaction.

Inevitability of Risk

The condition that risk shall be inevitable implies that risk is inseparable from real, value-adding transactions. As discussed in the last section, separating risk from real transactions creates even more risks and makes the economy highly unstable.

From Shari'ah point of view, exchange of pure liability for a given price (معاوضة على الضمان) is unanimously prohibited (al-Suwailem, 1999). This is consistent with the general trend of Islamic finance to be always linked to real transactions. Since derivatives by construction separate risk from ownership and thus from real activities, they appear in direct opposition to Shari'ah principles. Not surprisingly, several Fiqh councils ruled that options and futures are unacceptable from Shari'ah point of view (e.g. OIC Fiqh Council [14]).

From an economic point of view, risk is necessary for economic progress and wealth creation. According to Alan Greenspan:

> The willingness to take risk is essential to the growth of a free market economy. If all savers and their financial intermediaries invested only in risk-free assets, the potential for business growth would never be realized. (cited in Bernstein, 1996, p. 328.)

President of IMF, Horst Köhler (2004), reiterates this meaning: "Indeed, it is the willingness to take risk and tackle uncertainty that drives innovation and technical progress—and helps create jobs and build prosperity."

Thus risk by nature is inseparable from economic activities. Islamic requirements that risk may not be severed from real transactions therefore are only natural and conform to economic reality. Artificially severing risk will not make it disappear; rather, it will come back in even more dangerous forms, as discussed earlier.

Likelihood of Failure

It is clear from classical sources of fiqh that for risk to be tolerable the likelihood of failure shall be less than that of success. This is true regardless of the magnitude of the outcomes of the decision.

This is in sharp contrast to expected utility rule (and many competing rules for this matter), where decision is based on expected terms, i.e. the product of probability of the outcome times its magnitude. The difference between the two can be seen most clearly in lotteries.

In a lottery, an agent has an extremely small probability of wining the prize. Probability of losing the ticket's price is substantially large. From an Islamic point of view, this cannot be acceptable since it is almost certain that loss will materialize. Expected utility rule, in contrast, is based on the expected value regardless of which state is more likely to prevail. This is true even if probability of loss exceeds 99%, as long as the prize is sufficiently large. This rule leads to a kind of "wishful behavior," where an agent behaves according to his preferences or wishes more than to objective reality.

This kind of behavior is rightly described as deception and delusion, or gharar. The decision maker is deceived by the size of the prize such that he behaves as if it is more likely to obtain, when in fact it is more likely not.

Causality

The condition of dominant likelihood of success is equivalent to saying that the action shall lead or "cause" the successful outcome to materialize. A cause need not lead to the final outcome with certainty. It is sufficient that it does so more often than not (al-Suwailem, 2002).

From an Islamic perspective, uncertainty requires the decision maker to take proper causes to achieve desirable results, and entrust Allah to avoid possible but less likely failures. Taking proper causes is viewed as mandatory and not merely preferable. Entrusting Allah thus compliments rational decision-making and never substitutes for it. Taking an action that is more likely to lead to failure is a violation of Islamic teachings.

This clearly shows that playing a lottery is not acceptable since it is almost certain that the player will not win the prize and thus will lose the price. This is also true for any economic decision for which likelihood of failure dominates that of success.

Investment vs. Gambling

The causality rule can clearly distinguish investment from gambling. The key difference between the two is confidence of success. An entrepreneur starts a project because he is confident that the project would succeed. A gambler knows in advance that he is more likely to lose than to win. However, the size of the prize deceives him to engage into such a losing project.

This difference is consistent with the concept of causality according to Islamic principles. An action that leads to failure more frequently than success cannot be considered as a cause of success. It is a cause of failure.

Expected utility rule in contrast does not differentiate between a cause and a non-cause. It mixes the likelihood of the outcome with its magnitude, and decision is based on the final product. No attention is given to how the outcome is reached, whether systematically or by blind luck. This is not the way agents normally evaluate their decisions. According to Ben-Ner and Putterman (1998):

> Individuals care about the manner in which they themselves and others behave, including the ways in which they attain outcomes of interest. ... Uncommon is the individual who is indifferent about whether he has achieved his income through honest work or blind luck, whether he has cheated others or treated them fairly. (p. 20)

Choice under Uncertainty

Conventional theories of choice, most obviously expected utility, cannot distinguish investment from gambling. Rather, decision under uncertainty is viewed simply as a choice among lotteries (e.g. Varian, 1992). Not only this is inconsistent with the Islamic view, it is also inconsistent with real decision making in business environments.

Studies by MacCrimmon and Wehrung (1986) and Shapira (1995) show that business managers rarely take risk as given. They consistently attempt to adjust risks such that they are confident of the successful outcome. According to Shapira: “Managers see themselves as taking risks, but only after modifying and working on the dangers so that they can be confident of success” (p. 74; emphasis added). In this context, risk taking “is an endeavor where a manager can use his judgment, exert control, and utilize skills”. This is absent from gambling (p. 48). Shapira concludes that the “gambling metaphor appears as an inadequate description of managerial risk taking” (p. 120). James March, decision scientist at Stanford University, writes:

> Although theories of choice tend to treat gambling as a prototypic situation of decision making under risk, decision makers distinguish between "risk taking" and gambling, saying that while they should take risks, they should never gamble. They react to variability more by trying actively to avoid it or control it than by treating it as a tradeoff with expected value in making a choice. (1994, p. 54)

These results point to the fundamental difference between risk taking associated with real business activities, and gambling where likelihood of failure is dominant, but the size of the outcome deceptively makes the choice acceptable.

A Causal Decision Rule

If we want to amend the expected utility rule in the light of the above discussion, one way to do so is to impose a constraint on the likelihood of success. Suppose that an action a would lead to outcome $x_i \geq 0$ in state i, $i = 1, \ldots, n$, with probability p_i. Probabilities could be objective or subjective, as long as they satisfy axioms of probability. Let $v(x_i)$ be the payoff (utility) function of the decision maker in state i, and let $c(a)$ be the cost of action a. Expected utility requires an action a is admissible as long as:

$$[1] \quad U(a) = \sum_{i=1}^{n} p_i v(x_i) - c \geq 0 .$$

For example, the action could be to purchase a lottery ticket for which the prize is, say, one million, and $c = 1$ is the price of the ticket. Then the outcomes are either to win the prize, whereby $x_1 = 1{,}000{,}000$, or not, whereby $x_2 = 0$. The action is admissible as long as the expected payoff is non-negative. If the probability of winning is one in million, and the payoff function is linear, then we have:

$$v_1 = 1{,}000{,}000 \text{ with } p_1 = \tfrac{1}{1{,}000{,}000}, \text{ and } v_2 = 0 \text{ with } p_2 = \tfrac{999{,}999}{1{,}000{,}000}.$$

Consequently, $U(a) = 0$. Thus, purchasing the ticket would be admissible. To exclude this sort of behavior, we have to impose a restriction on admissible probabilities. This can be achieved by subjecting [1] to the constraint that probabilities of success are larger than those of failure. Let *S* be the set of outcomes for which $v(x_i) - c \geq 0$, and let S' be its compliment, i.e. for which $v(x_i) - c < 0$. The set *S* represents the set of successful outcomes, while S' represents unsuccessful ones. Then action a is admissible as long as:

[2] $U(a) = \sum_{i=1}^{n} p_i v(x_i) - c \geq 0$, and [3] $\sum_{i \in S} p_i > \sum_{i \in S'} p_i$.

The constraint [3] requires that total probability of success exceeds that of failure. Since total probability of all outcomes equals one, then condition [3] is equivalent to requiring that $\sum p_i > 0.5$ for $i \in S$. This condition therefore excludes outcomes with low probabilities that might be chosen merely because of the associated large payoffs, i.e. gambling.

Statistical Measure

A more direct representation of the causal rule can be obtained by invoking statistical measures of probability distribution. The expected utility rule is equivalent to the *mean* of the payoffs distribution. The mean is a measure of the central tendency of the distribution, defined as the sum of the values of the random variable weighted by their respective probabilities.

An alternative measure is the *median*. The median is commonly defined as the point that divides total distribution into two equal parts, each with probability of 50%. A more general definition, suitable for both discrete as well as continuous distributions, is provided by DeGroot (1986, p. 207). The median is defined as a value m of a random variable $\tilde{x}$ such that:

[4] $prob(\tilde{x} \leq m) \geq 0.5$ and $prob(\tilde{x} \geq m) \geq 0.5$.

That is, the probability distribution on either side of the median is *at least* 0.5. The two sides therefore need not be equal. For the outcomes of a given action *a*, the median payoff $\hat{v}$ is defined as:

[5] $prob(\tilde{x} \leq \hat{v}) \geq 0.5$ and $prob(\tilde{x} \geq \hat{v}) \geq 0.5$

A decision rule based on the median would require that an action *a* is admissible if the median payoff is non-negative, i.e.:

[6] $U(a) = \hat{v} - c \geq 0$.

To apply this rule to the lottery example, recall that there are two payoffs (assuming linearity of v):

$$v_1 = 1{,}000{,}000 \text{ with } p_1 = \tfrac{1}{1{,}000{,}000}, \text{ and } v_2 = 0 \text{ with } p_2 = \tfrac{999{,}999}{1{,}000{,}000}.$$

The median of this distribution is v_2, since it satisfies the conditions in [5]. To see this, note that $prob(v(\tilde{x}) \leq v_2) = p_2$. That is, probability to get at most a zero-payoff (which is the smallest payoff) is greater than 0.5. Next, $prob(v(\tilde{x}) \geq v_2) = 1$. That is, a player is certain to get zero or more. (The reader may want to verify that v_1 violates [5] and thus cannot be a median.) Since the median is zero, the utility of purchasing a lottery ticket becomes negative, and therefore the decision is not admissible.

Note that this result is obtained regardless of the shape of the utility function. This makes the median rule robust with respect to the specification of risk preferences of the decision maker. Statistically, it is well known that the median is more stable than the mean, and represents the central tendency of the distribution more accurately (DeGroot, 1986, pp. 208-209).

It is somewhat surprising that while the median is more robust than the mean, it is also more consistent with Islamic and moral principles regarding wagering and gambling. The rule succeeds, at least to some extent, in distinguishing acceptable risk taking from gambling, a problem that puzzled lawmakers and economists alike. The median rule is consistent with results of evolutionary game theory, which point that "nature abhors low probability events" (Gintis, 2000, p. 117). From an evolutionary point of view, low probability events add little to agents' fitness, and thus are evolutionarily unimportant. Since few studies examine the median as a decision rule under uncertainty, further investigation is needed to explore and better understand its implications.

Derivatives

As discussed in Al-Suwailem (2006), trading derivatives, such as futures and options, results in losses more than 70% of the time. Since likelihood of failure exceeds that of success, such instruments are considered as factors of loss, not of gain, which violates condition [3] above. Further, using the median rule in [6], the decision to trade derivatives becomes inadmissible. Only in expected terms might they appear profitable. But the expected utility rule is questionable, both from an Islamic perspective as well as real business decision-making, as explained earlier.

From the above discussion, none of the requirements of tolerable risks are satisfied by derivatives. This raises deep questions about Islamic legitimacy of these instruments.

The fact that derivatives by design are zero-sum games is another dimension of the subject that will be treated in the following section.

II. Theory of *Gharar*

The word *gharar* in Arabic language means risk. It also has the meaning of deception and delusion (al-Dharir [12]). The two meanings coincide most clearly in prospects with low probability but large magnitude, as in lotteries and all forms of gambling. The size of the payoff entices the agent to engage into an almost losing game. This is the essence of gambling that conventional choice rules fail to exclude, as discussed earlier.

While the previous section focused on individual decision-making, this section focuses on bilateral or interactive decisions. In such interactions *gharar* takes a definitive structure. It becomes equivalent to a zero-sum game with uncertain payoffs (al-Suwailem, 1999). This structure is consistent with Shari'ah measures of *gharar*. The measure can be used as a basis for evaluating as well as developing risk management instruments consistent with Shari'ah, as will be discussed below.

Types of Games

The term "game" is used for a variety of settings and arrangements. Here it is used to denote a for-profit exchange among two or more agents, whereby agents' payoffs are uncertain at the beginning of the game.

Games can be classified according to the sum of players' payoffs into three categories: positive-sum, zero-sum, or mixed-sum games.

1. Positive-sum games are games in which players have common interests, and thus they gain together or lose together (see Figure 7).

Since agents are assumed to be rational, the losing outcome will not be their objective of the game. The positive outcome therefore is the objective of the game, and for this reason it is described as a positive-sum game.

In Figure 7, (A , B) denotes players of the game. The right branch denotes the positive payoffs for each (the first is the payoff of A while the second is that for B). The left branch denotes negative payoffs. At the start of the game, it is not known which branch they will arrive at. However, each player is assumed to seek the positive outcome rather than the negative one, and thus the objective of the game becomes mutual gain. If agents follow the median rule discussed earlier, then the positive outcome will be more likely to materialize. This makes the game Pareto-optimal, since both players are likely to be better off playing the game compared to not playing it.

An example of a positive-sum game is partnership or Since each partner contributes capital and labor, both would gain if the project succeeds, and both would lose if it fails.

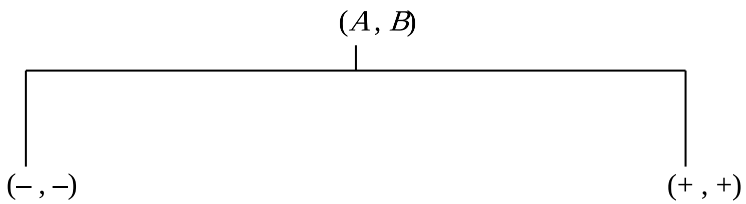

Figure 1: Positive-sum Games

Note that the size of the payoffs need not be equal for the two parties. But the sign must be identical; that is, they gain together and lose together, although the contribution of each might not be equal.

2. Zero-sum games are games in which one party gains and the other loses (Figure 8). Gambling is the most obvious example: Two players put, say, 1000 each, and a coin is thrown. If it comes head, A wins 2000, otherwise B wins.

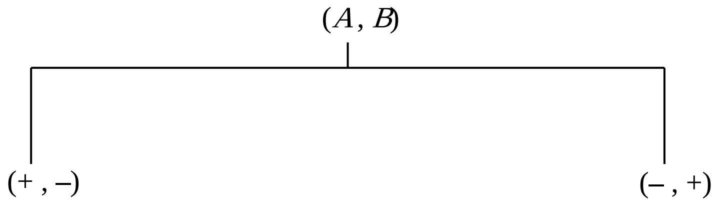

Figure 2: Zero-sum Games

Obviously, there is no possibility that the two could both win. One player wins only at the expense of the other. Again, the magnitudes of gain and loss need not be equal. The term “zero-sum” indicates that the interests of players are in direct opposition. As textbooks on game theory show, such games can always be reformulated so that the payoffs add to zero (Friedman, 1990, pp. 79-80; Binmore, 1994, pp. 276-277). We shall use the term “zero-sum game” to indicate games of direct opposition, regardless of the size of payoffs. Zero-sum games are Pareto-inferior, since they do not allow mutual gain of players. Agents are better off not playing the game (al-Suwailem, 1999).

3. Mixed games are games that include both sorts of outcomes: the zero-sum outcome as well as the positive-sum outcome (Figure 9).

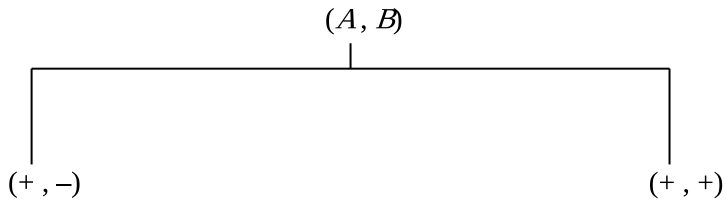

Figure 3: Mixed Games

These games allow for mutual gain, but also imply the possibility of conflict of interest. Examples of mixed-games include sharecropping or and (see al-Suwailem, 1999). In fact, most economic activities are mixed or non-zero-sum games, as Schelling (1980) points out. Life therefore is not a gamble, as many writers claim. It is a mixed game that could end up in conflict or in cooperation. Wright (2000) argues that evolution, both social and biological, progresses towards non-zero-sum interactions. We shall see later how the structure of mixed games can be useful in developing Islamic hedge instruments.

Measure of Gharar

In a zero-sum game, one party gains at the expense of the other. It is a pure transfer of wealth for no counter-value. Since each party is seeking profits not donations, it becomes therefore a sort of "eating wealth for nothing," strictly condemned in the Qur'ān. Further, a zero-sum game is a game with direct conflict of interests, which represents the source of enmity that accounts for the prohibition of *maysir* or gambling in the Qur'ān: "Satan only wants to plant enmity and hatred among you through wine and *maysir*" (6:91).

On the other hand, gambling represents the purist form of *gharar* (al-Dharir [12], p. 622). Since gambling is obviously a zero-sum game, it follows that *gharar* must be unacceptable to the extent that it possesses the zero-sum structure. Accordingly, the circle of *gharar* is wider than that of gambling. For this reason, some transactions might contain *gharar* (i.e. a zero-sum outcome) but they are still acceptable if it the zero-sum component is dominated by the positive component, as in sharecropping and

From Sharīah point of view, generally speaking, the acceptability of such mixed games depends on the likelihood of the cooperative, positive-sum, outcome. If this outcome is dominant, the game generally is acceptable. In this case, the zero-sum outcome is considered as "minor *gharar*." If the zero-sum outcome is dominant, it becomes "excessive *gharar*" and thus not acceptable.

Technical formulation of this measure, as well as detailed discussion of several examples and applications, is provided in al-Suwailem (1999).

Characteristics of Zero-sum Games

Although it might appear fuzzy, the zero-sum property, in its basic form, is quite clear: Whatever one party gains is what the other loses. The following points help clarify how this structure applies to different forms of transactions.

1. First, note that in any zero-sum game, uncertainty at the time of contract is an essential condition. If it were known upfront, the game would not have been played. For example, if it were known on which side the coin will land, there is no point of betting. This is not the case in games with mutual gain. In a normal sale, where relevant variables are

known upfront, the sale takes place with full information. Even if all future information were known at the beginning, the sale will still be performed if it satisfies the needs of the two parties.

2. It should be noted also that gains and losses in a zero-sum game are determined bilaterally, i.e. between the two parties of the contract. That is, an actual net transfer of wealth takes place at maturity from one party to the other, with no counter-value in exchange. If one buys a good on spot basis, and its price subsequently falls, this loss is not a direct gain to the first seller, except as foregone losses. But contractually, no counter party has these losses credited to his account as gains, and thus no net transfer of wealth takes place. Although trading of shares or commodities might at times appear as a zero-sum game, it is only at the system level. Individually, however, spot trading, with predetermined prices and parameters, cannot be a zero-sum game since the relationship between the two parties ends the moment the trade is concluded. Only in presence of uncertainty during the contract that a zero-sum exchange might, but not necessarily, arise.

3. Derivatives are clear examples of zero-sum games. They are obligations to exchange certain amounts of money in a future date. The difference between prices at the time of contract and at maturity is debited from one party and credited to the other, and that is why they are called contracts for differences. With mark-to-market system, this is done on daily basis. Even if the derivative is traded in a secondary market, the obligation as such survives throughout the life of the contract, and whoever becomes party to it has to settle these differences.

4. Financial markets as a whole might appear at times as zero-sum systems. Pyramid schemes are also zero-sum systems. But this applies to the system as a whole, not to individual contracts as such. Zero-sum systems arise because of misuse of normal, non-zero-sum contracts. However, with zero-sum contracts, the system by design will have a zero-sum structure. That is, systems of zero-sum contracts are zero-sum overall, but systems of non-zero-sum contracts may or may not be zero-sum overall.

For this reason the Prophet, peace be upon him, has put further conditions on normal sale, e.g. not to sell before possession or to sell what one doesn’t have. These conditions help make the system overall positive-sum and prevent what Shiller (2000) calls "naturally occurring Ponzi processes" (pp. 64-67). During speculative bubbles, the market as a whole behaves as a Ponzi scheme: early investors get returns from newcomers, and newcomers profit from those joining afterwards, and so on, but latecomers eventually bear the cost when the market crashes. While financial markets in principle are useful and provide important economic functions, they need to be regulated in order to minimize such Ponzi processes from taking over. For example, James Tobin (1978) and Lawrence and Victoria Summers (1989) propose a transaction tax to reduce frequent trading and thus to curb speculation. Allais (1993) calls for abandoning continuous quotation of prices, and having a single quotation per day. He also insists that margins on forwards should be considerably increased to avoid harmful speculation (p. 36). Recall that in Islamic forwards, i.e. salam, the full price must be paid in advance, which points to the economic rationale for this condition. Detailed discussion of financial markets reform is beyond the scope of this paper, but the point should be clear: non-zero-sum contracts might lead to Ponzi, zero-sum systems if not properly regulated.

The above discussion hopefully clarifies the difference between zero-sum contracts and zero-sum systems. The former implies the latter, but the opposite is not necessarily true.

Expected vs. Actual Measures

The zero-sum measure is based on actual, realized outcomes of the transaction. Derivatives and all forms of gambling are zero-sum games in this respect. In expected terms, however, they might be considered as mutual gain deals. In other words, they might be win-win games ex ante, but win-lose ex post. The two measures are clearly incompatible, and thus a choice must be made between the two.

Economic success obviously is based on, and measured in terms of, actual and realized performance. In expected terms, LTCM might have been a profitable investment. In early 1998, the fund's value-at-risk (VAR), which measures the maximum daily loss in any single day with 95% confidence, was less than 1% of its capital. The probability that the fund would lose all its capital within a year was . That is, it would take several multiples of the lifetime of the universe for this event to occur

(Lowenstein, 2000, p. 159; Partnoy, 2003, p. 257). Few months later, the fund collapsed when losses wiped out most of its capital. In other words, failure also is measured in ex post terms. Bankruptcy is decided according to actual, not expected, results. Similarly, profits and losses of derivatives are calculated daily through marking to market, not based on the overall, expected, value of the contract. Consequently, whenever expected and actual measures are in conflict, the latter obviously will have the precedence.

This is supported by the nature of uncertainty. Uncertainty reflects our ignorance of the reality. It therefore exists only in human minds. In reality, things either exist or do not exist. Nothing in the outside universe is random or undetermined. “God does not play dice,” as Albert Einstein famously affirmed (Pais, 1982). The Qur’an clearly states: “Verily all things We created in (precise) amount” (54:49), “And every single thing is before Him in (due) proportion” (13:8). Uncertainty and risk therefore cannot exist outside human mind.

Accordingly, risk per se is not in fact traded, as it cannot exist in reality. What is actually traded is money for money. Kenneth Arrow (1971) points to this fact with respect to commercial insurance. He describes it as an “exchange of money for money, not money for something which directly meets needs.” (p. 134.) Since this exchange is contingent on a certain event, the contract ends up in payment in one direction only. If the event occurs the insurer pays to the insured more than the latter has paid, and thus the net-payment becomes money for nothing. The opposite is true if the event does not occur. In either state one party pays something for nothing. Only in expected terms that there is a mutual exchange. Ex post, however, no mutual exchange takes place, and it becomes a sort of eating wealth for nothing.

This clearly reflects the discrepancy between actual and expected measures in case of zero-sum games. This discrepancy is closely related to that between the mean and the median discussed earlier. The discrepancy arises in case of “outliers,” i.e. outcomes with low likelihood but large magnitude. It is such cases where gambling arises, and the need for careful discrimination of types of risk is called for. The zero-sum measure provides an important landmark in achieving this objective.

Risk and Zero-sum Structure

There are several reasons why a zero-sum market is more risky than a normal market:

1. Earlier we argued that a zero-sum market does not create additional wealth to balance the additional risks created through interaction of agents. This is particularly true when the market is highly leveraged, as it is the case with respect to derivatives.

2. A zero-sum structure by design is relative: The payoff of one agent is the negative of the other. Relative payoff makes agents' behavior highly sensitive to each other. Consequently, a feedback loop is created as changes in an agent's behavior feeds back to itself through the behavior of others. The positive feedback loop and recursiveness of the system makes it increasingly nonlinear and thus prone to chaotic episodes, as several writers have pointed out (Sornette, 2003; Tumpel-Gugerell, 2003; Mandelbrot and Hudson, 2004; Bennett, 2004).

3. A derivative by design is derived from an underlying asset or variable. Movements in this variable would register profits for one party and equal losses to the other. In a zero-sum market, where all transactions are zero-sum games, any change in relevant economic variables will necessarily create losses to some parties. The market has no room for mutual gain and common reward. Since risk is defined in terms of exposure to loss, a zero-sum market almost by definition becomes more risky than a normal one.

For example, in a futures market of a certain commodity, any change in the price of the commodity registers profits to one party and equal losses to the other. In a salam contract, in contrast, the price is paid in full in advance. The advanced payment provides the seller the possibility to utilize it in a manner that could compensate for moderate price increases of the commodity. On the other hand, since delivery is destined to a future date, the paid price is lower than the spot price. This discount provides a cushion for the buyer against moderate price declines. Therefore, the advanced payment provides a "safety margin" for both parties against moderate price fluctuations. This is in contrast to leveraged futures, where any price fluctuations presents a gain to one party and a loss to the other (al-Suwailem, 1999, pp. 84-85).

As another example, consider companies that provide their employees options to buy shares of the company at a predetermined price. Rise in the share's price above that given to employees is a gain to the employee and a cost to the company. However, this cost is utilized as an incentive to employees, so the final result of the contract is a win-win outcome (notwithstanding possible misuses of stock options). That is, wealth created through employee's effort compensates for the loss arising from the increase in the share's price. In contrast, in a call option, any changes in the price of the underlying will register gains to one party and losses to the other.

Derivatives deliberately sever wealth-creating activities from risk management, making them by construction zero-sum games. A derivative contract does not require the creation of wealth that balance the losses involved. The argument that risk trading promotes value-creating activities, if true, reinforces the Islamic position, since integrating the two will not be harmful. The integration would produce effectively the same result, but provides better incentives to do so.

4. In a zero-sum market all players are in direct conflict. This results in players taking advantage of each other when economic variables move unfavorably to some. Thus the likelihood of failure of inflicted players will rise beyond that determined by exogenous economic forces. This apparently what happened to LTCM, when investors became aware of the losses the fund suffered after the crisis of Russian bonds and other emerging markets in 1998. Traders started betting against LTCM, causing further losses to the fund. In the words of Partnoy (2003, p. 260): "Other traders smelled blood at LTCM, and began betting against the hedge fund, trying to weaken its positions." LTCM was acting as "bank of volatility," and thus suffered "a classic run." According to Lowenstein (2000): "It made no difference whether banks were consciously trying to profit at Long-Term's expense or merely protecting themselves … Either motivation would have produced the same behavior" (p. 174, emphasis original). The fact that investors while protecting themselves necessarily attacked LTCM is a characteristic feature of zero-sum games. Since interests were in direct opposition, the benefit of one party necessarily implies the harm of the other.

Together with moral hazard, this shows that incentives react to the payoff structure in a manner that might distort behavior and thus create additional layers of risk to the system.

Since the zero-sum structure creates unnecessary risks, it becomes consistent with a widely held view that gambling is characterized by involving artificial risks (e.g. Borna and Lowery, 1987; Raines and Leathers, 1994). The zero-sum structure therefore is a sufficient condition to consider a certain transaction as gambling regardless of the tools used to implement it.

Two Measures of Gharar

In the last section we argued that taking risk would be acceptable, in a real transaction, if success was more likely than failure. A deal that is more likely to fail is more of a gamble than an investment. It is therefore a form of *gharar*. Here we argued that *gharar* is a predominantly zero-sum game. That is, we have two measures of *gharar*:

1. The likelihood measure.
2. The zero-sum measure.

The first is related to individual decisions, while the second is related to interactive decisions. But how these two measures are related to each other?

First, note that in a zero-sum game, there is no way that both players could win with probability greater than 0.5. Suppose that one player is likely to win with probability 70%. Since it is a zero-sum game, then if one party wins the other must lose. This means that the other player must lose with probability 70%. That is, a zero-sum game does not allow success to be more likely for both players. Thus the zero-sum measure implies the likelihood measure.

Next, the likelihood measure in principle is more general the zero-sum measure. To see this, consider an investment decision that has negligible chances to payoff. For example, a speculator decides to build a shopping mall in uninhabited area. Although the contract with the construction agent is a legitimate transaction, in terms of its final objectives it is a gamble on the side of the speculator. Thus, a legitimate, real transaction could be used for illegitimate purposes. This shows that the likelihood measure is broader than the zero-sum measure.

However, in a competitive economy, such highly risky decisions would eventually be transformed into zero-sum games. If an investor is willing to spend money for a highly risky project, then another agent would step in and offer to take less money in exchange for a higher return but with low likelihood. Ex ante, both parties are better off, and thus highly risky projects cannot continue for a long time. Accordingly, the likelihood measure, while pertain to individual decision-making, naturally leads to the zero-sum measure.

The two types of gharar might help clarify two widely used, but still ambiguous, terms: speculation and gambling. We might describe the first type of gharar as “speculation,” and the second type as “gambling.” Speculation thus is to use a legitimate contract for highly risky purposes. It describes a mixed game where the zero-sum outcome is more likely to obtain. Gambling, on the other hand, implies a stronger connotation, as both parties are involved in direct conflict or a strictly zero-sum game. From the above discussion, speculation eventually transforms into gambling. Further, speculation, in this context, transforms a market of non-zero-sum contracts to a zero-sum system, like Ponzi or pyramid schemes.

Value of Risk Management

As point out earlier, hedging is valuable and consistent with Islamic economic objectives. However, conventional instruments, mainly derivatives, cannot separate hedging from speculation. They are used indistinguishably for both purposes, but mostly, 97%, for speculation. How can we realize the value of hedging and risk management without incurring the increasing costs of speculation?

From an Islamic perspective, the answer may not be very difficult. Islamic rules of exchange, being revealed from Allah (s.w.t) and thus entail His perfect wisdom and knowledge, provide the right framework for achieving this challenging objective. The general principle, which is a matter of consensus, is that risk cannot be severed and separated from real transactions. This will make risk transfer a zero-sum game and thus a form of eating wealth for nothing, which is strictly and explicitly prohibited by the Qur’an (e.g. 2:188, 3:29).

To achieve desirable risk transfer, therefore, we have to utilize structures that allow for mutual gain, i.e. nonzero-sum games. Such games, while imply the possibility of a zero-sum outcome, permit a positive-sum outcome, and thus provide a room for mutual benefits. This is the general strategy for developing risk management tools that are consistent with Islamic principles.

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A PRODUCT THAT CAN SAVE A SYSTEM
Public Capitalization Notes

October 2011

Armen Papazian
Chairman and CEO
Keipr

We can't solve problems by using the same kind of thinking we used when we created them.

Albert Einstein

A PRODUCT THAT CAN SAVE A SYSTEM: Public Capitalization Notes

Armen Papazian*

***Abstract*.** The world's major money printers are in trouble. The debt-based monetary architecture is going through serious stress. The recent banking and sovereign debt crises are systemic symptoms indicating an upcoming and unavoidable change in money creation methodology. This paper addresses the key structural challenges of the crisis and proposes a solution in the form of a new product/channel designed for money creation that does not require a commensurate debt or credit increase in the system. Public Capitalization Notes (PCNs) are profit sharing investment instruments issued or guaranteed by the government treasury and purchased with fresh money by the central bank. PCNs are equity-like instruments with space value for money. PCNs, while channelling funding to where it is most needed, they facilitate job creation, employment, income, deposits, and real activity. Public Capitalization Notes allow the existing system: 1) to survive through a bypass of its own mechanisms, and 2) to balance the inadequacies of a purely debt-based model. After all, the State is the creator of money and a 'sovereign debt crisis' reveals a system chasing its own tale.

Key Words: Money Creation, Public Debt, Credit, Public Capitalization Notes, Space Value of Money.

Introduction

The 2008 and 2011 financial crises are the two acts of the same play. Both crises have put the current monetary architecture face to face with a systemic bottleneck. The source of this bottleneck is an architectural issue. Indeed, the world's major money printers are in trouble.

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After just a year or so from inventing trillions of dollars with their magic wands, Europe, the United States, and the United Kingdom cannot get their wands working again. Captive to a science of economics and its limitations, captive to a model of money creation that is grounded and founded on debt, captive to the banking industry's agenda and actions, the existing monetary architecture is facing a serious structural problem.

This paper proposes a solution to the crisis and the systemic blockages based on the creation and issuance of a new product designed for money creation, i.e., public capitalization notes.

The Debt Crises and Money Mechanics

Overextended and mismanaged credit and debt were an integral element of the 2008 banking crisis and the 2011 sovereign crisis. Along with debt, a plethora of regulatory and oversight issues and high level policy decisions, or their lack, played a major role in the unfolding events. From multibillion dollar Ponzi schemes to multibillion dollar losses, the 2008 crisis led governments to intervene quickly. Bailouts were orchestrated and quantitative easing was implemented to support the banks and the system further.

The 2008 crisis led to a significant jump in sovereign debt levels across the OECD landscape (Tables 1 and 2). From 2008 to 2010 the increases in deficits and aggregate debt have been phenomenal. Deficit as a percentage of GDP jumped from -4.8% to -10.8% in the UK in 2009. In Greece, it jumped from -9.8% to -15.6%. In France, the rate more than doubled from -3.3% to -7.5%. The minus sign here denotes a deficit. In terms of aggregate debt levels out of Nominal GDP, the rates speak clearly of a drastic increase. In France, public debt levels out of GDP jumped from 77.8% in 2008 to 94.1% in 2010, in the UK from 57% to 82.4%, and in the US, from 71% to 93.6%.

These increases were driven by the crisis, but increases in debt levels are a chronic feature of the current monetary architecture, and governments have been building up debt levels over the last many decades. Indeed debt is the driving mechanism of money creation and growth in our current model.

Table-1:

General government financial balances

Surplus (+) or deficit (-) as a per cent of nominal GDP

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Ireland	4.8	1.0	-0.3	0.4	1.4	1.6	2.9	0.1	-7.3	-14.3	-32.4	-10.1	-8.2
United States	1.5	-0.6	-4.0	-5.0	-4.4	-3.3	-2.2	-2.9	-6.3	-11.3	-10.6	-10.1	-9.1
Greece	-3.7	-4.4	-4.8	-5.7	-7.4	-5.3	-6.0	-6.7	-9.8	-15.6	-10.4	-7.5	-6.5
United Kingdom	3.7	0.6	-2.0	-3.7	-3.6	-3.3	-2.7	-2.8	-4.8	-10.8	-10.3	-8.7	-7.1
Spain	-1.0	-0.7	-0.5	-0.2	-0.4	1.0	2.0	1.9	-4.2	-11.1	-9.2	-6.3	-4.4
Portugal	-2.9	-4.3	-2.9	-3.1	-3.4	-5.9	-4.1	-3.2	-3.6	-10.1	-9.2	-5.9	-4.5
Japan	-7.6	-6.3	-8.0	-7.9	-6.2	-6.7	-1.6	-2.4	-2.2	-8.7	-8.1	-8.9	-8.2
Iceland	1.7	-0.7	-2.6	-2.8	0.0	4.9	6.3	5.4	-13.5	-10.0	-7.8	-2.7	-1.4
France	-1.5	-1.6	-3.2	-4.1	-3.6	-3.0	-2.3	-2.7	-3.3	-7.5	-7.0	-5.6	-4.6
Australia	0.4	-0.5	0.7	1.3	1.0	1.2	1.3	1.4	-0.2	-4.9	-5.9	-2.8	-1.4
Slovenia	-3.7	-4.0	-2.5	-2.7	-2.3	-1.5	-1.4	-0.1	-1.8	-6.0	-5.6	-5.6	-4.1
Canada	2.9	0.7	-0.1	-0.1	0.9	1.5	1.6	1.4	0.0	-5.5	-5.5	-4.9	-3.5
Netherlands	2.0	-0.3	-2.1	-3.2	-1.8	-0.3	0.5	0.2	0.5	-5.5	-5.3	-3.7	-2.1
Austria	-1.9	-0.2	-0.9	-1.7	-4.6	-1.8	-1.7	-1.0	-1.0	-4.2	-4.6	-3.7	-3.2
Turkey	..	..	..	..	..	..	0.8	-1.2	-2.2	-6.7	-4.6	-3.3	-3.0
New Zealand	1.8	1.5	3.6	3.8	4.1	4.7	5.3	4.5	0.4	-2.6	-4.6	-8.5	-5.8
Italy	-0.9	-3.1	-3.0	-3.5	-3.6	-4.4	-3.3	-1.5	-2.7	-5.3	-4.5	-3.9	-2.6
Belgium	-0.1	0.4	-0.2	-0.2	-0.4	-2.8	0.1	-0.4	-1.3	-6.0	-4.2	-3.6	-2.8
Germany	1.3	-2.8	-3.6	-4.0	-3.8	-3.3	-1.6	0.3	0.1	-3.0	-3.3	-2.1	-1.2
Denmark	2.2	1.2	0.3	-0.1	1.9	5.0	5.0	4.8	3.3	-2.8	-2.9	-3.8	-3.0
Finland	6.8	5.0	4.0	2.3	2.1	2.5	3.9	5.2	4.2	-2.9	-2.8	-1.4	-0.6
Luxembourg	6.0	6.1	2.1	0.5	-1.1	0.0	1.4	3.7	3.0	-0.9	-1.7	-0.9	0.0
Sweden	3.6	1.6	-1.5	-1.3	0.4	1.9	2.2	3.6	2.2	-0.9	-0.3	0.3	1.4
Korea	5.4	4.3	5.1	0.5	2.7	3.4	3.9	4.7	3.0	-1.1	0.0	0.5	1.3
Switzerland	0.1	-0.1	-1.2	-1.7	-1.8	-0.7	0.8	1.7	2.3	1.2	0.5	0.6	0.9
Norway	15.4	13.3	9.2	7.3	11.1	15.1	18.4	17.5	19.1	10.5	10.5	12.5	11.9

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Table-2:

General government gross financial liabilities

Per cent of nominal GDP

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Japan[3]	135.4	143.7	152.3	158.0	165.5	175.3	172.1	167.0	174.1	194.1	199.7	212.7	218.7
Greece	115.3	118.1	117.6	112.3	114.8	121.2	115.6	112.9	116.1	131.6	147.3	157.1	159.3
Italy	121.6	120.8	119.4	116.8	117.3	120.0	117.4	112.8	115.2	127.8	126.8	129.0	128.4
Iceland	72.9	75.0	72.0	71.0	64.5	52.6	57.4	53.3	102.0	120.0	120.2	121.0	120.2
Portugal	60.2	61.7	65.0	66.8	69.3	72.8	77.6	75.4	80.6	93.1	103.1	110.8	115.8
Ireland	39.4	36.9	35.2	34.1	32.8	32.6	28.8	28.8	49.6	71.6	102.4	120.4	125.6
Belgium[1]	113.7	112.0	108.4	103.5	98.5	95.9	91.7	88.1	93.3	100.5	100.7	100.7	100.4
France	65.6	64.3	67.3	71.4	73.9	75.7	70.9	72.3	77.8	89.2	94.1	97.3	100.0
United States	54.5	54.4	56.8	60.2	61.2	61.4	60.8	62.0	71.0	84.3	93.6	101.1	107.0
Germany[2]	60.4	59.8	62.2	65.4	68.8	71.2	69.3	65.3	69.3	76.4	87.0	87.3	86.9
Canada	82.1	82.7	80.6	76.6	72.6	71.6	70.3	66.5	71.3	83.4	84.2	85.9	88.0
United Kingdom	45.1	40.4	40.8	41.5	43.8	46.4	46.1	47.2	57.0	72.4	82.4	88.5	93.3
Austria	71.1	72.1	73.0	71.2	70.8	70.9	66.6	63.1	67.3	72.6	78.6	80.0	81.6
Netherlands	63.9	59.4	60.3	61.4	61.9	60.7	54.5	51.5	64.5	67.6	71.4	74.3	75.2
Spain	66.5	61.9	60.3	55.3	53.4	50.4	45.9	42.1	47.4	62.3	66.1	73.6	74.8
Poland	45.4	43.7	55.0	55.3	54.8	54.7	55.2	51.7	54.5	58.4	62.4	65.6	66.3
Finland	52.5	50.0	49.6	51.5	51.5	48.4	45.5	41.4	40.6	52.1	57.4	62.7	66.1
Denmark	60.4	58.4	58.2	56.6	54.0	45.9	41.2	34.3	42.6	52.4	55.5	57.1	60.0
Norway	32.7	31.6	38.8	48.2	51.0	47.9	59.4	57.4	54.9	48.0	49.5	56.1	51.2
Sweden	64.3	62.7	60.2	59.3	60.0	60.8	53.9	49.3	49.6	52.0	49.1	45.4	41.1
Slovenia	..	33.7	34.8	34.2	35.0	33.9	33.8	30.0	29.7	44.2	47.5	52.9	56.5
Switzerland	52.4	51.2	57.2	57.0	57.9	56.4	50.2	46.8	43.7	41.5	40.2	38.7	37.0
New Zealand	36.9	34.9	33.0	30.9	28.2	26.9	26.6	25.7	28.9	34.5	38.7	45.8	52.0
Korea[4]	..	..	19.2	19.3	22.6	24.6	27.7	27.9	29.6	32.5	33.9	33.3	33.4
Australia	24.6	21.8	19.8	18.3	16.5	16.1	15.3	14.2	13.6	19.4	25.3	29.3	30.9
Luxembourg	9.2	8.2	8.4	7.9	8.6	7.6	12.1	11.7	16.4	14.7	19.7	20.5	23.9

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Money is backed by government debt (Table-3). The Central Banks print the banknotes and balance the entry in their liabilities with assets that are mainly government bonds. Money is created by debt and then grows through credit. Credit, through the fractional banking system, creates new money. This is achieved by creating new deposits based on debt agreements and contracts that banks sign with their clients. Thus, at the creation level and at the expansion level, money is driven by debt and credit. Growth implies being bigger or larger or more active than previously. From a monetary perspective, in our current model, growth in money supply implies growth in debt or credit somewhere in the system (Figures 1 and 2).

Table-3: Selected components of the Federal Reserve balance sheet, 2009-2011

Balance sheet item	Dec. 30, 2009	July 7, 2010	Feb. 23, 2011
Total assets	**2,237,258**	**2,335,457**	**2,537,175**
Selected assets			
Credit extended to depository institutions and dealers			
Primary credit	19,111	17	24
Term auction credit	75,918	0	0
Primary Dealer Credit Facility and other broker-dealer credit	0	—	—
Central bank liquidity swaps	10,272	1,245	70
Credit extended to other market participants			
Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility	0	—	—
Net portfolio holdings of Commercial Paper Funding Facility LLC	14,072	1	—
Term Asset-Backed Securities Loan Facility	47,532	42,278	20,997
Support of critical institutions			
Net portfolio holdings of Maiden Lane LLC, Maiden Lane II LLC, and Maiden Lane III LLC[1]	65,024	66,996	64,902
Credit extended to American International Group, Inc.	22,033	24,560	—
Preferred interests in AIA Aurora LLC and ALICO Holdings LLC	25,000	25,733	—
Securities held outright			
U.S. Treasury securities	776,587	776,997	1,213,425
Agency debt securities	159,879	164,762	144,119
Agency mortgage-backed securities (MBS)[2]	908,257	1,118,290	958,201
Memo			
Term Securities Lending Facility[3]	0	—	—
Total liabilities	**2,185,139**	**2,278,523**	**2,484,141**
Selected liabilities			
Federal Reserve notes in circulation	889,678	907,698	956,012
Reverse repurchase agreements	70,450	62,904	59,484
Deposits held by depository institutions	1,025,271	1,061,239	1,297,905
Of which: Term deposits	—	2,122	5,070
U.S. Treasury, general account	149,819	16,475	23,123
U.S. Treasury, Supplementary Financing Account	5,001	199,963	124,976
Total capital	**52,119**	**56,934**	**53,035**

Source: Federal Reserve

The nature of the paperwork and or electronic communication that happens between the central bank and the government, i.e., the real and accounting exchange of banknotes for government bonds, is the key structural issue that must be addressed. Indeed, as it is discussed and proposed here, this equation must be transformed to allow governments to inject new money without additional debt. This is the systemic bottleneck that we are living today.

Figure-1: Money Creation and Expansion

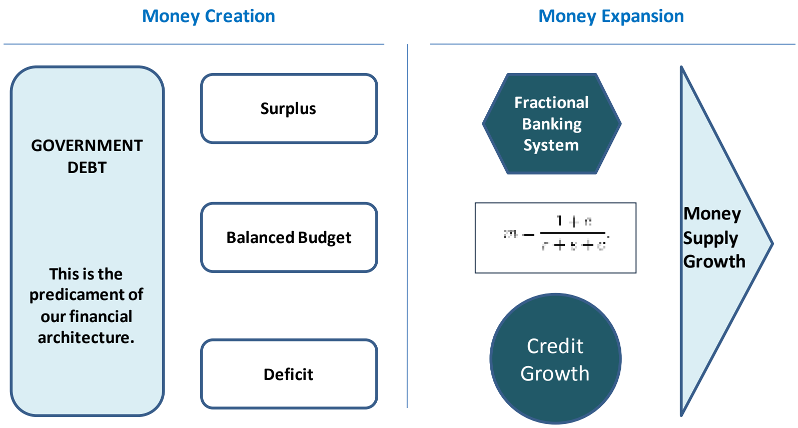
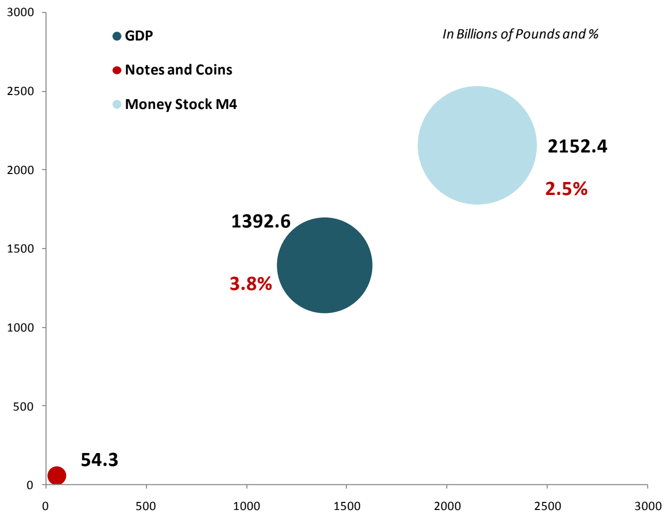


Figure-2: Notes, GDP and Money Stock

Source: Bank of England, 08/2011



When governments change their policy from quantitative easing and bailouts to austerity measures, they reveal a very worrying confusion regarding the source of money. Why was money so easily creatable when the banks were failing not long ago, and why is it so hard now?

The causes are systemic. Having just printed billions of debt and money, governments are now being threatened with market access and higher cost of capital for their bonds. Governments are being required to tighten budgets, reduce deficits, and cut debt in the middle of a fragile economic recovery, if the claw back can be described as a recovery. With high unemployment rates, hardly impressive real GDP figures (Table-4), and a series of social issues, governments are in the process of buying into market pressure.

Table-4:

Real GDP

Percentage change from previous year

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Greece	4.5	4.2	3.4	5.9	4.4	2.3	5.2	4.3	1.0	-2.0	-4.5	-2.9	0.6
Iceland	4.3	3.9	0.1	2.4	7.7	7.5	4.6	6.0	1.4	-6.9	-3.5	2.2	2.9
Ireland	9.7	5.7	6.6	4.4	4.6	6.0	5.3	5.6	-3.6	-7.6	-1.0	0.0	2.3
Spain	5.0	3.6	2.7	3.1	3.3	3.6	4.0	3.6	0.9	-3.7	-0.1	0.9	1.6
Norway	3.3	2.0	1.5	1.0	3.9	2.7	2.3	2.7	0.8	-1.4	0.4	2.5	3.0
Slovenia	4.4	2.8	4.0	2.8	4.3	4.5	5.9	6.9	3.7	-8.1	1.2	1.8	2.6
United Kingdom	3.9	2.5	2.1	2.8	3.0	2.2	2.8	2.7	-0.1	-4.9	1.3	1.4	1.8
Portugal	3.9	2.0	0.7	-0.9	1.6	0.8	1.4	2.4	0.0	-2.5	1.3	-2.1	-1.5
France	4.1	1.8	1.1	1.1	2.3	2.0	2.4	2.3	0.1	-2.7	1.4	2.2	2.1
Netherlands	3.9	1.9	0.1	0.3	2.2	2.0	3.4	3.9	1.9	-3.9	1.8	2.3	1.9
Denmark	3.5	0.7	0.5	0.4	2.3	2.4	3.4	1.6	-1.1	-5.2	2.1	1.9	2.1
Belgium	3.8	0.7	1.4	0.8	3.1	2.0	2.7	2.8	0.8	-2.7	2.1	2.4	2.0
Austria	3.3	0.5	1.6	0.7	2.6	2.8	3.5	3.7	2.2	-3.9	2.1	2.9	2.1
New Zealand	3.7	2.5	4.6	4.4	4.1	3.2	2.0	3.4	-0.7	0.0	2.5	0.8	4.1
Switzerland	3.6	1.2	0.4	-0.2	2.5	2.6	3.6	3.6	1.9	-1.9	2.6	2.7	2.5
Australia	3.4	2.7	3.9	3.6	3.3	3.4	2.5	4.7	2.4	1.4	2.6	2.9	4.5
United States	4.1	1.1	1.8	2.5	3.6	3.1	2.7	1.9	0.0	-2.6	2.9	2.6	3.1
Finland	5.3	2.2	1.7	2.1	4.1	3.0	4.4	5.3	1.0	-8.3	3.1	3.8	2.8
Canada	5.2	1.8	2.9	1.9	3.1	3.0	2.8	2.2	0.5	-2.5	3.1	3.0	2.8
Estonia	10.0	7.5	7.9	7.6	7.2	9.4	10.6	6.9	-5.1	-13.9	3.1	5.9	4.7
Germany	3.5	1.4	0.0	-0.2	0.7	0.9	3.6	2.8	0.7	-4.7	3.5	3.4	2.5
Luxembourg	8.4	2.5	4.1	1.5	4.4	5.4	5.0	6.6	1.4	-3.6	3.5	3.2	3.9
Japan	2.9	0.2	0.3	1.4	2.7	1.9	2.0	2.4	-1.2	-6.3	4.0	-0.9	2.2
Chile	4.6	3.4	2.1	3.7	5.9	5.6	4.9	4.9	3.2	-1.5	5.1	6.5	5.1
Sweden	4.6	1.4	2.5	2.5	3.7	3.1	4.6	3.4	-0.8	-5.3	5.3	4.5	3.1
Mexico	6.0	-0.9	0.1	1.4	4.0	3.2	5.2	3.2	1.5	-6.1	5.5	4.4	3.8
Korea	8.8	4.0	7.2	2.8	4.6	4.0	5.2	5.1	2.3	0.3	6.2	4.6	4.5
Turkey	6.8	-5.7	6.2	5.3	9.4	8.4	6.9	4.7	0.7	-4.8	8.9	6.5	5.3

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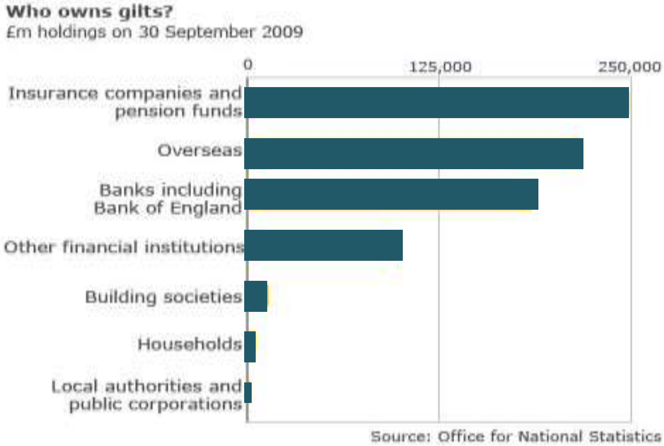
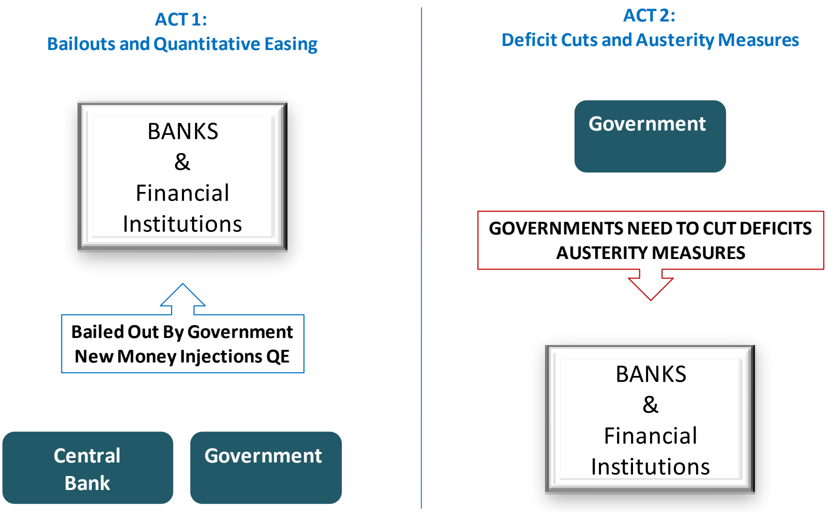
Figure-3: Who owns UK government Gilts



Given that a large chunk of government debt is owned by banks and other financial institutions (Figure-3), the market is trading government bonds and keeping governments hostage to its investment criteria. By choosing to hold a government bond, or not, banks and financial institutions influence the policies of governments when it comes to deficit financing and borrowing costs. Credit Default Swaps and buy-side demand are powerful tools that keep governments on their toes when it comes to capital market access.

Figure-4: Act 1 and 2 of the Crisis: Yielding to Banks



The paradoxical sequencing of bailouts, quantitative easing and austerity measures reveals how governments ended up doing what the banks wanted and needed in both stages of the crisis. In the first act banks were too big to fail and had to be rescued, except Lehman Brothers for some reason, in the second act, they needed to be convinced to hold government debt with tighter budgets and deficit reduction plans, because cutting deficits is the sustainable approach in the current model of debt-based money creation.

As such, deficit reduction is the appropriate target for policy makers in the current model. The issue, however, is the state of the economy and the levels of projected activity. How can we cut debt and deficits when the economy is still struggling out of a recent crisis, unemployment is high, and growth is at risk? The timing of the austerity measures is due to the fact that the 2008 crisis already pushed public debt levels much higher, breaching 100% of nominal GDP for many OECD countries.

A serious problem arises when the economy needs more money to get out of a recession, but government debt levels are already high enough and the market is concerned with sovereign defaults. Central banks can always purchase existing government bonds from the banks, as done through quantitative easing, but the new injection must become credit to have any real impact on economic activity. This has been proven to be helpful to save the banks, but not to stimulate growth in already overleveraged economies.

The results of austerity policies have already been demonstrated in Greece. Budget cuts had a negative impact on aggregate expenditure and income, reinforcing the recession and thus reducing tax revenues and failing the very purpose of the policy. Although tax evasion seems to be a key challenge in Greece, the decline in tax revenues in 2011 is indicative of how fruitless the policy trend is because expenditure declines lead to further decline in income and thus tax revenues, making effective deficit reduction almost impossible.

The upcoming recapitalisation of European Banks and the Greek haircut shift the debt burden, they do not eliminate the issues. Moreover, increasing the size of the European Financial Stability Facility (EFSF) through some form of leverage, pending details and implementation, will eventually ensure there is enough buying power to support banks and governments, but it will be a long way before these policy actions create more jobs. Meanwhile, austerity measures reduce expenditure and income, further increasing the risks of contraction.

Similarly, the recent quantitative easing announced by the Bank of England consists in purchasing covered bonds, which provides fresh capital to the banks and the financial institutions. The issue and key systemic bottleneck remains: for the new injection to have any real economy impact it must be lent out by the banks. In the UK, under current circumstances, in an overleveraged economy with declining trends in business lending, and increasing regulatory requirements, the real activity impact of such an injection will be minimal in the foreseeable future.

This paradoxical situation has its solution in the monetary architecture behind money creation. We need to reform the existing central bank/government debt-based relationship by adding a parallel channel of money creation and injection, through Public Capitalization Notes (PCNs). PCNs will allow the injection of fresh money into the system without adding government debt, and will simultaneously support income, deposits, new investment, and real activity, while creating jobs and opportunities.

The breakthroughs that human science and imagination have achieved in technology and telecommunications have been thanks to a fundamental open attitude towards invention and mastering new ways of doing things better. In Economics, we need to approach the debt-based system with similar openness to identify the structural innovations required to address the current bottleneck.

Money Mechanics and Public Capitalization Notes

When human institutional organization is the ultimate source of money, why is it that the securities used by central banks to back currency issuance are debt instruments? while they could, in principle, be anything we find appropriate. Indeed, it is quite absurd to witness a money inventor inventing a system that enslaves itself to debt. The inventor must invent a system based on a principle of wealth, which happens to serve the inventor's original purpose far better.

The solution we need right now, to be real and effective, must have a positive and immediate impact on employment, investment, income, and deposits, and finally, must not increase the debt exposure of governments.

I believe that the solution rests in designing and issuing a new financial instrument, which I call Public Capitalization Note, and using it for monetization purposes. Public Capitalization Notes are designed as profit sharing instruments attached to real economic projects in different industries, whereby the Central Bank and the Government jointly undertake an investment in the very fabric of society. Using such an instrument for monetization implies that the government treasury issues Public Capitalization Notes (PCNs) and the Central Bank Purchases them directly with fresh money.

The monetary and real impact of such an instrument used for money creation would be very direct and strong on income, expenditure, employment, bank deposits, capital formation, and real productive activity.

Using PCNs for monetization purposes is equivalent to adding a money creation channel that allows the injection of money into the system without any debt. PCNs introduce equity-like monetization. Equity-like refers to the nature of rights and obligations exchanged between the central bank and the government, and not to public or private shares or stocks of any kind. PCNs introduce the logic of investment and ownership as they are profit sharing instruments and are aimed at building and improving the socioeconomic structures of society.

Indeed, equity-like monetization could be a key concept that can help governments deal with high levels of public debt, like in the US, Japan, Europe, the UK and elsewhere in the world. Indeed, the use of Public Capitalization Notes between the treasury and the central bank is equivalent to a symbiotic merger of monetary and fiscal policy. Adding a new channel of money creation and injection to the current debt-based system would allow the states in crisis to inject new money without adding more debt to their exposure.

Equity-like monetization allows human societies to print and manage their monies (which they already do) in a logic of existence and ownership, rather than a logic of survival and debt. Given that we are creating money through an institutional arrangement between governments and central banks, optimizing the nature and basis of money creation would exponentially multiply what we can achieve in terms of prosperity.

Equity-like monetization is a viable solution and is also compatible with the principles of Islamic finance. The nature of authentic Islamic finance lends itself to such a transformation. Indeed, the financial engineering principles behind Public Capitalization Notes are principles commonly used in Islamic Finance, i.e., risk sharing, profit potential, no interest, real assets and real activity.

Moreover, PCNs have no more impact on inflation than standard bonds. Inflation relates to the quantity of money injected, not the method of money injection. Indeed, if there is to be a QE3, for it to have a direct impact, it must be done via Public Capitalization Notes. At this point, it really does not matter if banks have more money or not. QE3 must have a direct impact on aggregate income to ensure the fragile recovery does not end up as another unprecedented recession. QE3 must be spent in the economy to become immediate income.

Interestingly, the Bank of England Issue Department does actually implement a mechanism that allows it to back its banknotes with what it calls a "Deposit with Banking Department" on its asset side of the balance sheet. Indeed, in 2010, the Issue Department and the Banking Department of the Bank of England were inventing more than 50% of the British Pounds in circulation through an internal deposit (Table-5).

Table-5: Bank of England Issue Department Balance Sheet 2010

Assets (£m)		Liabilities (£m)	
Securities of, or guaranteed by, British Government	5,679	Notes issued	50,220
Other Assets, Including those acquired under reverse repurchase agreements	44,541		
Deposit with Banking Department	*26,655*		
Reverse repurchase agreements	*17,886*		
Total Assets	**50,220**	**Total Liabilities**	**50,220**

If money can be backed by a deposit in the other branch of the same bank (BOE), then it sure can be backed by Public Capitalization Notes that have a direct impact on the economy. The struggling advanced economies need a systemic breakthrough in order to transform the current equation once and for all. This is particularly urgent given the paradoxical sequencing of bailouts, quantitative easing, and austerity measures. We cannot possibly think that we are going to achieve more growth with less money.

Instead of backing money with Public Debt, which is untenable without ever increasing debt levels, we could also back it with Public Investments, i.e., wealth.

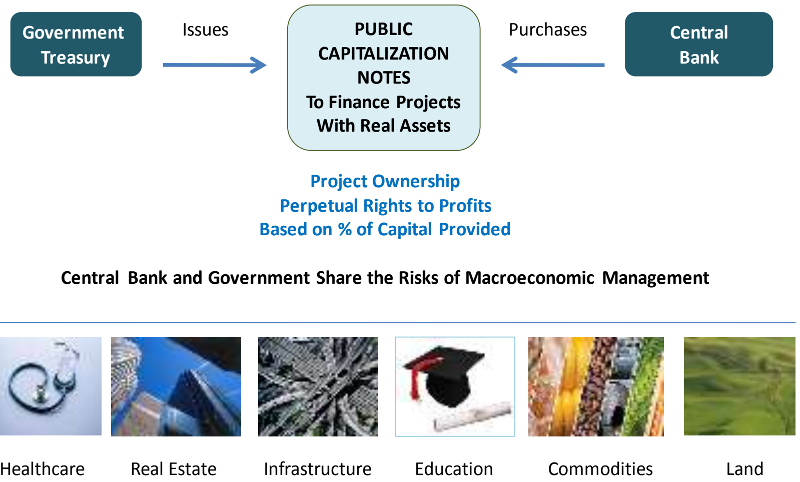
To resolve the crisis effectively and fundamentally, the debt-based monetary architecture must be complemented with a channel of money creation that does not add more debt to the system. and creates income without depending on bank credit.

Public Capitalization Notes: Structure and Impact

If the existing money creation equation were to be transformed to include non-debt injections through Public Capitalization Notes, governments will not be in such a crisis to cut deficits and adopt austerity measures. This is so because they would have the option to inject money via debt or investment. If they cannot afford more debt, then the right choice would be to inject new money via investment instruments such as PCNs.

The name and actual legal structure of the proposed instrument here can be debated and altered as necessary in different jurisdictions and by different governments. Moreover, many changes and additions, variations and complexities can be introduced into such instruments. I do not intend to turn this paper into a financial engineering exercise, and I leave term sheets for a later opportunity. Instead, I describe the key features that such notes must have, and how they could be introduced.

Figure-5: Public Capitalization Notes



Public Capitalization Notes are profit sharing instruments that are issued by the government treasury, or guaranteed by the treasury, and aim at funding a public investment in a specific industry (Figure-5).

A real project hiring real people and real assets and creating new opportunities. Through PCNs, central banks and governments will earn a return when the underlying project earns a return.

All sectors of the economy that need a boost to overcome the debt-lock can be supported with real spending, subject to a project management entity being created to administer and manage the funds and bring the projects to execution.

Public Capitalization Notes (PCNs) will have to be issued by the government treasury, and offered for sale to the country’s Central Bank. In other words, unlike government bonds which are bought and traded by commercial banks and other financial institutions, PCNs will be available for purchase only for the Central Bank. Naturally, they will have to be in domestic currency, the currency printed and managed by the central bank.

PCNs can be used in parallel to government bonds. The key issue is to allow money injection into the system without additional government debt. This does not mean that all existing government bonds have to be replaced with PCNs. Indeed, existing bonds and new ones could still be issued by governments. For countries who have amassed huge amounts of public debt, this could be an appropriate mechanism to stop or slow down debt accumulation.

A PCN execution platform can coexist with the existing government bond market. Indeed, the structural work involved only complements the debt based system, does not replace it (Table-6).

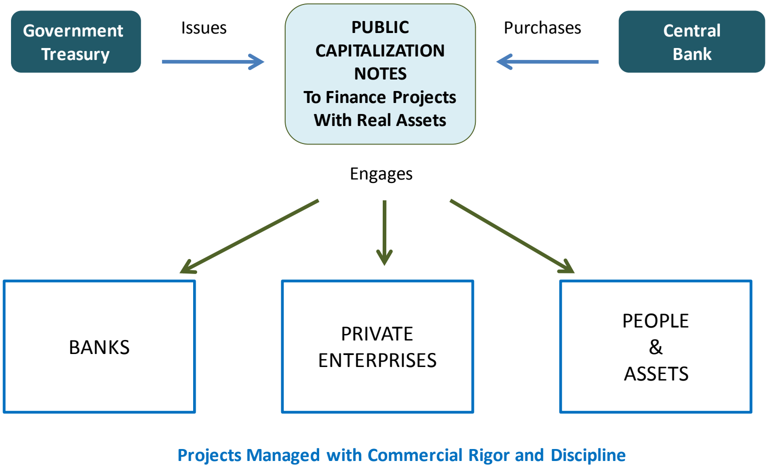
Table-6: Government Bonds and Public Capitalization Notes

PUBLIC CAPITALIZATION NOTES	**Can Coexist**	**GOVERNMENT BONDS**
• PCN Execution Platform • Public Private Partnerships • Regulatory Oversight • Project Planning		• "Risk Free Rate" • Yield Curve • Fixed Income Investment • Reference

PCNs allow direct and immediate impact on real activity without more debt.
Over time PCNs could replace a significant % of Government Bonds.

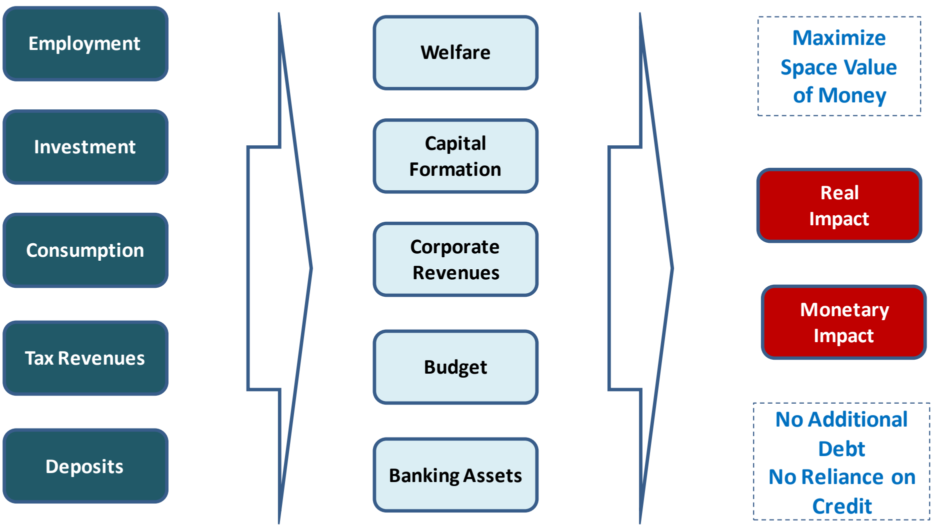
Public Capitalization Notes as described in Figure-6 have a direct impact on private and corporate income because the execution of the project will inject new money into households, businesses, industries and banks. The government agency that is responsible of the project management of PCN generated funds, must subcontract the business to private enterprise while ensuring job creation and employment generation are achieved.

Figure-6: Public Capitalization Notes: Project Execution



Public Capitalization Notes allow the government and the central bank to fund and execute new projects in real industries with fresh new money. By doing so, the new money injection has a direct impact on employment, investment, consumption, tax revenues, and deposits. In turn, they allow improvements in welfare expenditure, capital formation, corporate revenues, budgets, and banking assets (Figure-7).

Figure-7: Impact of PCNs



The impact of PCNs is both monetary and real as the injected money is being introduced as income first. By the fact that PCNs involve direct expenditure, they engage real assets and people early on.

PCNs can be a channel of money injection that ensures an immediate space value to the injected monetary stimulus without adding debt.

Many economists and industry experts might wonder about the inflationary impact of PCNs. It must be stated that such pressures could result if excessive injections are undertaken. However, this is also the case with bonds. Thus, the change in the method of injection should not by itself be an additional concern. It should be noted however that PCNs will have a faster and more direct impact on income and thus consumption and investment. As such, the price impact of a PCN driven money injection could have a much shorter time lag.

When used for monetization purposes PCNs allow and lead to a fundamental reform in modern money mechanics while simultaneously addressing the paradox of 'Public Debt.' Indeed, by stimulating the economy without additional debt, PCNs generate the activity levels and tax revenues required to pay down public debt levels.

When money is created via debt *and* wealth-based instruments, when government and central bank share the ownership of projects aimed at supporting the very fabric of the economy, taxes can be reduced over time to become fairer and more manageable. High taxation is a side effect of the debt-based monetary architecture and can be dealt with through the implementation of PCNs.

Using PCNs as a monetary tool transforms the role of Central Banks without compromising their political independence. Indeed, central banks will be able to have a greater say in how the invented money is spent and where. After all, political independence should not absolve central banks from their socioeconomic responsibilities.

PCNs and Space Value of Money

Across the theory and practice of finance and financial valuation, the two most important principles used to value instruments and investments are *Time Value of Money* and *Risk and Return*. This is a textbook fact, and is also true about theoretical and applied financial valuation models. I have elsewhere proposed the concept of *Space Value of Money* as the missing yardstick. This concept is relevant because it is one of the principles upon which Public Capitalization Notes are structured.

An investment project of whatever nature has space value of money when it has an impact on the physical space and its inhabitants. Such a project or instrument achieves its earnings by using, alongside time and capital, real people and real assets. The real activity involved gives the project or instrument a community impact that would otherwise be absent if the earned return was to be interest on time and capital alone. Space value of money is the aggregate real asset impact of a project or instrument.

Space value of money does not replace the principle of time value of money. It comes to compliment its basic proposition of time value with space value. Indeed, time-space is a more complete representation of our reality than time alone. Moreover, taking into account time and space parameters is bound to make us more relevant to our current moment.

The space value of money impact of a project can be derived via a detailed scrutiny of a number of factors. The real assets used in an investment, the nature of the assets, and the type of engagement used for their utilization are crucial variables that determine the eventual space impact of a project.

Space Value of Money is a crucial valuation principle especially for governments. Individual and private investors may be indifferent to the space impact of their investments as long as the discounted time value and percentage return is appropriate to their assessment of risk, whatever the nature of the risks. Governments, on the other hand, as public servants, have the responsibility to ensure their investments have an impact on people and activity from micro and macro perspectives.

A conventional bond can also finance real projects. In other words, the above discussion does not ignore the fact that bonds could also have a space value indirectly through the projects and types of spending they finance. There is a distinction, however, as bonds may also be used to finance other bonds, and other non-physical investments. An instrument that has space value of money is *embedded* in the real economy by design. Public Capitalization Notes have space value for money because they engage people, businesses, and banks to administer and execute public projects financed directly by the Central Bank.

Interestingly, the principle of banning interest within Islamic finance is based on the idea of having more than just time and capital in the cooking pot, i.e., involve real people and real activity.

Conclusion

Money is the result of an institutional arrangement derived through a specific relationship between the two major arms of the state, i.e., the central bank and the government. Given that the state is the ultimate source of money, and therefore by extrapolation the ultimate source of credit, it is interesting to observe the system chasing its own tale.

To date, the equation through which money is created and injected into an economy is a debt-based equation. I suggest in this paper that indeed, this relationship could be complemented with an equity-like dimension.

Equity-like is defined not in terms of share ownership, but rather in terms of the nature of cash-flows and commitments that are exchanged between the government and the central bank. The new equation would allow central banks to capitalize governments rather than lend to governments. Naturally, this change boils down to a change in the instruments used to back local currency issuance, which are also used to inject new money in an economy.

I propose the basic features of an instrument that could be used for such a purpose: Public Capitalization Notes. PCNs are project -based and profit-sharing instruments that have to be issued by treasuries, and offered for sale to central banks. They could be used in parallel to government bonds. They could be of different maturities, including perpetuity. They would be structured as dividend paying notes where payment is not based on a predetermined fixed interest rate, but a discretionary dividend paid when real projects earn a return. This is very important in order to ensure that the new instruments are not debt or debt-like instruments – thus transforming the underlying equation behind money creation.

Public Capitalization Notes when used to inject new money into the economy open the door to a whole new chapter in value and money creation. States could indeed print what they need to print, but based on a principle of investment rather than debt. We can, should, and deserve to imagine a wealth-based system.

The only true challenge that a transformed and healthier financial architecture faces is our ability and willingness to think and implement a better system.

Data Sources

US Federal Reserve, Bank of England, OECD, UK Office of National Statistics.

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Sukuk, An Economic and Shari'ah Examination

Mohamed A. Elgari

<u>Contents:</u>

Praise be to Allah the Cherisher and Sustainer of the Worlds. Blessings and salutations be to His Prophet Mohammed, his family and all his companions.

1. Introductory remarks

By way of introduction, we have to say a few words about Islamic finance before we delve into the subject of *Sukuk*.

The core of the financial sector, Islamic and otherwise, is the function of intermediation. It happened that individuals, corporate and government can't perfectly match their income with their spending.

Hence, there is always those who have more money than they need now and those who need more money than they have now. Everyone will be happier if resources were pooled, whereby those who have more than they need now can make that surplus available to them who need it now.

Since they invented money, humans realized that by being a store of value money can also facilitate this process of intermediation.

Because money is essentially an “order” on real assets, the existence of an efficient system for savings and investment the real factors of production becomes more efficient. They work more.

Intermediation came a long way from the simple wheat silos of ancient Egyptians to Wall Street’s commercial and investment banking. The basic idea, however, remains the same. It is simply making savings ready for investment in an efficient manner.

None of the above is contrary to Shari'ah (Shari'ah being Islamic Law). In fact we should use more affirmative language by saying it is desirable from Shari'ah point of view.

There are many indications, even in the Quran itself, to this end. The Quranic firm prohibition of hoarding money when money was gold and silver coins (intrinsic value) clearly leads to fostering a more liquid economy, and thus a more productive real sector.

What is objectionable from Shari'ah point of view is the modus operandi in contemporary finance. Within the western approach to financial intermediation the contract of “loan” is the foundation of the process of moving savings to investment.

Individuals lend their savings to banks who in turn lend them to users of funds. They charge interest and pay savers some of that. Alternatively, corporate and governments can cut the middle man and go directly to borrow from savers by issuing papers in the market thus paying less and giving more to savers. But it is simply a contractual arrangement: money for money with interest as a consideration.

This is where the conflict arise. In Islamic setting money (i.e. the medium of exchange) must remain a medium of exchange. It can’t by itself be a profit generating asset. It is only when it is used against a real asset or service that return can be made. There is nothing un Islamic with the contract of loan except for the fact that profit can't be made in the context of borrowing and lending money. Thus it remains a tool for benevolent and charitable purposes. For investment other contractual arrangements are used.

Two things are now apparent. One is economic and other is legalistic.

Number one

From an economic point of view it is clear that a restriction of this nature means that the dichotomy between the real sector and the financial sector will be suppressed in a fully functioning Islamic economy. It is only when you allow what we call in the Shari'ah jargon "money for money" transaction as a profit generating arrangements that such dichotomy becomes robust.

This is not confined to giving \$1000 today to contractually receive \$1050 a year from today. In fact the whole debt and money market machinery are nothing but examples of this money for money enterprise.

It has always been assumed by Islamic economists that a dichotomy between real and monetary sector is a bad thing, and that one of the superiority features of the Islamic system is that both real and monetary sectors are interlinked by the fact that Islamic law of contract does not allow the creation of pure inter-temporal monetary transaction for commercial purposes. When money is exchanged a real "thing" must also changes hands. I don't know of any serious research on this particular point. It remains, therefore, that the ill effect of a dichotomy between the real and monetary sectors are not very obvious, except for the fact that such dichotomy causes trade cycles in capitalist system.

Many experts believe that, at the core of the current financial crises a process they termed the "financialization of the economy"; whereby the financial sector start sucking all the investable funds into a limitless "money for money" bubbles by offering an ever increasing rate of returns which is a mere book entry. Returns that are not supported by real sector productivity. It is claimed that this process, which brought havoc to world economy, started in the U.S. Circa 1970. The roots of this lies down in the financial sector insane expansion while the real sector shrinks because it can't match the rates of return on investment generated to savers from debt trading and derivatives, and thus can’t compete for investable funds(1).

Number Two

From Shari'ah perspective, deciding if a transaction is permissible or otherwise is based on the contractual relationships between the parties involved. Therefore, the legalistic aspect and point of view becomes essential.

Thus the outcome of sale contract involving a commodity against a deferred price with a mark-up for the deferment of the price may not look exceedingly different from an interest based loan from economic point of view. But vis the contractual relationship, i.e. legalistic, they certainly are not the same.

The main challenge in modern Islamic finance is how to design financial products that can deliver the same economic outcome of the conventional (non Islamic) products but only within the Shari'ah permissibility. Because the basic function of financial intermediation is not contrary to Shari'ah (only the means that is questionable) all we need to do is to design contractual arrangements that are Shari'ah approved bearing comparable level of risk and reward compared to the conventional, yet with the rules of contract of Shari'ah. *Sukuk* is a good case in point.

2. *Sukuk*

We are all familiar with bonds (of all types) or what is sometimes called fixed income securities. Those are important papers because they meet the needs of issuers and investors. For investors a paper that compared to the alternative (time deposit, equity…) have its advantages. We will not go over why fixed income securities constitute the bulk of the investment market, suffice it to say that we need something similar to bonds in the Islamic sphere.

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(1) Nothing exemplify this more than the fact that for years GM and Ford Motor companies were generating most of their income from finance not car production to the point that some commentators described GM as a “Bank” making cars.

What is *Sukuk*

"*Sukuk*" is the plural of the Arabic word "SUK" which means in classical Arabic: a certificate evidencing financial obligation. Modern *Sukuk* can be defined as:

Tradable certificates that offer predictable return at relatively lower risk.

There are those who refer to *Sukuk* as Islamic bonds. This is not correct. Bonds are debt instruments creating lender-borrower contractual relationship. They are interest based. They guarantee the payment of a coupon as well as principal at maturity.

Sukuk represent an undivided ownership in an income generating asset.

Therefore, from legalistic point of view *Sukuk* are different from bonds. They represent ownership of assets and their income is generated from that asset. They include the commercial risks embedded in the assets. However, it is quite obvious that *Sukuk* are designed to have a similar risk of the bonds and behave in the market in a similar way. There is nothing in Shari'ah against managing risks as long as such management doesn't included an non Islamic procedures. Nor that a paper that behaves in the market in a manner similar to conventional fixed income securities, would be prohibited just for this reason.

The legal setting of *Sukuk*

Sukuk are certainly the product of Muslims desire to have a Shari'ah based paper. However, the fact of the matter is that most *Sukuk* were issued under common law though abiding by Shari'ah. There are reasons for this:

i) There is a similarity between Shari'ah and common law in that they both provide a wider freedom to contract and place the will of the parties supreme.

ii) Because the majority of *Sukuk* were issued in common law countries such as Malaysia.

iii) Because courts of England are the choice in this area of world for dispute settlement in financial agreements for well known reasons like efficiently and high qualification judges.
It is only natural, therefore, to design *Sukuk* in line with the basic tenants of common law, so that courts of England can be even more expedient.

iv) Last but clearly not least is that law offices of Anglo-American origin are the most active in the Islamic banking business and naturally they are experts in common law.

Sukuk benefitted from the standard asset securitization structure which was, again, born and groomed in a common law environment.

The standard *Sukuk* issuance program include basic elements which are now standard and were drawn from the securitization book. For example:

- The Trust or Special Purpose Vehicle (SPV).
- Separating title from beneficial (or equitable) ownership.

Challenges in issuing *Sukuks* under civil law

It is now apparent that *Sukuk* involves the ownership by *Sukuk* holders of an income generating real asset. In *Ijarah Sukuk* for example the real estate or equipment that generates income must be owned by *Sukuk* holders. This ownership can only be effected through a true sale contract. If we are to go into the standard procedures of sale and ownership registration this makes the process extremely costly and may not be attractive to both issuers and investors. This is because it will involve stamp duty, other taxes and costly registration problems.

Worse yet, since *Sukuk* holders interest in these assets is not permanent, a second round of the same costly and complicated procedures render the *Sukuk* issuance infeasible. However, through the separation of title from beneficial ownership, none of the above will be much of consequence.

Although the basic idea of such separation finds its lineages in English law, there is nothing contrary to Shari'ah in such conception. When it comes to contracts the basic Shari'ah rule is that what really counts in contracts is fact and reality. Therefore, if an offer and acceptance results in transfer of ownership that can be enforced in a court of law, Shari'ah requirements are satisfied. This is fulfilled in the common law set-up of separating title from beneficial ownership.

Under French law (civil law) ownership includes rights of use (usus), and enjoy (fructus) and right to dispose (absus). However, ownership right can only be held by one person. Attempts to issue Sukuk in France against leased assets came up against this stumbling block. No Shari'ah approval can be granted without transfer of ownerships that is enforceable in courts. This is not achievable under French law.

In the absence of trust law, the current structure of *Sukuk* issuance may not be conceivable.

3. The basic structure of *Sukuk*

In the basic structure of *Sukuk* we have the issuer where a corporate of a sovereign entity, this is the party that needs finance and would alternatively borrow on interest basis. Then we have the manager who is usually an investment bank making all the arrangements especially being an agent for *Sukuk* holders. We will also have the trust or special purpose vehicle (SPV) whichever is available within the going legal infrastructure.

The agent will receive the proceeds from *Sukuk* holders and act on behalf of them to enter into a contract with the issuer. If we are talking about *Ijarah Sukuk*, then he will purchase an asset from the issuer, such as a building and lease it back to him with a promise to sell at end of contract. The building is now owned by the *Sukuk* holders and the coupon generated from the rentals.

A *Mudarabah Sukuk* holder advances the capital of the *Mudarabah* to the manager who will enter into a *Mudarabah* contract with issuer who will become the *Mudarib*. *Mudarabah* is a profit sharing partnership between financier and manager. If such funds are to be utilized in a separate project this will be pure equity. However, it is more interesting if *Mudarabah* capital is commingled with the rest of assets of this corporation and used in its operations. To apply the rules of *Mudarabah* we at the end of the year, have to see if value is created over and above the day one value of the company, then this is profit in the meaning of Shari'ah which must be shared in accordance with the ratio agreed upon in the *Mudarabah* agreement. If the corporation loses money, the *Mudarabah Sukuk* holders will get no profit. However, they will not lose their capital except when all the equity of the company is wiped out. Since the *Mudarib* is the legal person, loss will eat in the *Mudarabah* capital only if equity of the corporation is wiped out. This gives the *Sukuk* holders a position in the capital structure of the corporation not too different from the position of conventional bond holders thus creating the low risk features of the *Sukuk* without the purchase undertaking. We saw in the *Ijarah Sukuk*.

4. Some milestone *Sukuks*

As we can see *sukuks* are still evolving. In the following I am going to briefly highlight some of the *sukuks* that, in my view, represent a milestone in the brief annals of *Sukuk*.

i- Government of Bahrain *Sukuk*

In the year 2001 the first *Sukuk* were issued by the government of Bahrain. The government sold parts of the Manama Airport to an SPV which represent the *Sukuk* holders, which in turn leased the same back to the government of Bahrain. The sale price was paid cash, while lease payments were made semi annually. The lease contract included a promise (undertaking) to buy-back these assets at the same sale price, as well as a promise to purchase issued by the lessee (i.e. government of Bahrain). Although the above structure was approved by a Shari'ah committee, some members of that Shari'ah committee took exception to some aspects of those *sukuks*. Until, today this undertaking to buy back at the same sale price(which is actually the face value of the *Sukuk*) present a point of debate. Many Shari'ah scholars will not approve a structure with such reciprocal undertaking.

ii) SABIC *Sukuk*

The first Saudi *Sukuk* were issued by the Saudi Basic Industries Corp (SABIC). SABIC is a holding company, which holds a dozen subsidiaries each is a world class petrochemical vendor. However, none of them has the right to directly market its products. This is held by SABIC. Subsidiaries as JV's with major multinational petrochemical companies. That "right" to market which is sealed long term agreements with these subsidiaries, was the asset on which *Sukuk* were issued. Hence, the SPV purchased this right from SABIC for cash and appointed SABIC as agent to manage the right, i.e. to render the marketing service to the subsidiaries for a fee. Evaluating this right was quite a challenge, but through the engagement of several auditing firms, a fair price was reached. To avoid the disputed point of purchase undertaking, the term was made to be 20 years with an option to retire after each five years, at the discretion of *Sukuk* holders. The promise to purchase is never a the same sale price.

SABIC made 3 successful issues of *Sukuk* on the same structure.

iii) Mobily *Sukuk*

Mobily is the holder of the second GSM license in Saudi Arabia. To issue *Sukuk* you need an asset to sell to *Sukuk* holders. In its early days the only asset it has is the license itself. Legal councils confirmed that the terms of the concession doesn't allow such sale.

The company offered to sell "airtime". Therefore SPV representing the *Sukuk* holders purchased airtime from Mobily and appointed Mobily as agent to sell the same to its customers. This structure became a standard for telephony companies in many Muslim countries.

v) Saudi Hollandi *Sukuk*

Saudi Hollandi is a JV bank in Saudi Arabia. Most of the bank activities are done Islamically. They wanted to issue *Sukuk* that can qualify as tier two capital for the bank. They ended up with the following design which was approved by their Shari'ah board.

The bank will issue *Sukuk Mudarabah*. *Mudarabah* is a form of partnership between a financier and a manager (or entrepreneur) who provides management and share in the profit generated. The bank has already built a sizable portfolio of Islamic assets generated from sale (on installment basis) and leasing of cars and houses.

Though they were called *Sukuk Al-Mudarabah* they actually involve both a contract of *Mudarabah* where SHB is the *mudarib* (manager) and a contract of *Musharakah* where SHB and *Sukuk* holders shares in the ownership of a portfolio consisting of the assets already created and the ones that are going to be created using the proceeds of the *Sukuk*. Profits generated in the pool are firstly divided into two parts one for SHB as co-owner of the pool and the other to *Sukuk* holders prorata to shares in the pool. Then the *Sukuk* holders portion of profit will then be also divided into two portions one for SHB as manager and the other belongs to the *Sukuk* holders.

vi) Aljazirah *Sukuk*

Rating is very important for *Sukuk*. Most investors rely completely, when it comes to making sure about the quality of any paper, on rating agencies.

While theoretically it is possible to rate any paper effectively, rating agencies only rate credit risk, i.e. the likelihood of an obligor (borrower) meeting his obligation to pay principal and coupon.

Islamic *Sukuk* faced a problem because as *Ijarah*, *Mudarabah* or *Musharakah Sukuk* are suppose to represent ownership of an asset not a “loan”.

For *Sukuk alijarah*, the undertaking to purchase which is issued by the issuer (as lessee) approximate an obligation that relies on the credit worthiness of the obligor. It can be rated.

This innovation structure done by bank Aljazirah, leads itself to credit rating in a way not too different from conventional bonds.

From Shari'ah point of view creating a debt obligation via a commodity sale contract where price is deferred or paid on installment basis is not objectionable. However, with such thing is done through *Sukuk* that traded in the market problems arises. This because trading a paper that represent a debt obligation (receivables) is prohibited and considered “usurious”.

However, wealth a paper boils down to a debt obligation or represent a real asset (like ownership or real estate or machinery) depends on what the paper actually represent. In Shari'ah, there is an established maxim which says that “rule is based on the majority not minority”. So when two things are mixed and they are both “*Halal*” but the rule change due to the mixing then the judgment depends on the majority.

Therefore, if we have a pool or real and financial assets represented by a paper and we want it to be traded we look, based on the first component, it can be traded but based on the second, it can't.

The judgment, however, will be based on majority. If the real asset represent 51% or more, then the real asset rule will apply. In this Aljazirah structure, a pool consisting of 51% or more leased autos and houses and 49% a *Murabaha* (deferred payment sale contract) creating a receivable equal to 49% or less of the face value of the *Sukuk*.

The interesting thing is that the profit in this *Murabaha* is calculated in such a way that at maturity, the issuer is obliged to pay an amount equal to 100% of the face value. Hence, the *Sukuk* starts as non-debt but end up so. Thus, a credit rating will be most fitting.

5. *Sukuk* facts

Some useful current statistics:

1) Geographical distribution of issues:
   - Malaysia 31.6%
   - Cayman Island 10%
   - Indonesia 3.7%
   - Saudi Arabia 2.9%
   - Qatar 2.1%
   - United Arab Emirates 1.3%

2) Listing of Sukuk:
   - Bourse Malaysia 27.4%
   - London Stock Exchange 20.6%
   - Luxembourg 2.5%

3) Local / non local:
   - Domestic Sukuk 86%
   - Global Sukuk 14%

4) Issuers:
   - Sovereign 75%
   - Corporate 15%
   - Quazi Sovereign 10%

5) Top Lead Managers:
   i) Deutsche Bank.
   ii) AM Merchant
   iii) HSBC Amanah
   iv) CIMB
   v) Citi Islamic Investment Bank

6) Investors:

- Central Banks and Governments	25%
- Asset Managers	23%
- Islamic Banks	20%

7) Geographical Distribution of Investors:

- Middle East	47%
- Asia	31%
- Europe	22%

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Shari'a-based Ethical Performance Measurement Framework

M. Houssem eddine BEDOUI(1)

Abstract. This paper is presenting a new framework to manage ethical (financial and non-financial) performances. This model is based on the concept of *Maqasid Shari'a*. Considering the fact that Business ethics is one of the most needed in the market nowadays, this framework is a solution for Islamic financial institutions but can obviously be used for other organizations looking for ethical investments.

Since Islam (*Shari'a* in particular) is focusing on ethics, this framework is providing an answer to have an "Islamic" rating for businesses and is giving benchmark tools to compare corporate and different organizations in general.

One benefit of this framework is its general form, since it could on one hand be adapted to different interpretations of *Maqasid Shari'a* (Al Ghazali, Nejjar, Ibn Ashur…), and on another hand, it could also be personalized to the definition of sustainable development (economic, ecological and social objectives). By the end of this paper, a case study is prepared to clarify the explained framework.

Key Words: Business Ethics, Social Responsible Investment, Maqasid Shariah, performance management, performance measurement, ethical rating.

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INTRODUCTION

Recently, we are attending a new huge change in the world. People all over the world are claiming ethical ambitions such as freedom, dignity and work. Islamic finance as an ethical industry by nature has a colossal opportunity to take action to these needs.

Given an organization setting up ethical responsibilities and objectives, these targets performed have to be measured. Whereas, the current performances used nowadays are mostly based on the financial results. First, I'll show the link between Islam and ethics. After that, I am setting a new way to measure and represent performances of an organization.

ISLAM AND ETHICS

The *Shari'a* is considered as central to Islam's worldview. The *Shari'a* is identified as a system of ethics and values covering all aspects of life (e.g., personal, social, political, economic, and intellectual). *Al Qurtubi*[(2)] defined *Shari'a* as the canon law of Islam. Thus, containing all the commandments of Allah to mankind *Shari'a* is usually divided into three main fields: '*aqidah* (beliefs), `*ibadah* (worship), and *akhlaq* (moral and ethics). Hence, it is clear that ethics is an integral part of *Shari'a*. Furthermore, economic aspects cannot be isolated from moral and ethical aspects, and vice versa.

MAQASID SHARI'A

To understand the *Shari'a*, one needs to comprehend its objectives, which allow flexibility, dynamism, and creativity in social policy.[3] Accordingly, *Maqasid Shari'a* is often translated as the goals and objectives of Islamic law. Hence, since the *Shari'a* is usually predicated on the benefits of the human being and that of the whole community (*Ummah*), its laws are consequently designed to protect these benefits and help development and perfection of the conditions of human life on earth.

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(2) Abu 'Abdullah Muhammad ibn Ahmad ibn Abu Bakr al-Ansari al-Qurtubi (القرطبي أبو عبدالله) was a famous mufassir, muhaddith and faqih scholar from Cordoba of maliki school.

(3) Wael B. Hallaq, A History of Islamic Legal Theories: "An Introduction to Sunni Usul al-Fiqh"

Imam Abu Hamid Al Ghazali, a prominent and highly respected reformer in the eleventh century, classified the *Maqasid* into five major categories by stating that(4):

"The very objective of the *Shari'a* is to promote the well-being of the people, which lies in safeguarding their faith (*Deen*), their self (*Nafs*), their intellect (*Aql*), their posterity (*Nasl*), and their wealth (*Mal*). Whatever ensures the safeguard of these five serves public interest and is desirable, and whatever hurts them is against public interest and its removal is desirable."(5)

Hence, Imam Ghazali considered ensuring human well being should be stressed on the safeguarding (*Hifth*) of five *Maqasid* below:

- Faith (*Deen*)
- Human self (*Nafs*)
- Intellect (*Aql*)
- Posterity (*Nasl*)
- Wealth (*Mal*)

Two centuries later, Imam Shatibi approved *Imam Ghazali* list defining *Maqasid Shari'a* (Objectives of Islamic Law). These five objectives approved later on by other scholars.

About a century after Imam Ghazali, *Fakhruddin Arrazi*(6), a prominent jurist gave the first place to *Maqasid* to the human self (*Nafs*).

To summarize, The purpose of *Maqasid Shari'a* is to spread the ethical values of compassion and guidance, establish justice, eliminate prejudice and alleviate hardship by promoting cooperation and mutual support within the family and society in general.

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(4) The Islamic Vision of Development in the Light of Maqasid al-Shari'ah, (Jeddah: IRTI/IDB, 2008 and Washington: International Institute of Islamic Thought, 2008)

(٥) قال حجة الإسلام الإمام الغزالي: (إن جلب المنفعة ودفع المضرة مقاصد الحق وصلح الخلق في تحصيل مقاصدهم، لكننا نعنى بالمصلحة المحافظة على مقصود الشرع، ومقصود الشرع من الخلق خمسة: وهو أن يحفظ عليهم دينهم وأنفسهم وعقلهم ونسلهم ومالهم فكل ما يتضمن حفظ هذه الأصول الخمسة فهو مصلحة وكل ما يفوت هذه الأصول الخمسة فهو مفسدة ودفعها مصلحة) (الممتصفى للغزالى، ج١، ص٢٨٧).

(6) Al-Razi, 1997, Vol. 5, p. 160

ETHICAL OBJECTIVES

Chandler defined the strategy as, "The determination of the basic long term goals and objectives of an enterprise and the adoption of the courses of action and the allocation of resources necessary for carrying out these goals". Besides, Andrews added that strategy is: "The pattern of objectives, purposes, goals and the major policies and plans for achieving these goals stated in such a way so as to define what business the company is in or is to be and the kind of the company it is or it is to be".

Therefore, strategy is essentially about how the institutions look for surviving and growing within its environment over the long-term by building up and following the implementation of its strategic objectives.

The common and the relevant definition of objective that I found is: "Objectives are statements of specific outcomes that are to be achieved"(7). In fact, in scope an objective is broader than a goal and it may consist of numerous ones. Hence, objective is the end outcome and result of planned actions and tasks. Objectives should shape what is to be achieved and the achievement of objectives should result in the fulfilment of the strategy. For strategic planning and activities, objectives are the crucial means and they serve as the performance evaluations and set and shape the strategy of a business.

Henry Ford, Sr said: "*For a long time people believed that the only purpose of industry is to make a profit – They are wrong. Its purpose is to serve the general welfare*." (Harting Harmeling & Venkataraman 2006).

Business ethics engage successful structure of interactions with institution's stakeholders based on its integrity. (Boatright, 2005; White, 2006).

In this paper, we are modeling ethical objectives. Therefore, for one corporate, we set up ethical strategic objectives based on *Maqasid Shari'a*:

(7) Exploring corporate strategy - Gerry Johnson, Kevan Scholes, Richard Whittington (page 164).

Chapra (2006)[8] defined Islamic Law objectives as below and showed the interdependence of the five above *Maqasid* and mainly he set up an order which is significant to work with in my approach:

1- Human self (*Nafs*)
2- Faith (*Deen*)
3- Intellect (*Aql*)
4- Posterity (*Nasl*)
5- Wealth (*Mal*)

Moreover, recently new visions have been written on *Maqasid Shari'a*. I may provide Dr *AbdelMajid Nejjar*[9] outlook:

A. Safeguard the value of human life

 1: Faith
 2: Human rights.

B. Safeguard of Human self

 3: Self
 4: Mind

C. Safeguard the value of society

 5: Prosperity
 6: Social entity

D. Safeguard physical environment

 7: Wealth
 8: Environment (Ecology)

To sum up, ethical strategic objectives are typically chosen based on *Shari'a*.

(8) The Islamic Vision of Development in the Light of Maqasid al-Shari'ah
(9) مقاصد الشريعة بأبعاد دار 'جديدة الغرب الاسلامي بيروت، ط١، ٢٠٠٦م ــ
(*New dimensions of Maqasid Shari'a*)

MAQASID SHARI'A BASED PERFORMANCE

Performance is a consequence and a result of a predetermined objective and a goal. For strategic planning and activities, objectives are the crucial means and they serve as the performance evaluations and set and shape the strategy of a business. Moreover, the validation of plans and the performance management are what basically link decisions and theirs implementation.

W. Edwards Deming affirmed: "*If you can't measure it, you can't manage it*". Thus, without evaluation, managers would not know whether the implemented strategies are running. The monitoring of specific criteria either validates the strategy in state if positive signals are put together, or makes any necessary corrections if certain criteria are revealed lowest made. There are various potential techniques to evaluate performances.

The proposed framework is may be considered as a rating model to benchmark organizations. Hence, a score is given to each "objective".

- Faith (*Deen*) → the performance measured is p_1
- Human self (*Nafs*) → the performance measured is p_2
- Intellect (*Aql*) → the performance measured is p_3
- Posterity (*Nasl*) → the performance measured is p_4
- Wealth (*Mal*) → the performance measured is p_5

This framework will be explained below with both graphical and numerical methods

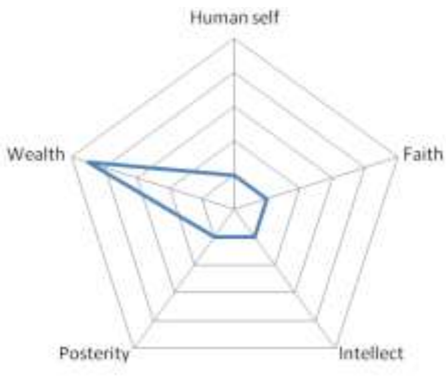
GRAPHICAL METHOD

Based on the five *Maqasid Shari'a*, the graphical method consist on assigning a score 'the performance (p_i)) to each axis. Every axis represent one objective (*Maqsid*[10]) of the five *Maqasid* previously defined. Following the order (and the interdependence of the five *Maqasid*)

So we will have a spider-graph with five axes.

(10) *Maqsid*: singular of *Maqasid*.

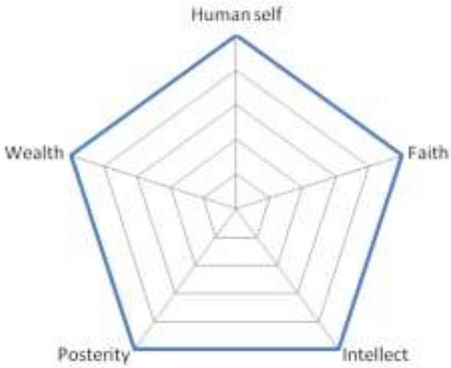
Recently, most we can see that organizations results are based on only one objective (which is generally: wealth/ financial results). So the representation is like this one:



In Quran (Chapter 2) we find these precious words:

"And thus have we willed you to be a community of the middle way, [118] *so that [with your lives] you might bear witness to the truth before all mankind, and that the Apostle might bear witness to it before you.* [119]*"*

So as we can see, Islam and Islamic law is a middle way. This concept, gave me the idea of *Shari'a*-based framework based on balance. The balance could be adopted with all firm's objectives but in this case the balance should be done between all five objective of *Shari'a* (*Maqasid Shari'a*).



As a result, to get logically a balanced performance, the representation should be like a regular pentagon. This representation has the advantage to distinguish the favorite axe adopted by the organization in case the balance does not exist. Furthermore, since we have adopted interdependent axes in this order, we can envisage also vector to each performance representation. The sum vector shows on which *Maqasid* (objective) the institution is focused. With vector representation and respecting the order of interdependent axes, we will have a vector in an area between to axes which may guide us to which 2 *Maqasid*; the institution drew attention to them.

NUMERICAL METHOD

1st method:

The first method is to make use of the graphics above,

As we can see above, the 5 axes divide the plan equally (an angle of $2\pi/5$).

My approach is to have a global performance by calculating the area limited by the graph. The total area is the sum of 5 triangles.

To calculate the area of each triangle of the five triangles, I used the "law of Sines". I concluded then, that the *Maqasid Shari'a* based performance is equal to:

$$PerformanceMaqasid(5) = \frac{\sin(\frac{2\pi}{5})}{2}[p1p2 + p2p3 + p3p4 + p4p5 + p5p1]$$

If we think about an institution which does not apply a balanced performance representation, so it may give more significance to Wealth (*Mal*) axis. Accordingly, this institution will weigh each axis so each performance p_i with w_i (i€{1;2;3;4;5})

Using the same logic as before, I found a general *Maqasid Shari'a* based performance:

$$GeneralPerformance(5) = \frac{\sin(\frac{2\pi}{5})}{2}[w1p1w2p2 + p2w2w3p3 + p3w3w4p4 + w4p4w5p5 + w5p5w1p1]$$

- p_i: the note/the result of each objective (i) during the project or during the year
- w_i: the weight assigned to each axis (i) by the institution

Maqasid Shari'a (_Najjar_ Model)

The same principle applied previously, is useful here. So we represent graphically the *Maqasid Shari'a* (defined by Najjar).

A. Safeguard the value of human life

   1: Faith
   2: Human rights.

B. Safeguard of Human self

   3: Self
   4: Mind

C. Safeguard the value of society

5: Prosperity
6: Social entity

D. Safeguard physical environment

7: Wealth
8: Environment (Ecology)

There are four *Maqasid* which are considered as key objectives, eight others may be referred as their consequences. Realization of the corollary *Maqasid* is also indispensable because realization of the primary *Maqasid* may be difficult without this.

Hence, my model for this approach will be based on the 8 corollaries. So, every axis represents one objective (*Maqsid*) of the eight *Maqasid* previously defined.

I applied the same reasoning in calculating the performance based on *Maqasid Shari'a* (Najjar Model).With applying also "the law of sinus" I found that the *Maqasid Shari'a* based performance is equal to:

$$PerformanceMaqasid(8) = \frac{\sin(\frac{2\pi}{8})}{2}[\sum_{1}^{7} p_i * p_{i+1}] + p8p1$$

Again, if we think about an institution which doesn't apply a balanced performance measurement, so it may give more significance to Wealth (*Mal*) axis. Accordingly, this institution will weigh each axis so each performance p_i with w_i (i€{1;2;3;4;5;6;7;8}).

Using the same logic as before, I found a general *Maqasid Shari'a* based performance:

$$\boxed{GeneralPerformance(8) = \frac{\sin(\frac{2\pi}{8})}{2}[\sum_{1}^{7} w_i p_i * w_{i+1} p_{i+1}] + w8p8w1p1}$$

- p_i: the note/the result of each objective (i) during the project or during the year
- w_i: the weight assigned to each axis (i) by the institution

<u>Global performance (sustainable development)</u>

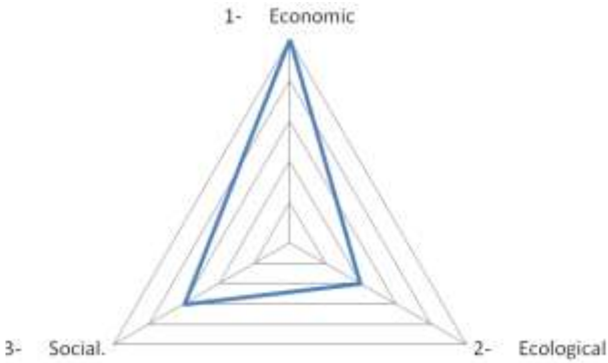
Global performance"[11] (Reynaud 2003[12]) is the fundamental definition of sustainable development. "Global Performance" consists of three basic performance axes:

1- Economic
2- Ecological
3- Social.

The graphical representation is illustrated with the three axes as below.

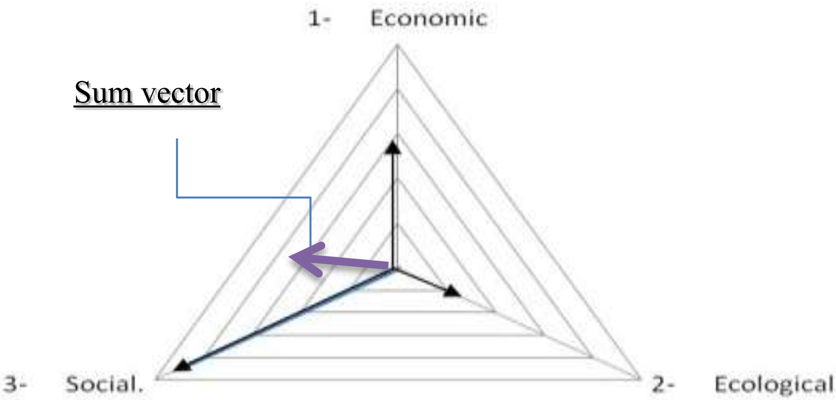
(11) http://www.bourgogne.gouv.fr/assets/bourgogne/files/dvlpt_durable/ORSE_strategies_de_DD_et_performance_des_entreprises.pdf
http://www.strategie-aims.com/events/conferences/11-xiieme-conference-de-laims/communications/896-quand-lenvironnement-devientstrategique/download
http://cermat.iae.univ-tours.fr/IMG/pdf/Actes_texte_2.pdf
http://www.industrie.gouv.fr/pdf/notationdevdurable.pdf

(12) http://www.iae-aix.com/fr/cv/enseignants/reynaud-emmanuelle/



This configuration is interesting since the order is not important. So, the use of this approach may be generally used. When we have more than 3 objectives, the order should be agreed between many institutions (for benchmark reasons especially).

Moreover, this configuration is also important because the use of vector illustration is legitimate and possible.



For instance, we can see from the illustration above, that if we sum the three vectors we will have a vector in the area limited by “Social” and “Economic” axes. Obviously, in case of balance, the sum of the 3 vectors is a null vector.

Performance measurement in this case, is similar to what I have demonstrated before.

So the measure of a global performance is equal to:

$$GlobalPerformance(3) = \frac{\sin(\frac{2\pi}{3})}{2}[p1p2 + p2p3 + p3p1]$$

Once more, if we think about an institution which does not apply a balanced performance representation, so it may give more significance to economic performance axis. Accordingly, this institution will weigh each axis so each performance p_i with w_i (i€{1;2;3})

Using the same logic as before, I found a general *Maqasid Shari'a* based performance:

$$GeneralGlobalPerformance(3) = \frac{\sin(\frac{2\pi}{3})}{2}[w1p1w2p2 + p2w2w3p3 + w3p3w1p1]$$

General Global performance with n Objectives

I succeeded to demonstrate by mathematical induction reasoning to have a global performance measure with n objectives ($n \geq 3$)

The graphical illustration is a spider graph with n axes. And the measure is equal to:

$$n - GlobalPerformance(n) = \frac{\sin(\frac{2\pi}{n})}{2}[[\sum_{1}^{n-1} p_i * p_{i+1}] + (pn * p1)]$$

Again, if we think about an institution which doesn't apply a balanced performance measurement, so it may give more significance to one axis. Accordingly, this institution will weigh each axis so each performance p_i with w_i (i€{1;2;3;..;n})

Using the same logic as before, I found a general *Maqasid Shari'a* based performance:

$$n - GeneralGlobalPerformance(n) = \frac{\sin(\frac{2\pi}{n})}{2}[[\sum_{1}^{n-1} w_i p_i * w_{i+1} p_{i+1}] + (wnpn * p1w1)]$$

- p_i: the note/the result of each objective (i) during the project or during the year
- w_i: the weight assigned to each axis (i) by the institution.

<u>*2nd method:*</u>

- This method is based on couple results:
- - average of n performances (pi)
- The standard deviation of performances (pi): This will show us how the balance was respected on results.

CASE STUDY: ETHICAL PERFORMANCE FRAMEWORK OF A CORPORATE WITH FIVE *MAQASID* SHARI'A BALANCED BASED PERFORMANCE

In this case study, I used *Umar Chapra*(13) model. In the next page I expressed the model in a matrix form with a weighting for each criterion.

I suggest as a scoring performance, the rating Scale below:

- 5: When performance far exceeded all expectations.
- 4: When performance consistently exceeded expectations.
- 3: When performance consistently meet expectations.
- 2: When performance did not consistently meet expectations and improvements are needed.
- 1: When performance was unsatisfactory and consistently below expectations

This table below show how we can proceed to manage performances based on *Maqasid Shari'a* balanced framework.

(13) The Islamic Vision of Development in the Light of Maqasid al-Shari'ah.

Objectives(*Maqasid Shari'a*)	**Criteria**	**Questions**	**Results**	**Ratings**
***Maqasid* 1**	**Criteria 1**	Set of questions to measure the performance		Score (from 1 to 5)
***Maqasid* 2**	**Criteria 2**	Set of questions to measure the performance		Score (from 1 to 5)

	Criteria	*Enrichment of Human self*	*Enrichment of Faith*	*Enrichment of intellect*	*Enrichment of posterity*	*Development of wealth*
1	Dignity	100%				
2	Education	25%		25%	25%	25%
3	Employment And Self1Employment Opportunities	33%	33%			33%
4	Equitable Distribution Of Income And Wealth	33%	33%			33%
5	Family And Social Solidarity	100%				
6	Family Integrity		50%		50%	
7	Finance			50%		50%
8	Freedom	20%	20%	20%	20%	20%
9	Fulfillment Of All Socio1Economic And Political Obligations		100%			
10	Good Governance	20%	20%	20%	20%	20%
11	Healthy Environment				100%	
12	High Quality Of Education At Affordable Prices			100%		
13	Honesty		50%			50%
14	Honor		50%			50%
15	Improvement In Technology And Management				50%	50%
16	Intellectual And Moral Development				100%	
17	Justice	50%	50%			
18	Library And Research Facilities			75%		25%
19	Marriage And Family Integrity		50%		50%	
20	Mental Peace And Happiness	100%				
21	Minimization Of				100%	

	Criteria	*Enrichment of Human self*	*Enrichment of Faith*	*Enrichment of intellect*	*Enrichment of posterity*	*Development of wealth*
	Crime And Anomie					
22	Moral And Worldly Education				100%	
23	Mutual Care		100%			
24	Mutual Trust		50%			50%
25	Need Fulfillment	25%	25%		25%	25%
26	Optimum Rate Of Development					100%
27	Patience		100%			
28	Proper Upbringing of children		50%		50%	
29	Property	33%	33%			33%
30	Prudence		100%			
31	Removal Of Poverty		50%			50%
32	Research			75%		25%
33	Reward For Creative Work			100%		
34	Saving And Investment					100%
35	Security Of Life	25%	25%		25%	25%
36	Self-Respect	100%				
37	Social Equality	100%				
38	Social Solidarity	25%	25%		25%	25%
39	Spiritual And Moral Uplift		100%			
40	Thriftiness		100%			
41	Tolerance		100%			
42	Trust	100%				

In conclusion, having the best result based on this framwork is having a score of 5 on each of the five objectives. Hence to have the best rating we should have:

An average of 5

1- A standard deviation of 0
2- Global Performance(5)= $\frac{125}{2}\sin\frac{2\pi}{5} \approx 59{,}44$

CONCLUSION

In this work, I tried to put the stress on the Islamic way of business ethics. During all the study, I showed the significance and the weight of an ethical framework based on *Maqasid Shari'a*. I proposed a new geometric (graphic) and mathematical (numeric) approach to assess performance and hence evaluate objective application. These approaches are to measure no-financial as well financial performances of any organization. The weight of each performance depends on the firm. So the approach is quite general to be applied by organizations to assess their different performances.

To conclude, the market is only waiting to initiatives to be started. I estimate that 2012 will be a key year of the ethical investments.

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(New dimensions of *Maqasid* Shari'a)

ط١، ٢٠٠٦م جديدة بأبعاد الشريعة مقاصد ـ الاسلامي الغرب دار - بيروت.

Measuring the Performance of Islamic Banks by Adapting Conventional Ratios- Ahmed Mohamed Badreldin Financial Performance of Malaysian Islamic Banks Versus Conventional Banks.

Rosnia Masruki1, Norhazlina Ibrahim, Elmirina Osman and Hishamuddin Abdul Wahab Performance comparison of Islamic and Conventional banks in Pakistan.

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Internationalization of Islamic Financial Institutions: Challenges and Paths to Solution - Samy Nathan Garas

Risk Mitigation in Islamic Finance through Policies and Regulatory Model- A Way to Long-Term Stability - Abdul Rehman Zaki

Testing the Performance Measures Based on *Maqasid* al-Shari'ah (PMMS) Model on 24 Selected Islamic and Conventional Banks - Mustafa Omar Mohammed

A Critical Appraisal On The Challenges Of Realizing *Maqasid* Al-Shariaah In Islamic Banking And Finance-Asyraf Wajdi Dusuki; Abdulazeem Abozaid

Challenges of Realizing *Maqasid* al-*Shari'a* (Objectives of *Shari'a*) in Islamic Capital Market: Special Focus on Equity-Based Sukuk - Assoc. Prof. Dr. Asyraf Wajdi Dusuki

The Challenges of Realizing *Maqasid* al-Shari`ah in Islamic Banking and Finance - Dr. Abdulazeem Abozaid /Dr. Asyraf Wajdi Dusuki

The recent financial Growth of Islamic banks and their fulfillment of *Maqasid* al-*Shari'a* (GAP ANALYSIS) - Mughees Shaukat / Pr Shahul Hameed

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Rating of Islamic Financial Institutions - Some Methodological Suggestions - Mohammed Obaidullah

Social Responsibility for Islamic Financial Institutions: Laying Down A Framework - Sayd Farook

Incorporating Corporate Social Responsibility (CSR) into sustainable financial performance of Islamic banks in Malaysia - Rosnia Masruki [Faculty of Economics and Muamalat Universiti Sains Islam Malaysia (USIM)] / Bandar Baru Nilai, 71800 Nilai/Negeri Sembilan, Malaysia/Norhazlina Ibrahim (Universiti Sains Islam Malaysia) /Noor Azlinna Azizan (Universiti Malaysia Pahang)

Measurement of Islamic Banks Performance Using a *Shari'a* Conformity and Profitablity Model

Islamic Finance: Debt versus Equity Financing in the Light of *Maqasid* al-Shari'ah

CHAIR FOR ETHICS AND FINANCIAL NORMS
University Paris 1 Panthéon-Sorbonne
in collaboration with King Abdulaziz University

Presentation: 7th Seminar held on February 11th 2012

The Islamic Vision of Development in the Light of *Maqāsid Al-Sharī'ah*

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Abstract. Islam has emphasized all the ingredients of human well-being, including the human self, faith, intellect, posterity and wealth, along with their corollaries, instead of just wealth. They are all interdependent and play the role of supporting each other. With progress in ensuring the enrichment of all these ingredients, it may be possible for the five-point star of Islam to shine with its full brightness and help realize real human well-being . Only then will it be possible for the Muslim world to be a reflection of what the Qur'ān says about the Prophet (pbuh): "We have sent you as a blessing for mankind. Concentration only on economic development with the neglect of other requisites for realizing the Islamic vision may enable the Muslim world to have a relatively higher rate of growth in the short-term. However, it may be difficult to sustain it in the long-run because of a rise in inequities, family disintegration, juvenile delinquency, crime, and social unrest. This decline may gradually get transmitted to all sectors of the polity, society and economy through circular causation, emphasized by Ibn Khaldun (d.808/1400) in his Muqaddimah, and lead ultimately to a further deterioration of the Muslim civilization from the low point it has already reached as a result of centuries of decline.

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INTRODUCTION

The ultimate goal of all Islamic teachings is to be a blessing for mankind. This is the primary purpose for which the Prophet, peace and blessings of God be on him (pbuh), was sent to this world (al-Qur'an, 21:107).(1) One of the indispensable ways to realize this goal is to promote the *falāh* (فلاح) or real well-being of all the people living on earth, irrespective of their race, colour, age, sex or nationality.(2) The word *falāh* and its derivatives have been used 40 times in the Qur'ān. Another word, *fawz* (فوز), which is a synonym of *falāh,* has also been used 29 times along with its derivatives. This is also the goal towards which the *mu'adhdhin* (مؤذن) calls the faithful five times a day, showing thereby the importance of *falāh* in the Islamic worldview.

It may be argued here that this is the goal of all societies and not just of Islam. This is certainly true. There seems to be hardly any difference of opinion among all societies around the world that the primary purpose of development is to promote human well-being. There is, however, considerable difference of opinion in the vision of what constitutes real well-being and the strategy to be employed for realizing and sustaining it. The difference may not have been there if the pristine vision of all religions had continued to dominate the worldviews of their respective societies.(3) However, this vision has been distorted over the ages.

(1) The words used in the Qur'an are *Rahmatun lil-'Alamīn* (رحمة للعا لمين). The word '*ālamīn* (عالمين) has been understood in different senses by the Qur'ān commentators. Their interpretations vary from the broadest sense of including everything created by God in this universe to the narrowest sense of including everything on planet earth: all human beings, animals, birds, insects and the entire physical environment (see al-Qurt□ubī, 1952, Vol.1, p. 138, the commentary on the first verse *(āyah)* of the first *sūrah* of the Qur'an). I have used the word 'mankind' assuming that the well-being of mankind is not possible without protecting the environment.

(2) This is a crucial aspect of the universality of the Islamic message. According to the Qur'an, Prophet Muhammad (pbuh), was sent to all people and not to any particular group (7:158 and 34:28).

(3) The Qur'an clearly states that "Every nation has had its guide" (13:7), and that "Nothing is being said to you which was not said to Messengers before you" (41:43).This verse refers to only the basics of the religious worldview. There have been changes in some details according to changes in circumstances over space and time.

Moreover, the Enlightenment Movement of the 17th and 18th centuries has influenced almost all societies around the world in different degrees by its secular and materialist worldview. Consequently, the primary measure of development has become a rise in income and wealth. This raises the question of whether *real* human well-being can be realized and sustained by merely a rise in income and wealth and the satisfaction of just the material needs of the human personality. Religious scholars as well as moral philosophers and a number of modern academics have questioned the identification of well-being with a rise in income and wealth.(4) They have also emphasized the spiritual and non-material contents of well-being.

Empirical research has also provided a negative answer to the undue emphasis on material ingredients of well-being at the cost of the spiritual and non-material. This is because, even though real income has dramatically risen in several countries since World War II, the self-reported subjective well-being of their populations has not only failed to increase, it has in fact declined.(5) The reason is that happiness is positively associated with higher income only up to the level where all basic biological needs get fulfilled.(6) Beyond that, it remains more or less unchanged unless some other needs, which are considered indispensable for increasing well-being, are also satisfied.

What are these other needs? Most of them are spiritual and non-material in character and need not necessarily become satisfied as a result of increase in income. Single-minded preoccupation with wealth may in fact hurt the satisfaction of these needs. Economists have, however, generally tended to abstain from a discussion of these. The primary reason given for this is that spiritual and non-material needs involve value judgements and are not quantifiable. They are, nevertheless, important and cannot be ignored.

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(4) Hausman and McPherson, 1993, p 693.

(5) Easterlin, 2001, p 472. See also, Easterlin, 1974 and 1995; Oswald, 1997; Blanchflower and Oswald, 2000; Diener and Oishi, 2000; and Kerry, 1999.

(6) These include among others: nutritious food, clean water, adequate clothing, comfortable housing with proper sanitation and essential utilities, timely medical care, transport, education, and a clean and healthy environment.

One of the most important of these spiritual or non-material needs for realizing human well-being is mental peace and happiness, which may not necessarily be attained by a rise in income and wealth. Mental peace and happiness requires, in turn, the satisfaction of a number of other needs. Among the most important of these are justice and human brotherhood, which demand that *all* individuals be dealt as equals and treated with dignity and respect, irrespective of their race, colour, age, sex or nationality, and that the fruits of development be also shared equitably by *all*. Equally important is spiritual and moral uplift which serves as a springboard for the realization of not only justice but also the fulfilment of all other needs. Some of the other equally important and generally recognized requirements for sustained well-being are security of life, property and honour, individual freedom, moral as well as material education, marriage and proper upbringing of children, family and social solidarity, and minimization of crime, tension and anomie. Even though some of these have now become recognized in the new development paradigm, the spiritual foundation needed for the realization of these does not get the emphasis that it needs. It may not be possible to sustain long-term development of a society without ensuring adequate satisfaction of all these needs.

While Islam considers a rise in income and wealth through development to be necessary for the fulfilment of basic needs as well as the realization of equitable distribution of income and wealth, its comprehensive vision of human well-being cannot be realized by just this. It is also necessary to satisfy the spiritual as well as the non-material needs, not only to ensure true well-being but also to sustain economic development over the longer term. If all these needs are not taken care of, there will be a lapse in well-being, leading ultimately to a decline of the society itself and its civilization. The satisfaction of all these needs is a basic human right and has been addressed in Islamic literature under the generic term *maqāsid al-Sharīʻah* (goals of the *Sharīʻah*) referred to hereafter as the *maqāsid* (sing. *maqsid).* This paper will try to explain what these *maqāsid* or goals are, how they are all mutually interrelated, what their implications are, and in what way they can together help promote *real* human well-being.

MAQĀSID (OBJECTIVES OF) *AL-SHARĪ‘AH*

The *maqasid al-Shari‘ah* have been either directly stated in the Qur’ān and the *Sunnah* or inferred from these by a number of scholars.(7) All of these address the raison d'être of the *Sharī‘ah* which, as recognized by almost all the jurists, is to serve the interests (*jalb al-masalih* : جلب المصالح) of all human beings and to save them from harm (*daf‘ al-mafasid*:دفع المفاسد).(8) Imām Abū Hāmid al-Ghazālī (d.505AH/1111AC),(9) a prominent and highly respected reformer in the fifth century Hijrah, classified the *maqasid* into five major categories by stating that:

> “The very objective of the *Sharī‘ah* is to promote the well-being of the people, which lies in safeguarding their faith (*dīn*), their self (*nafs*), their intellect (‘*aql*), their posterity (*nasl*), and their wealth (*māl*). Whatever ensures the safeguard of these five serves public interest and is desirable, and whatever hurts them is against public interest and its removal is desirable.”(10)

In the above quotation, Ghazālī has placed great emphasis on the safeguarding of five *maqāsid*.**:** faith (*dīn*), the human self (*nafs*), intellect (‘*aql*), posterity (*nasl*) and wealth (*māl*). Imām Abū Ishāq al-Shātibī (d. 790/1388) also, writing a little less than three centuries after al-Ghazālī,

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(7) Some of the most prominent exponents of the *maqasid al-Sharī‘ah* are : al-Māturīdī (d.333/945), al-Shāshī (d.365/975), al-Bāqillānī (d. 403/1012), al-Juwaynī (d.478/1085), al-Ghazālī (d.505/111), Fakhr al-Dīn al-Rāzī (d. 606/1209), al-Āmidī (d. 631/1234), ‘Izz al-Dīn ‘Abd al-Salām (d. 660/1252), Ibn Taymiyyah (d. 728/1327), al-Shātībī (d. 790/1388) and Ibn ‘Āshūr (d.1393/1973) For a modern discussion of these, see: Masud, 1977; al-Raysuni, 1992; Ibn al-Khojah, 2004, Vol.2, pp. 79-278; Nyazee, 1994, pp. 189-268; al-Khadimī, 2005; and ‘Awdah, 2006.

(8) This is agreed by all the jurists without exception. See, for example, ‘Izz al-Din ‘Abd al-Salam (d. 660/1252) (n.d.), Vol.1, pp. 3-8; Ibn ‘Ashur (d. 1393/1973) (2001), pp. 274 and 299; and Nadvi, 2000, Vol.1, p.480.

(9) All dates of death given in this paper refer first to the Hijrah year and then to the Gregorian year.

(١٠) مقصود الشرع من الخلق خمسة، وهو أن يحفظ عليهم دينهم ونفسهم وعقلهم ونسلهم ومالهم، فكلما يتضمن حفظ هذه الأصول الخمس فهو مصلحة، وكل ما يفوت هذه الأصول فهو مفسدة، ودفعها مصلحة (الغزالي: المستصفي، ١٩٣٧م، ج١، ص ١٣٩-١٤٠).

(Al-Ghazālī, *al-Mustasfā*, 1937, Vol.. 1, pp 139-40; see also al-Shātibī (d.790/1388), n.d., Vol.1, p.38 and Vol.3, pp.46-7).

put his stamp of approval on al-Ghazālī's list. These are, however, not the only *maqāsid* aimed at ensuring human well-being by honouring human rights and fulfilling all human needs. There are many others indicated by the Qur'an and the *Sunnah* or inferred from these by different scholars. Therefore, while these five may be considered as primary (*al-as□liyyah)*, others may be referred to as their corollaries *(tābi'ah).* Realization of the corollary *maqasid* is also indispensable because realization of the primary *maqasid* may be difficult without this. The generally accepted *fiqhi* principle is that means (*wasa'il*) enjoy the same legal status as that of the *maqasid.* Accordingly, a well-known legal maxim *(al-qa'idah al-fiqhiyyah)* stipulates that "something without which an obligation cannot be fulfilled is also obligatory".[11] Some of these corollaries may be less important than others in the short-run. However, in the long-run they are all important and their non-fulfilment is likely to lead to serious socio-economic and political problems. Moreover, the corollaries may keep on expanding and changing with the passage of time. The richness and dynamism inherent in the teachings of the Qur'an and *Sunnah* should enable us to expand and refine the corollaries as needed to ensure that all human rights are duly honoured and that all the different human needs are adequately satisfied.

Moreover, if we wish also to ensure the sustained development and well-being of a society, the word 'safeguarding' used by al-Ghazālī in the above quotation need not necessarily be taken to imply preservation of just the *status quo* with respect to the realization of the *maqasid.* We safeguard when we have reached the peak of achievement. However, this is not possible for human beings in this world. There is always room for improvement. The verdict of history is that unless there is a continuous progress in their realization through a movement in the positive direction, it may not be possible to safeguard them and to sustain the society's well-being in the long-run. Stagnation will ultimately set in and lead to decline. Dr. Muhammad Iqbal, poet-philosopher of the Indo-Pakistan sub-continent, has clearly stated this when he says in a couplet written in

(11) للوسائل أحكا م المقاصد ('Izz al-Din 'Abd al-Salam, *n.d.* Vol. 1, p. 46); and فهو واجب مالا يتم الواجب إلا به (See al-Shatibi, n.d., Vol. 2, p. 394; see also Mustafa al-Zarqa, 1967, pp. 784 and 1088; and Nadvi, 2000, Vol. 1, p. 480.

Persian: “I am, as long as I move; not moving, I am not”.(12) It is, therefore, necessary to strive for the continued enrichment of the primary *maqasid* as well as their corollaries in such a way that well-being keeps on improving continuously in keeping with the changing needs and environment of not only the individuals but also their society and mankind, thereby enabling everyone to continue the march forward towards a better future. Such an enrichment may be difficult to attain if we stick to the framework of just the needs that were discussed by the classical *fuqaha’.* Times have changed and needs have also changed and multiplied. It is, therefore, important to discuss the *maqasid* within the context of our own times.

While the five primary *maqasīd* have been generally endorsed by other scholars, all of them have not necessarily adhered to al-Ghazālī's sequence.(13) Even al-Shātībī has not always followed al-Ghazālī’s sequence.(14) This is because sequence essentially depends on the nature of the discussion. For example, Fakhr al-Dīn al-Rāzi (d.606/1209), a prominent jurist writing around a hundred years after al-Ghazālī, gives the first place to the human self (*al-nafs*).(15) This seems to be more logical in a discussion of sustainable development for the simple reason that human beings, as *khalifahs* or vicegerents of God, are the end as well as the means of development. They are themselves the architects of their development or decline as the Qur’an has clearly emphasized by saying that “God does not change the condition of a people until they change their own inner selves” (13:11). The *Sharī‘ah* serves the purpose of helping human beings reform themselves as well as the institutions that

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(12) (هستم اگـرمی روم، گـرنه روم نیستم) ،Iqbal, 1954, p.150.

(13) See al-Raysuni, 1992, p. 42.

(14) While al-Shātībī has given the same sequence as that of Ghazālī *on* p.38 of Vol..1, he has given somewhat different sequence on pp.46-7 of Vol..3 : *al-Dīn, al-Nafs, al-Nasl, al-Māl,* and *al-‘Aql*. This implies that he does not consider al-Ghazali’s sequence to be inevitable. The sequence may change in accordance with the purpose of the discussion. See also al-Raysunī, 1992, pp. 41-55, particularly p. 48.

(15) Al-Razi, 1997, Vol..5, p. 160. His sequence is: *al-Nafs, al-mal, al-Nasab, al-Din and al-‘Aql.* Instead of *al-Nasl,* he has put *al-Nasab* which stands for lineage or pedigree. *Al-Nasl,* as used by both al-Ghazali and al-Shatibi, stands for the entire future generation. It has, thus, a much wider coverage than *al-nasab* and is, therefore, preferable.

affect them. Accordingly, if we put the human self (النفس) first, then the *maqāsid al-Sharīʻah* may be expressed as shown in Figure 1.

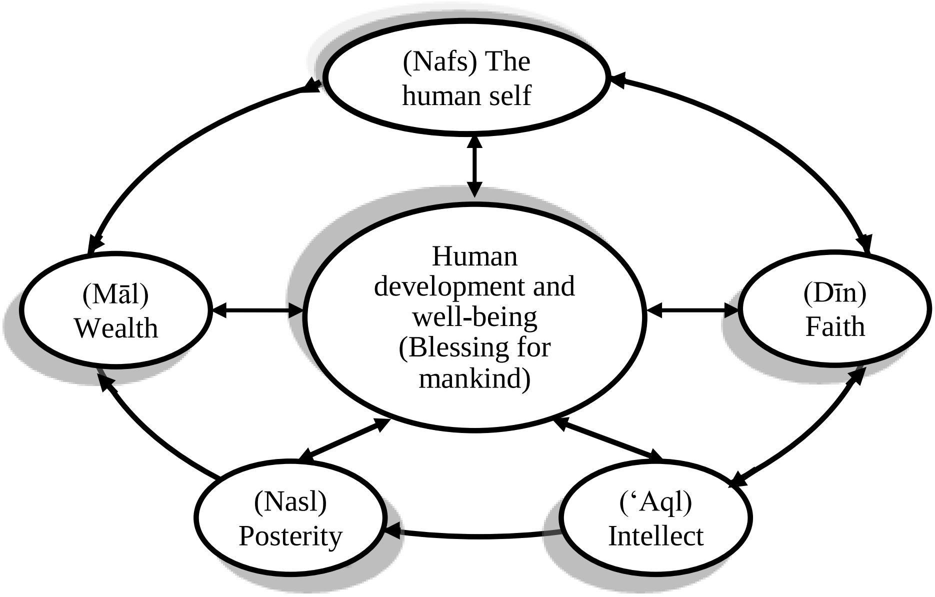

Fig. (1). ***Al-Maqāsid Al--Sharīʻah***
Human Development and Well-Being
To be realized by ensuring the enrichent of the following
five ingredients for every individual

Invigorating the Human Self (*Nafs*)

Since invigoration of the human self is one of the five primary objectives of the *Sharī'ah,* it is imperative to show how this objective can be realized. For this purpose it is necessary to specify the major needs of human beings that must be satisfied to not only raise and sustain their development and well-being, but also enable them to play their roles effectively as *khalīfahs* of God. These needs, which may be termed as corollaries of the primary objective of strengthening the human self, are explicitly or implicitly evident from the Qur'ān and the *Sunnah* and elaborated by the jurists in their discussions. Ensuring the fulfilment of these needs can help raise the moral, physical, intellectual and technological capabilities of the present as well as future generations and thereby ensure sustained well-being.

One of the most important of these needs is dignity, self respect, human brotherhood and social equality (Figure 2). The Islamic worldview addresses this need by declaring that the inherent nature of human beings (*fitrah)* is good and free from any spiritual flaw (al Qur'ān, 30:30 and 95:4) as long as they do not corrupt it.(16) It is the obligation of human beings to preserve their true nature or innate goodness (*fitrah)*. In addition, the Creator and Master of this universe has Himself conferred an enviable honour and dignity on all of them, irrespective of their race, colour, sex or age, by clearly stating in the Qur'ān that "We have honoured mankind" (17:70). This honour has been conferred on them by being made the *khalīfahs* or vicegerents of God on earth (al-Qur'ān, 2:30). What could be a greater honour for human beings than to be the vicegerents of the Supreme Being Himself? Since all of them are *khalīfahs* of God, they are equal and brothers unto each other. There must, therefore, be peaceful coexistence between them with a great deal of tolerance and mutual care to promote the well-being of all through the efficient and equitable use of all the resources made available to them by God as a trust (al-Qur'an, 57:7). The environment, including animals, birds and insects, is also a trust and must be protected so that no harm is done to the present or the future generations.

(16) See al-Qurtubi (d.463/1070), 1952, Vol.14, pp. 24-31. See also, Ibn 'Ashur, 2001, pp. 261-266.

Islam does not, thus, consider human beings to be ‘born sinners’. The concept of a ‘born sinner’ is derogatory of human dignity and is, therefore, totally alien to the Islamic worldview. Why would the Most Merciful God create a ‘born sinner’ and condemn him eternally for no fault of his? The idea of original sin implies that sinfulness is genetically transferable and that each human being comes into this world already tainted by the failures and sins of others. Moreover, if a ‘saviour’ had to come to ‘atone’ him for the ‘original sin’ which he did not commit, why did he come so late in history and not with the appearance of the first human beings on earth? If man were a born sinner how could he be held responsible for his deeds?

The concept of ‘original sin’ is thus in sharp conflict with the unequivocal emphasis of the Qur’an on individual responsibility for all his/her deeds (al- Qur’ān, 6: 164, 17: 15,35: 18,39: 7 and 53: 38). It is also in conflict with God’s attributes of *al-Rahmān* and *al-Rahīm* (the Most Merciful and the Most Compassionate), which a Muslim repeats most often during his lifetime. It would be impossible for Him to do so, given that He is a Loving (ودود) and Forgiving (غفور) God and has all the good attributes that can be conceived (Qur’ān, 7: 180). No wonder even the Rationalists and the Romantics of the nineteenth century rejected the notion of an inherent flaw in human nature (original sin), as do almost all modern philosophers.

Similarly, the concepts of determinism and existentialism coined by Western philosophers under the influence of the Enlightenment movement are also alien to Islam. Islam does not consider human life to be determined by material (Marx), psychological (Freud), instinctive (Lorenz) or environmental (Pavlov, Watson, Skinner and others) forces.[17] Determinism and human responsibility cannot be reconciled

(17) Problems of determinism and responsibility are discussed by several authors in Sydney Hook (ed.), *Determinism and Freedom in the Age of Modern Science* (1958), which is a selection of papers by contemporary philosophers; and also by Sydney Morgenbesser and James Walsh, (eds.), *Free Will* (1962), which brings together carefully selected discussions from classical and modem writers and is intended mainly for students. See also A. J. Alden, *Free Action* (1961), which offers elaborate and penetrating analysis of a wide range of concepts that have =

with each other. It does not only lower human dignity but also negates human responsibility for the prevailing conditions, and for the inefficient and inequitable use of resources.(18)

Sartre's existentialism, the other extreme of determinism is also not acceptable to Islam.(19) Human beings are, according to Sartre, "condemned to be free". There is no limit to their freedom except that they are not free to cease being free.(20) Every aspect of man's mental life is intentional, chosen and his responsibility. This is undoubtedly an improvement over determinism. However, for Sartre this freedom is absolute, everything is permitted. There is no ultimate meaning or purpose in human life. There are no transcendent or objective values set for human beings, neither laws of God nor Platonic Forms nor anything else. Human beings are 'forlorn' and 'abandoned' in the world to look after themselves completely. The only foundation for values is human freedom, and there can be no external or objective justification for the values anyone chooses to adopt.(21) There can be no question of having agreed values, and of imposing restrictions on individual freedom to create harmony between individual and social interest, or of leading to an efficient and equitable allocation and distribution of resources not brought about automatically by market forces. Such a concept of absolute freedom can only lead to the notions of *laissez-faire* and value neutrality. While freedom is indispensable for every individual, the well-being of all is also indispensable and cannot be compromised. Therefore, some socially agreed restrictions are necessary on individuals to ensure that they do not trespass the rights of others and jeopardize their well-being. This raises the question of who can determine these restrictions. This question is discussed under the fifth need of the human personality.

= always been central to the free will controversy. Although the author does not try to prove directly that men have free will, he attacks the bases of certain widely held determinist theories.

(18) See also, Chapra, 1992, pp. 202-206.

(19) Jean-Paul, Sartre, *Being and Nothingness*, tr. by Hazel Barnes ((1957). See also Stevenson (1974), pp.78-90: and Anthony Manser, *Sartre: A Philosophic Study* (1966).

(20) Sartre (1957), pp. 439 and 615,

(21) *Ībid.,* p. 38.

A second need of the human personality is justice.(22) The goals of human dignity, self-respect, brotherhood, social equality and the well-being of all would remain hollow concepts having absolutely no substance if they are not buttressed by socio-economic justice. Accordingly, the Qur'ān places justice 'nearest to piety' (5:8) in terms of its importance in the Islamic faith. Piety is naturally the most important because it serves as a springboard for all rightful actions, including justice. Establishment of justice has, therefore, been the primary mission of all God's Messengers (al-Qur'ān, 57:25). The Qur'ān has emphatically made it clear that there can be no peace without justice by saying that "Those who have faith and do not impair it by injustice, for them there is peace, and they are the really guided ones" (al- Qur'ān, 6:82).(23) The absence of justice cannot but lead ultimately to misery and destruction (al-Qur'an, 20:111).

The Prophet (pbuh) also condemned injustice in very emphatic terms. He equated the absence of justice with "absolute darkness on the Day of Judgement."(24) The darkness in the Hereafter is nothing but a reflection of darkness created by us in this world through injustice (*zulm*). This darkness can frustrate all efforts to realize peace, sustainable development, and social solidarity and lead ultimately to discontent, tension, conflict and decline. Injustice and Islam are, hence, at variance

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(22) Empirical studies have consistently found that high rates of religious commitment and activity are associated with mental health, reduced stress and increased life satisfaction (Ellison, 1991and 1993; and Iannaccone 1998).

(23) The context of this verse refers to injustice done to God through disbelief (*kufr)* and association of partners with him *(shirk)*, as rightly pointed out by commentators like al-Qurtubi (d.671/1272) and Ibn Khathir (d. 744/1375). However, looking at the intense emphasis of the Qur'an and the *Sunnah* on Justice to everyone and everything, one can readily extend the implications of this verse to all human beings and other God's creatures. This was done by a number of rationalist (*mu'tazilah*) scholars as reported by Fakhr al-Din al-Razi (d.606/1209) in his commentary of this verse in *al-Tafsir al-Kabir,* Vol.7, p. 60.

(24) "الظلم ظلمات يوم القيامة" (*Sahīh* Muslim, Vol. 4, p. 1996:56*, Kitāb al-Birr wa al-Silah wa al-Adab, Bāb Tahrīm al-Zulm*, from Jābir Ibn Abdullah). The Prophet, peace and blessings of God he on him, has used the word *zulumāt* in this *hadīth. Zulumāt* is the plural of *zulmah* or darkness, and signifies several layers of darkness, leading ultimately to 'pitch' or 'absolute' darkness, as is also evident in the Qur'ānic verse 24:40.

with each other and cannot coexist without either of the two being uprooted or weakened. *Zulm* (injustice) is a comprehensive Islamic term referring to all forms of inequity, injustice, exploitation, oppression and wrongdoing, whereby one person hurts others, deprives them of their rights, and does not fulfil his/her obligations towards them.(25)

It is this emphasis of both the Qur'ān and the *Sunnah* on justice which has become reflected in the writings of nearly all classical Muslim scholars. Al-Mawardi (d.450/1058), for example, argued that comprehensive justice "inculcates mutual love and affection, compliance with norms, development of the country, expansion of wealth, growth of progeny, and security of the sovereign", and that "there is nothing that destroys the world and the conscience of the people faster than injustice".(26) Ibn Taymiyyah (d.728/1328) emphasized that "justice towards everything and everyone is an imperative for everyone, and injustice is prohibited to everything and everyone. Injustice is absolutely not permissible irrespective of whether it is to a Muslim or a non-Muslim or even to an unjust person".(27) He zealously upheld the adage prevailing in his time that: "God upholds a just state even if it is non-believing, but does not uphold an unjust state even if it is believing."(28) Ibn Khaldun (d. 808/1406) unequivocally stated that it is not possible for a country to develop without justice.(29)

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(25) See Chapra, 1985, pp.27-8.

(26) Al-Mawardi, *Adab* (1955, p. 125).

وأما القاعدة الثالثة فهي عدل شامل، يدعو إلى الألفة، ويبعث على الطاعة، وتعمر به البلاد، وتنموية الأموال، ويكثر به النسل، ويأمن به السلطان ....

"وليس شيء أسرع في خراب الأرض، ولا أفسد لضمائر الخلق، من الجور" (أدب الدنيا والدين، الماوردي، ١٩٥٥م، ص١٢٥).

(27) Ibn Taymiyyah, Vol.8, p. 166.

كان العدل أمرًا واجبًا في كل شيء وعلى كل أحد، والظلم محرما في كل شيء ولكل أحد، فلا يحل ظلم أحد أصلاً، سواء كان مسلمًا أو كافرًا أو كان ظالمًا" (مجموع فتاوى ابن تيمية، ج٨، ص١٧٧).

See also his *Minhaj al-Sunnah*, 1986, Vol. 5, p. 127.

(٢٨) إن الله يقيم الدولة العادلة وإن كانت كافرة، ولا يقيم الظالمة وإن كانت مسلمة.

(Imām Ibn Taymiyyah, *Al-Hīsbah fī al-Īslām*, 1967, p. 94).

(٢٩) إن الظلم مخرب للعمران. (Ibn Khaldun, *Muqaddimah*, p. 287).

It may not, however, be possible to ensure justice without the faithful observance of certain rules of behaviour by all members of society. These rules are termed moral values in religious worldviews and institutions in Intuitional Economics. Some of these values are: honesty, fairness, punctuality, conscientiousness, diligence, self-reliance, tolerance, humility, thrift, respect for parents, teachers and the elderly, sympathy and care for the poor, the handicapped and the downtrodden, and concern for the rights and obligations of others, not only those in ones' own society but also those around the world. Faithful observance of these values can lead to mutual trust and cordial relations among the people, and motivate them to fulfill their mutual obligations and to help each other, thereby promoting family and social solidarity, tolerance and peaceful coexistence, and curbing the spread of anomie.(30) This will lead to an increase in social capital, which is necessary for promoting efficiency and equity and, consequently, accelerated development and human well-being. Moral uplift is, therefore, the third dire need of the human personality if the well-being of all is to be realized and the Islamic vision is to be fulfilled. Faithful observance of all the rules of behaviour enshrined in moral values may, however, not be possible without a proper motivating system which requires an enabling worldview discussed under the second primary objective of strengthening faith.

The Islamic worldview and its values also address the fourth dire need of the human personality, which is security of life, property and honour. The Qur'ān equates the unwarranted killing of even a single individual (irrespective of whether he/she is a Muslim or a non-Muslim) with the killing of the whole of mankind, and the saving of a single life with the saving of the whole of mankind (5:32). This is but natural because the Islamic call for the respect of life and the brotherhood of mankind would be meaningless if the life of even non-Muslims were not considered to be as sacred as that of Muslims. The Prophet (pbuh), also pronounced in the address which he delivered during his farewell pilgrimage that: "Your lives, your property and your honour are as sacred as this Day of yours (*Hajj*), in this month of yours, in this city of

(30) All these values are emphasized in the Qur'an and/or Sunnah and constitute an inseparable part of the Islamic worldview. Whoever violates them is not considered to be a practicing Muslim.

yours."[31] Since the *Hajj* enjoys a maximum degree of sanctity in Islam, the life, property and honour of every individual also enjoy the same degree of sanctity.

A fifth need of the human self is freedom. Freedom is indispensable for the development of the human personality. Without it he/she may lack the initiative and drive that are necessary for creativity and innovation and, consequently, for human development and well-being. As *khalifahs* of God, they are subservient to none but Him. Therefore, one of the primary missions of Muhammad (pbuh) was to relieve mankind of the burdens and chains that have been imposed on them (al-Qur'an, 7:157). Serfdom of any kind, irrespective of whether it is social, political or economic is, therefore, alien to the teachings of Islam. Accordingly, no one, not even the state, has the right to abrogate this freedom and to subject human beings to any kind of bondage or regimentation. It is this teaching, which prompted 'Umar, the second Caliph, to ask: "Since when have you enslaved people when their mothers gave birth to them as free individuals?"[32]

However, as *khalifahs* of God, human beings are not absolutely free in the sense of Sartre's existentialism. Their freedom is bounded by moral values to ensure not just their own well-being but also the well-being of all God's creatures. When the angels realized at the time of man's creation that he was going to be God's *khalīfah* on earth with freedom to act on his own initiative, they had an apprehension that this freedom might lead him to corrupt the earth and to shed blood (al-Qur'ān, 2:30). This apprehension may perhaps have been because they did not realize at that time that, in addition to freedom, God was also going to provide human beings with three other assets that could help them lead a life that would be contrary to the angels' apprehension. The first of these is their conscience, which is a reflection of their true nature *(fitrah)* on which God has created them (al-Qur'ān, 30:30). If the *fitrah* is

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(٣١) إن دماءكم وأموالكم وأعراضكم حرام عليكم كحرمة يومكم هذا في شهركم هذا في بلدكم هذا
(Reported by Ibn Kathīr (d. 774/1373) (1981) in his commentary of verse 13 of *sūrah* 49 *(al-Hujurāt),* Vol.. 3, p. 365).

(٣٢) متى استعبدتم الناس وقد ولدتهم أمهاتهم احرارًا ؟"
('Alī al-Tāntawī and Nājī al-Tantāwī, *Akhbāru 'Umar*, 1959, p.268).

not preserved, human beings can stoop "to the lowest of the low (*asfala safilin*)" (al-Qur'an, 95:5). To help them avoid such a fall, God has Himself provided them with the second precious asset which is the guidance sent by Him to all human beings and nations at different times in history through a chain of His Messengers. The purpose of this guidance is to assist them in managing their affairs in this world in a way that would help ensure the well-being of all in harmony with their mission as *khalifahs* of God.(33) Their freedom is, therefore, within the bounds of the guidance provided by Him. The third asset is the intellect which God has provided to human beings. If used in the light of the promptings of their conscience as well as the Divine Guidance, it would enable them to use their freedom wisely to actualize the vision of Islam and not to spread corruption or shed blood, which are among the worst crimes in the value system of Islam

This leads us to a sixth need of the human personality, which is the enrichment of his/her intellect through a high quality of education. Education should perform a dual purpose. First, it should enlighten the members of society about the worldview and moral values of Islam as well as their mission in this world as *khalifahs* of God. Secondly, it should enable them to not only perform their jobs efficiently by working hard and conscientiously but also expand the knowledge and technological base of their society. Without the moral uplift and expansion of their knowledge and technological base, it may not be possible to enrich the intellect and enable it to contribute richly to the goal of accelerating and sustaining development. The Qur'ān and *Sunnah* have, therefore, laid great emphasis on education as will be indicated later while discussing the enrichment of intellect, the third primary objective of the *Sharī'ah*.

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(33) The Qur'an clearly states that "We have indeed sent Our Messengers to every community in every period" (16:36) and that "We have sent Messengers before you, some of them We have motioned to you, while some of others We have not mentioned" (40:78 and 4:164). According to a *hadith* of the Prophet (pbuh) from Abu Dhar, God has sent 124000 Messengers to this world at different times to different communities (See the commentary on verse 4:164 in the *Tafsir* of Ibn Kathir). Islam is undoubtedly the only religion which recognizes all the Messengers of God.

Good governance, as will be discussed further under faith, is the seventh indispensable need of the human personality. Without political stability and good governance, it may not be possible to enforce the society's rules of behaviour. In this case, the violation of rules may tend to spread and become locked-in through the operation of path dependence and self-reinforcing mechanisms.(34) There will then be a rise in corruption, inefficiency, and lack of concern for the satisfaction of other people's needs. Hence the imperative of good governance has been stressed throughout Muslim history by almost all scholars, including Abu Yūsuf, al-Māwardi, Ibn Taymiyyah and Ibn Khaldūn. One of the major causes of Muslim decline has generally been understood to be the absence of good governance over the last several centuries.(35)

The intense commitment of Islam to human dignity, justice and brotherhood leads logically to the eighth requisite which is the removal of poverty and the fulfillment of all basic human needs. Poverty leads to incapacity, helplessness and dependence on others. It can even, according to the Prophet (phub), drive a person close to disbelief.(36) It is thus in conflict with the goal of human dignity ingrained in Islamic teachings. However, the removal of poverty may not be possible without an efficient and equitable use of all resources at the disposal of mankind. All these resources are, as indicated earlier, a trust from God and one of the terms of this trust is that they must be utilized in such a responsible manner that the needs of all are satisfied.

Removal of poverty and the need fulfillment of all individuals in society has, therefore, received an important place in the *fiqh* and other Islamic literature throughout Muslim history. The jurists have unanimously held the view that it is the collective obligation (*fard kifāyah*) of a Muslim society to take care of the basic needs of the poor.(37) In fact, according to al-Shātibī, this is the raison d'être of society

(34) See North, 1990, pp. 93-94.

(35) See the author's new book, *Muslim Civilization: The Causes of Decline and the Need for Reform* (2008).

(36) كاد الفقر أن يكون كفرا

(Cited by al-Suyuti (d.911/1505) in his *al-Jami*'*al-Saghir* from Anas ibn Malik on the authority of Abu Nu'aym's *al-Hilyah* under the word Kada, p.89).

(37) See, for example, *Ibn Hazm*, Vol. 6, p.156: 725.

itself.(38) All modern scholars, including Mawlānā Mawdūdī, Imām Hasan al-Bannā, Sayyid Qutub, Mustafā al-Sibā'ī, Abū Zahrah, Bāqir al-Sadr, Muhammad al-Mubārak, and Yūsuf al-Qaradawī, are unanimous on this point.

This leads us to the question of what constitutes a need, the fulfillment of which has been made an individual as well as social imperative. Needs have been divided by the *fuqhahā'* into three categories. These are necessities *(durūriyyāt)*, comforts (*hajīyyāt*), and refinements (*tahsīniyyāt)*). All of these, as defined by the *fuqahā'*, refer to goods and services that make a real difference in human well-being by satisfying a certain need, reducing a hardship, or providing comfort and mental peace and happiness.(39) They do not include 'luxuries' which may be defined as those goods and services which are wanted for their snob appeal and do not make a difference in a person's real well-being. All such goods and services which go beyond need have been considered by the *fuqahā'* as prodigality and self–indulgence, and strongly disapproved.(40)

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(38) al-Shātibī, Vol. 2, p. 177.

فجعل الله الخلق خلائف في إقامة الضروريات العامة (الشاطبي، ج٢، ص١٧٧).

(39) For the definition of these terms within the perspective of *fiqh*, see al-Shātibī, *al-Muwāfaqāt,* Vol.. 2, pp. 8-12: and Anas Zarqa, "Islamic Economics: An Approach to Human Welfare", in K. Ahmad, 1980, pp.13-15. See also Imām Hasan al-Bannā, *Majmū[ah Rasā'il* (1989), p. 268, and *Hadīth al-Thulāthā'* (1985), p.410; and Sayyid Abul A'lā Mawdūdī, *Īslām awr Jadīd Ma[āshī Nazariyyāt* (1959), pp. 136-40.

(40) See the Qur'an, 7: 31,17: 26-7 and 25: 67 for verses against waste and extravagance. The Prophet (pbuh), also spoke against extravagance and in favour of simplicity and humility in life-style. He emphasized that waste of resources was forbidden not only in times of scarcity but also in times of abundance *(Tabrīzī, Mishkāt,* 1966, Vol.. I. p.133:427). He also said: "God has revealed to me to teach you to be humble so that no one wrongs others or shows arrogance" *(Sunan Abu Dawud,.* 1952, Vol.. 2, p. 572, from 'Iyad ibn Hīmār); and that: "God does not look at those who wear clothes reflecting arrogance" *(Sahih al-Bukhārī,* Vol. 7, p. 182, *and Sahīh Muslim,* 1955, Vol. 3, p. 1651:42). He also said: "Whoever abstains from wearing an expensive dress out of humility, in spite of being capable of doing so, will be summoned by God in the presence of all humanity on the Day of Judgment and given the option to wear any of the distinguished attires of faith that he wishes" *(Jamī[al-Tīrmīdhī* wīth commentary, *Tuhfat al- Ahwadhī,* Vol. 3, pp. 312-13, from Mu'adh ibn Anas al-Juhani); and: "Eat and drink, give in charity,

However, it is important to bear in mind that, since Islam does not approve of monasticism or a life of self-denial and renunciation of the world (al-Qur'an, 57:27), the classification of goods and services into the three above categories need not be inflexible. Islam allows a person to satisfy all his needs (both necessities and comforts) to increase his

= and dress up without extravagance or conceit" (Suyūtī, *al-Jāmi' al- Saghīr.* Vol.. 2, p. 96, from Ibn 'Umar, on the authority of *Musnad Ahmad,* Nasa'i, Ībn Mājah and *Mustadrak Hākim).* Accordingly, the weight of the Qur'an and the *Sunnah* is on the side of a simple life-style for its followers, and the jurists have concluded that vainglory and vying with each other for worldly symbols of prestige is *harām* (prohibited). (See "Kitāb al-Kasb" of al-Shaybānī in al-Sarakhsī, *Kitab a/-Mabsūt,* Vol. 30, pp. 266-8.)

عن عبدالله بن عمرو بن العاص أن النبي صلى الله عليه وسلم مر بسعد وهو يتوضأ فقال (ما هذا السرف يا سعد) قال أفي الوضوء سرف قال: (نعم وإن كنت على نهر جار) رواه أحمد في المسند وابن ماجه، مشكاة، ج١، ص١٣٣، نمرة ٤٢٧ كتاب الطهارة – باب سنن الوضوء.

عن عياض بن حمار رضي الله عنه أنه قال: قال رسول الله صلى الله عليه وسلم: (إن الله أوصى إلى أن تواضعوا حتى لا يبغى أحد على أحد ولا يفخر أحد على أحد) ابو داؤود، ج٢، ص٥٧٢.

عن ابن عمر رضي الله عنه أن رسول الله صلى الله عليه وسلم قال: "لا ينظر الله إلى من جر ثوبه خيلاء"، رواه البخاري كتاب اللباس، باب قوله تعالى " قل من حرم زينة الله"، ج٧، ص١٨٢.

عن معاذ بن أنس الجهني عن أبيه أن رسول الله صلى الله عليه وسلم قال: من ترك اللباس تواضعًا لله وهو يقدر عليه دعاه الله يوم القيامة على رؤوس الخلائق حتى يخيره من أي حلل الإيمان شاء يلبسها)، رواه الترمذي في كتاب الزهد قال حديث حسن، تحفة الأحوذي، ج٣، ص ٣١٢–٣١٣.

عن ابن عمر رضي الله عنه عن النبي صلى الله عليه وسلم أنه قال: (كلوا وأشربوا وتصدقو والبسوا في غير إسراف ولا مخيلة) رواه أحمد في مسنده والنسائي وابن ماجه والحاكم في المستدرك، الجامع الصغير للسيوطي، ج٢، ص٩٦.

الحاصل أنه يحرم على المرء فيما اكتسبه من الحلال، الافساد والسرف والخيلاء والتفاخر والتكاثر، أما الإفساد فحرام لقوله تعالى: "وابتغ فيما آتاك الله الدار الآخرة "الآية، وأما السرف فحرام لقوله تعالى: (ولا تسرفوا) الآية، وقال جل وعلا: والذين إذا أنفقوا الآية، فذلك دليل على أن الاسراف تبذير وقال الله تعالى (ولا تبذر تبذيرا) (ص٢٦٦)، والمخيلة حرام والتفاخر والتكاثر حرام يعني أنه كما نهى عن الإسراف والتكثير من الطعام فذلك نهى عن ذلك في اللباس والأصل فيه ما روى أن النبي صلى الله عليه وسلم نهى عن الثوبين والمراد أن لا يلبس نهاية ما يكون من الحسن والجودة في الثياب على وجه يشار إليه بالأصابع فإن أحدهما يرجع إلى الإسراف والآخر يرجع إلى التقتير وخير الأمور أوسطها (كتاب الكسب لمحمد بن حسن الشيبانى، المبسوط للسرخي، ج٣٠، ص٢٦٨).

efficiency and well-being. The classification of goods and services into these categories should, therefore, reflect the wealth and general living standard of any given Muslim society. Accordingly, the perspective on needs is bound to undergo a change over time with the development of technology and the rise in wealth and living standards. In fact, most Muslim countries are richer today and can afford a higher standard of need fulfillment than what was possible in the early Muslim societies. Moreover needs do not remain constant over time and space. Some of the things which did not even exist during the Prophet's (pbuh) times are now considered needs. They should not, however, reflect snobbery or lead to wide gaps in living standards which may weaken the bonds of Islamic brotherhood and social solidarity. The objective should also not be to create a monotonous uniformity and drabness in Muslim societies. Simplicity can be attained in life styles without adversely affecting creativity and diversity.

Since begging degrades a person's dignity and is also strongly discouraged by Islam,[41] a ninth requisite of the human personality and an essential corollary of human dignity is that need fulfillment must be realized through the individual's own effort. Accordingly, it is the personal obligation (*fard 'ayn*) of every Muslim to earn a living to

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(41) The Prophet (pbuh), disapproved of begging by saying: "Do not beg anything from people" (لا تسألوا الناس شيئًا) Abū Dawud, 1952, Vol. Ī, p, 382, from 'Awf ibn Malik), and that "The hand that is above is better than the hand that is below" (اليد العليا خير من اليد السفلى) (Al-Bukhārī. Vol. 2, p. 133. from 'Abdullah ibn 'Umar). The Prophet (pbuh), also declared unlawful the giving of charity to those who have no real need and who are healthy and able-bodied. (لا تحل الصدقة لغني ولا لذي مرة سوى) (Abū Dāwūd, 1952, Vol.. I, p, 379; Nasā'ī, 1964, Vol.. 5, p. 74 and Ibn Mājah, 1952, Vol.. Ī. p. 589:1839). He assigned a place of high esteem to earning one's own living by saying: "He who seeks the world lawfully to refrain from begging, to cater for his family, and to be kind to his neighbour, will meet God on the Day of Judgement with his face shining like the full moon".

(من طلب الحلال استعفافا عن المسألة وسعيًا على أهله وتعطفًا على جاره لقي ربه تعالى يوم القيامة ووجهه مثل القمر ليلة البدر).

(*Tabrizi, Mīshkāt,* 1381 A.H., Vol.. 2, p. 658:5207, from Abū Hurayrah, on the authority of Bayhaqī's *Shu'ab al-Īmān*).

support himself and his family.(42) The Prophet (phub) has also enjoined Muslims to acquire skill in some profession so that they can earn a respectable living.(43) The jurists have, therefore, emphasized that without fulfilling this obligation of earning a living through his own effort, a Muslim may not even be able to maintain his body and mind in a state of adequate health and efficiency to carry out even his devotional duties, leave alone the fulfillment of all his other obligations as vicegerent of God on earth.(44)

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(42) The Qur'ān instructs Muslims to go out into the world and seek of God's bounties after having attended to their prayers (62: 10). The Prophet (pbuh) said that: "Earning a lawful livelihood is obligatory upon every Muslim" (طلب الحلال واجب على كل مسلم) (Suyūtī, *AĪ-Jami' al-Saghir,* from Anas ibn Malik. p. 54). He elaborated this point further by saying: "A man has not earned better income than = that which is from his own effort" (ما كسب الرجل كسبًا أطيب من عمل يده) (*Sunan Ibn Mājah,* 1952, Vol. 2, p. 723:2138, from Miqdam ībn Ma'dikarib). According to the Prophet (pbuh), trust in God does not imply that a Muslim should refrain from making an effort. He should in fact do his utmost, but trust in God for the best results. This is the implication of his displeasure at a man who left his camel untied thinking that the camel would not stray because God would take care of him. The Prophet admonished him to tie the camel first and then trust in God (see "Kitāb al-Kasb" of Muhammad Ibn al-Hasan al-Shaybānī in al-Sarakhsī, *Kitāb al-Mabsūt,* Vol. 30,.p. 249). Caliph 'Umar emphasized the Islamic injunctions to earn one's own livelihood

قال عمر رضي الله عنه "لا يقعد أحدكم عن طلب الرزق ويقول: اللهم ارزقني، فإن السماء لا تمطر ذهبًا ولا فضة ولكن الله يرزق الناس بعضهم من بعض" (على الطنطاوي وناجي الطنطاوي، أخبار عمر، ص٢٦٨).

"أن من يزعم أن حقيقة التوكل في تركه الكسب فهو مخالف للشريعة وإليه أشار رسول الله صلى الله عليه وسلم في قوله للسائل الذى قال أُرسل ناقتي وأتوكل، فقال صلى الله عليه وسلم: "لا بل اعقلها وتوكل" (كتاب الكسب لمحمد بن الحسن الشيباني، المبسوط للسرخسي، ج٣٠، ص٢٤٩).

(43) The Prophet (pbuh) said: 'God loves a Muslim who has a professional skill" (Narrated by al-Mundhiri from Ibn 'Umar on the authority of al-Tabarani's *al-Kabir* and al-Bayhaqi, Vol.2, p.523:10).

– عن ابن عمر رضى الله عنهما عن النبي صلى الله عليه وسلم قال: "إن الله يحب المؤمن المحترف" (رواه الطبراني في الكبير والبيهقى، المنذري، ج٢، ص٥٢٤).

(44) A complete list of juristic references would be too long; the reader may however wish to see "Kitāb al-Kasb" of al-Shaybānī īn al-Sarakhsī, *Kitāb al-Mabsūt,* Vol. 30, pp. 344-87, particularly, pp. 245, 250 and 256; Abū Hāmid Muhammad al-Ghazālī, *Īhyā 'Ulūm al-Dīn,* Vol. 2, pp. 60-4; al-Shātībī, *Al-Muwāfaqāt,* Vol. 2, pp. 176-7; and al- 'Abbādī (1974-75), Vol. 2, pp. 22-5.

It is, therefore, the collective obligation (*fard kifāyah)* of a Muslim society to manage the economy in such a way that everyone has a suitable opportunity to earn an honest living in keeping with his/her ability and effort. In the present-day world, microfinance has proved to have a great potential for expanding employment and self-employment opportunities and needs to receive high priority in Muslim countries. Nevertheless, there are bound to be those who are unable to earn enough through their own effort because of some handicap or inability. Islam has, therefore, ordained a social self-help programme to help such people through its institutions of *zakāh, sadaqāt* and *awqaf* to fulfill their needs without stigma or recrimination. If it is not possible to raise adequate resources through these institutions then it is the obligation of the state to play a complementary role.

The Qur'an requires that wealth should not circulate only among the rich (59:7). In accordance with this vision of Islam, the tenth need is equitable distribution of income and wealth. This is because excessive disparities in income and wealth tend to degrade those who are extremely poor and unable to utilize their full potential. Lack of an effective programme to reduce inequities is bound to destroy, rather than foster, the feelings of brotherhood that Islam wishes to promote. Hence, Islam not only requires the removal of poverty and fulfillment of everyone's needs, primarily through a respectable source of earning, but also emphasizes the social self-help programme of *zakāh, sadaqat* and *awqaf*. It would, however, be a mistake to rely primarily on these charitable contributions to realize the objective of equitable distribution of the income and wealth. It is also necessary to accelerate development, as will be discussed later under wealth, and to adopt all other methods that have proved to be useful around the world, provided that they are *Shari''ah* compatible.

An eleventh indispensable natural need of both the male and the female members of society is a companion and partner-in-life through marriage.(45) The purpose of this is not merely to satisfy the sexual desire

(45) The Qur'an uses the words *zawj* and *sahibah* for a wife which signifies that she is a partner and friend or companion and not an employee or subordinate. In the light of this, *fiqhi* literature defines marriage as a partnership agreement based on the equality of the partners. It is solemnized for the purpose of fulfilling mutual needs through

but also to have a congenial partner-in-life to find peace and solace in each other through mutual care, affection and kindness. The Qur'ān states: "And among His signs is that He has created for you mates from among yourselves and sown love and compassion in your hearts so that you may find peace of mind in her. In these, there are signs for those who reflect" (al-Qur'ān 30:21). Married life can, however, help realize this objective only if both husband and wife have a noble character *(khuluq hasan)*,(46) are concerned about each other's well-being, and are willing to make the sacrifice of self-interest that this entails.(47) Such an affectionate and caring relationship of husband and wife with each other will lead to the establishment of stable families which are essential not only for the loving care and upbringing of the future generation but also the development and survival of the society itself.

For creating an atmosphere of love, compassion and tranquility between husband and wife, the Qur'an has prescribed for women rights equal to those of men (2:228), and has required men to treat them gently and fairly (4:19) and to fulfill their obligations towards them graciously (2:237). The Prophet (pbuh) has further reinforced these and other verses of the Qur'an by characterizing women as "sisters of men".(48) In a sermon that he delivered during his farewell pilgrimage, he exhorted men

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cooperation with each other. (See al-Sarakhsī (d.483/1090) (n.d.), *al-Mabsut*, Vol. 5, p. 109; al-Qarafi (d.684/1284) (1994), *al-Dhakhirah*, Vol. 13, p. 34).

– "عقد الزواج عقد ازدواج وهو ينبني على المساوات في الأصل" والمراد بالأزدواج معنى المشاركة (السرخسي، المسبوط، ج٥، ص١٠٩).

" إن الزوج والزوجة كالشريكين المتعاونين على المصالح" (القرافي، الذخيرة، ج١٣، ص٣٤).

These *fiqhi* references were indicated to me by my colleague Dr. Sami AlSuwaylem.

(46) The Prophet (pbuh) said: "The best of you is one whose character is best" (Al-Bukhārī, Vol. 8, p.15).

إن من أخيركم أحسنكم خلقا (البخاري، كتاب الآداب، باب لم يكن النبي فاحشا ولا متفحشًا).

(47) Empirical studies have shown that religious commitment leads to lower levels of divorce and greater marital stability (Iannaccon, 1998; Lehrer and Cheswick, 1993; and Gruber, 2005).

(48) Cited from 'Ā'īshah by al-Suyuti in his *al-Jami[al-Saghir* on the authority of Ahmad, Abu Dawud and al-Tirmidhi, Vol... 1, p.102..

عن عائشة رضي الله تعالى عنها، عن البزار، عن انس رضي الله تعالى عنهما، أن رسول الله صلى الله عليه وسلم قال (انما النساء شقائق الرجال) الجامع الصغير للسيوطي، ج١، ص١٠٢، رواه أحمد وأبو داؤود والترمذي.

to fear God in their treatment of women because they (men) have accepted them (women) as a "trust from God".(49) On another occasion, he warned men against usurping the rights of women by taking advantage of their weakness.(50) He also warned them against humiliating their daughters and preferring their sons over them.(51) These, as well as a number of other *ahādīth,* have been interpreted as a testimony of their equal (and not inferior) status and their playing of a complementary role to men in promoting human well-being. 'Umar the second Caliph (d,23/644), felt prompted, therefore, to say that: "During the pre-Islamic period *(al-Jahiliyyah),* we did not consider women to be anything. However, after the coming of Islam, when God Himself expressed His concern for them, we realized that they also had rights over us." (52) There is no reason to believe that nobility of character, good relations between husband and wife, and loving care of children by both parents cannot

(49) Cited from Jabir ibn 'Abdullah by Muslim in his *Sahih, Kitab al-Manasik, Bab hajjat al-Nabiyy,* Vol. 2, p. 889:147; and Abū Dāwūd, *Kitāb al-Manasik, Bab sifat hajj al-Nabiyy;* also Ibn Majah and *Musnad* Ahmad.

عن جابر بن عبد الله رضى الله تعالى عنه، قال: قال رسول الله صلى الله عليه وسلم في خطبة الوداع: "فالتقوا الله في النساء فإنكم أخذ تموهن بأمان الله واستحللتم فروحهن بكلمة الله" (صحيح مسلم، كتاب الحج، باب حج النبي صلى الله عليه وسلم، ج٢، ص٨٨٩ رقم ١٤٧)، (فإنكم أخذ تموهن بأمانة الله)، ابن ماجة، كتاب المناسك، أبو داود، كتاب المناسك.

(50) The actual words of the *hadīth* are: "I forbid usurpation of the right of two weak persons – the orphan and the woman." (Narrated from Abū H□urayrah by al-Hākim in his *Mustadrak,* Vol. 1, p. 63.) This *h□adīth* īs *s□ah□īh* (authentic) on the criteria of Muslim.

عن أبي هريرة رضي الله عنه قال: " قال رسول الله صلى الله عليه وسلم: (إني أحرج عليكم حق الضعيفين: اليتيم والمرأة) مستدرك الحاكم، ج، ص٦٣ ، كتاب الإيمان.

(51) Reported from Ibn 'Abbas by al-Mundhiri on the authority of Abu Dawud and al-Hakim, Vol. 3, p. 68:29.

عن ابن عباس رضي الله تعالى عنه قال، قال رسول الله صلى الله عليه وسلم: من كانت له أنثى فلم يئدها ولم يهنها ولم يؤثر ولده عليها أدخله الله الجنة. رواه أبو داوود والحاكم (المنذري ج٣، ص٨٦، رقم ٢٩).

(52) Narrated from 'Umar by al-Bukhari in his *Sahih, Kītāb al-Libās, Bāb mā kanā al-Nabiyy yatajawwaz min al-libās wa al-bust□,* Vol. 4, p.281: 735.

كنا في الجاهلية لا نعد النساء شيئا، فلما جاء الاسلام وذكرهن الله، رأينا لهن علينا حقا (صحيح البخاري، كتاب اللباس، باب ما كان النبي صلى الله عليه وسلم يتجوز من اللباس والبسط، ج٤، ص٢٨١، رقم ٧٣٥).

lead to fulfillment of the twelfth need of the human personality which is family and social solidarity.

The fulfillment of all the above twelve needs of the human personality should hopefully create an enabling environment for the fulfillment of the thirteenth need of the human personality, which is minimization of crime and anomie. If all these thirteen major needs are duly satisfied, one can hopefully expect that the fourteenth need of mental peace and happiness would also be satisfied. The satisfaction of all these needs should together have a positive effect not only on the human self, intellect, posterity and wealth, but also on faith by creating a more congenial environment for its better understanding and implementation. This should go a long way in promoting sustained development in all sectors of the society, economy and polity.

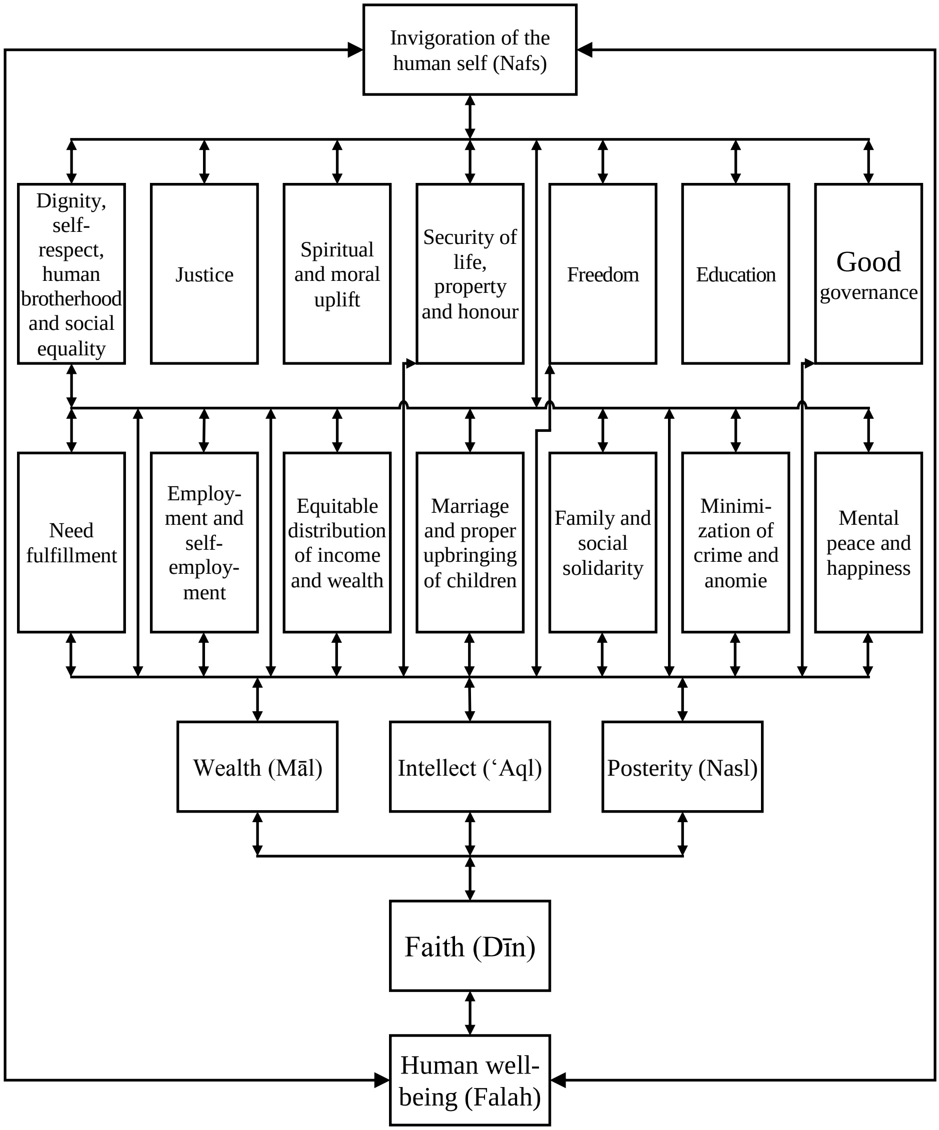
Invigoration of the human self (Nafs)
Dignity, self-respect, human brotherhood and social equality
Justice
Spiritual and moral uplift
Security of life, property and honour
Freedom
Education
Good governance
Need fulfillment
Employ-ment and self-employ-ment
Equitable distribution of income and wealth
Marriage and proper upbringing of children
Family and social solidarity
Minimi-zation of crime and anomie
Mental peace and happiness
Wealth (Māl)
Intellect (‘Aql)
Posterity (Nasl)
Faith (Dīn)
Human well-being (Falah)

Fig. (2)

ENRICHING FAITH, INTELLECT, POSTERITY AND WEALTH

While the ultimate *Sharī'ah* goal of ensuring the well-being of all people cannot be realized without reforming and strengthening the human self, it is also necessary to strengthen the four other primary *maqasid* (faith, intellect, posterity and wealth). All these four have a strong role to play in the reform and enrichment of the human self. If these four are not strengthened in keeping with the challenges created by changing circumstances, optimum well-being of the present and future generations will fail to be realized and even the long-run survival of the civilization may itself be jeopardized.

Strengthening Faith

The first question that may arise in the reader's mind is about why has faith been placed immediately after the human self in the present-day world where secularism, liberalism and materialism rule the roost. Does faith really deserve the importance that such a sequence of the *maqasid* signifies? The undeniable fact, however, is that, if human beings are the end as well as the means of development, then their reform as well as well-being need to be given the utmost importance. It is the religious worldview which carries the greatest potential of ensuring the reform of the human self in a way that would help ensure the fulfillment of all the spiritual as well as material needs of the human personality specified above. This it does by injecting a meaning and purpose into life, providing the right direction to all human effort, and transforming individuals into better human beings through a change in their behaviour, life-style, tastes, preferences, and attitude towards themselves as well as their Creator, other human beings, resources at their disposal, and the environment. This is why the Qur'an has clearly indicated that "he succeeds who purifies his own self, remembers his Lord and prays" (87:14-15; see also 91: 9-10). Accordingly, all Muslim scholars have also emphasized the need for reform of human beings and the role that faith plays in such reform.

Toynbee and the Durants have also rightly concluded after their extensive study of history, that moral uplift and social solidarity are not possible without the moral sanction that religions provide. Toynbee asserts that "religions tend to quicken rather than destroy the sense of social obligation in their votaries" and that "the brotherhood of man presupposes the fatherhood of God – a truth which involves the converse proposition that, if the divine father of the human family is left out of the reckoning, there is no possibility of forging any alternative bond of purely human texture which will avail by itself to hold mankind together."[53] Will and Ariel Durant have also observed forcefully in their valuable book, *The Lessons of History*, that "there is no significant example in history, before our time, of the society successfully maintaining moral life without the aid of religion."[54]

This raises the question of why are moral uplift and social solidarity not possible without the aid of faith. This is because two of the foremost requisites for moral uplift are: first, the existence of values or rules of behaviour which command such a wide and unconditional acceptance that they become categorical imperatives; and secondly, the observance of these rules by everyone with a sense of moral obligation such that anyone who violates them gets censured. This raises another question of how to arrive at rules which are unconditionally accepted and observed by everyone. Is it possible to arrive at such rules by means of 'social contract' as suggested by some secularist modern philosophers and political scientists? The answer may be yes only if all participants in the discussion are socially, economically and intellectually equal so that everyone has an equal weight in the formulation of the desired rules. Since such equality is impossible to find, the rich and powerful will tend to dominate the decision-making process and lead to the formulation of rules that serve their own vested interests. This would frustrate the universal acceptance and observance of the rules that have been formulated. It is, therefore, necessary that an omniscient and benevolent outsider be assigned this task - an outsider who is impartial, who knows the strengths and weaknesses of all human beings, who treats them all as equals, who cares for the well-being of all without any discrimination, and who is capable of analyzing not only the short-term but also the long-term effects of the rules given by him. Who could be more qualified to take this position than the Creator of this Universe and of human beings Himself?

(53) Toynbee, Somervell's abridgement, 1958, Vol.2, p. 380 and Vol.1, pp 495-96.
(54) Will and Ariel Durant, 1968, p. 51.

The Creator has done this job. According to the Islamic worldview, He has sent, as indicated earlier, His guidance to all people at different times in history through a chain of His Messengers (who were all human beings), including Abraham, Moses, Jesus and, the last of them, Muhammad, peace and blessings of God be on all of them. Thus, there is a continuity and similarity in the basic worldview and value system of all Revealed religions to the extent to which the Message has not been lost or distorted over the ages. Human beings, as vicegerents of God, have the mission of faithfully observing the values given by their Creator. This is their mandate during their brief sojourn in this world. If they utilize the scarce resources, which are a trust in their hands, and interact with each other in accordance with these rules, it may not only be possible to ensure the well-being of all humans but also to protect the environment, including animals, birds and insects. “Social morality”, as Schadwick has rightly observed, “depends on agreed standards, upon a consensus which is received as so axiomatic that it hardly ought to be discussed”, and that, “except in the case of a small number of exceptional groups of people, morality never had been separated from religion in the entire history of the human race."[(55)] Bernard Williams is, therefore, right in observing that "social morality is not an invention of philosophers".[(56)]

However, even when we have the values that command wide and unconditional acceptance, there arises the question of how to ensure the observance of these values by everyone. Living up to these values requires a certain degree of sacrifice of self-interest on the part of all individuals. How does faith help motivate an individual to live up to these values and to fulfill all his/her social, economic and political obligations that involve a sacrifice of self-interest. Faith tries to accomplish this by giving self-interest a long-term perspective – stretching it beyond the span of this world, which is finite, to the Hereafter, which is eternal. An individual’s self-interest *may* be served in this world by being selfish and not fulfilling his/her obligations towards others. His/her interest in the Hereafter cannot, however, be served except by fulfilling all these obligations.

(55) Schadwick, 1975, pp.229 and 234.
(56) Williams, 1985, p. 174

It is this long-term perspective of self-interest, along with the individual’s accountability before the Supreme Being and the reward and punishment in the Hereafter, which has the potential of motivating individuals and groups to faithfully fulfill their obligations even when this tends to hurt their short-term self-interest. It would be highly irrational for a person to sacrifice his long-term eternal well-being for the sake of a relatively short-term this-worldly benefit. This dimension of self-interest has been ignored by Conventional Economics after being cast in its secularist Enlightenment worldview. It has, therefore, no mechanism to motivate individuals to sacrifice for the well-being of others.

However, even the existence of values and motivating system may not be very helpful unless people get acquainted with these. Therefore, Islam makes it obligatory for every Muslim to have a proper grounding not only in the Islamic worldview and values but also in the existing knowledge base and technology (see the section on Intellect). This would not only help them be better Muslims and open up for them employment and self-employment opportunities that would enable them to stand on their feet in keeping with their dignity, but also enable their society to accelerate development, reduce poverty, and inequalities in the distribution of income and wealth. This would get a further boost if the financial system is also reformed in a way that would enable it to make financing available to a large spectrum of society on the basis of the Islamic modes of financing.(57)

Islam also aims at creating an enabling environment that is conducive to righteousness, the strengthening of family and social solidarity, and the promotion of mutual care and cooperation among individuals. Without such an enabling environment, the values as well as the motivating system may both become blunted. Congregational prayers, fasting in Ramadan, *zakāh* and pilgrimage, along with the society’s respect of, and admiration for, those who abide by moral norms and disdain for those who violate them (*amr bi al-ma’rūf wa nahī ‘an al-*

(57) There is a great deal of literature available now on the subject, which it is not possible to encompass here. The reader may see, for example Chapra, 2007a and 2007b.

munkar) are a part of the Islamic programme to create such an environment.

The existence of such an enabling environment can help promote the desired qualities in individuals and curb the vices that jeopardize the realization of humanitarian social goals. For example, the promotion of simple living and the reduction of wasteful and conspicuous consumption can help reduce excessive claims on resources. This may not only release a greater volume of resources for general need-fulfillment, which is necessary for promoting social harmony, but also enhance saving and investment and, thereby, help promote higher employment and growth. The absence of a discussion of such values and environment in microeconomics has created a gulf between it and macroeconomics. Without a discussion of the kind of behaviour and tastes and preferences that are needed in individuals, families and firms to realize the humanitarian macroeconomic goals, these goals hang in the air without support. The humanitarian goals of macroeconomics are, thus, out of tune with microeconomics as a result of the latter's excessive stress on individualism and the serving of self-interest through the maximization of wealth and want satisfaction.

The Enlightenment movement of the 17th and 18th centuries tried to undermine this role of religion in the West by its secular and materialist worldview. It, however, succeeded only partially because Christian values continued to prevail until they gradually started becoming weaker and weaker. The sour fruits of this development have raised protests and the religious worldview is having a comeback around the world.[(58)] Schweitzer, a Nobel Laureate, has rightly emphasized that "if ethical foundation is lacking, then civilization collapses even when in other directions creative efforts of the strongest nature are at work".[(59)] Therefore, according to him, "moral control over men's dispositions is much more important than control over nature".[(60)] More recently Benjamin Friedman, a Harvard Professor, has also argued in his recent

(58) The editors of *Religion in Contemporary Europe* admit that they are seeing the beginning of the end of 200 years of hostility towards religion (Fulton and Gee, 1994)
(59) Schweitzer, 1949, p.xii.
(60) Schweitzer, 1949, pp. 22-23, 38-39, 91.

book that moral growth and economic growth go hand in hand, reinforcing each other.(61) Long before these Western authors, al-Ghazālī, al-Shatībī and a number of other Muslim scholars, assigned a place of great prominence to faith in the realization of human well-being.

A question that may be raised here is about whether the injection of faith into the picture would lead to the curbing of human freedom. Not necessarily. Human beings are still free to choose. They may either live up to the demands of their faith or reject them. This freedom to choose is emphasized in several verses of the Qur'ān, one of which says: "The truth has come from your Lord. Whoever wishes may believe in it and whoever wishes may reject it" (18:29). However, even if they reject faith, they cannot have absolute freedom. There are curbs on freedom in every society in the form of rules of behaviour. For example, a red traffic light is also a curb on individual freedom. Nevertheless, nobody minds it because everyone knows that this promotes the *maqasid* by helping prevent accidents, saving people from harm and, thereby, enhancing well-being.

The Role of the State

Faith alone cannot, however, help realize human well-being. It is unrealistic to assume that all individuals will become morally conscious in human societies as a result of belief in God and accountability before Him in the Hereafter. Moreover, even if a person is morally conscious, it is possible that he/she may be simply unaware of the social priorities in resource use. This makes it incumbent upon the state to play a complementary role. The Prophet (pbuh), therefore, clearly stated that "God restrains through the sovereign more than what he restrains through the Qur'ān."(62) The Qur'ān can only give values, it cannot by itself enforce them. It is the job of the state to do so. It is the moral and legal

(61) Friedman, 2005.

(62) إن الله ليزع بالسلطان أكثر مما يزع بالقرآن (Cīted by al-Māwardī, 1955, p. 121).

"Ibn 'Ashur has rightly indicated that if the *Shari'ah* is not respected by everyone and does not get duly enforced, the benefit expected to be derived from it will not be fully realized (2001, p.376),

"من مقاصد الشريعة من التشريع أن يكون نافذًا في الأمة وأن يكون محترمًا من جميعًا، إذ لا تحصل المنفعة المقصودة منه كاملة بدون نفوذه واحترامه" ابن عاشور، ص٣٧٦.

responsibility of the state to ensure justice and the well-being of the people. The Prophet (phub) said: "Anyone who has been given the charge of a people but does not live up to it with sincerity, will not taste even the fragrance of paradise". [63] This has also become reflected in the writings of a number of classical as well as modern writers. For example, Imam Hasan al-Banna stressed that governments are the heart of socio-economic reform; if they become corrupt, they may corrupt everything and, if they are reformed, they may be able to reform everything.[64]

The state should, however, try to perform the task in a way that does not make it totalitarian and despotic. Curbing of individual freedom excessively will hurt the initiative and innovation on the part of individuals and groups. For this purpose, it is imperative to have effective checks and balances on the state through a number of institutions, including the *shura* (parliament), an honest judiciary, a free press, and properly conceived laws and regulations. These need to be buttressed by appropriate material incentives and deterrents to reinforce the moral base of society and to create an enabling environment. Nevertheless, there is no escape from proper moral upbringing and education of individuals to motivate them to do what is right and abstain from doing what is wrong on their own volition.

The greater the motivation people have to implement Islamic values on their own volition, and the more effective socio-economic, judicial and financial institutions are in creating a proper environment for the realization of a just socio-economic order, the lesser may be the role of the state in enforcing the rules of behaviour and realizing the desired social goals. Moreover, the greater the accountability of the political

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(٦٣) عن معقل بن يسار رضي الله تعالى عنه، قال: سمعت النبي صلى الله عليه وسلم يقول: "ما من عبد استرعاه الله رعية فلم يحطها بنصيحةٍ إلا لم يجد رائحة الجنة" (رواه البخاري، ج٩، ص٨٠، كتاب الأحكام، باب من استرعي رعية فلم ينصح).

Al-Bukhārī, from Ma‘qil Ibn Yasar, Vol. 9, p. 80, *Kitāb al-Ahkām*.

(٦٤) "الحكومة ولا شك قلب الإصلاح الاجتماعي كله، فإذا فسدت أوضاعها فسد الأمر كله، وإذا صلحت صلح الأمر كله" (مجموعة رسائل الإمام الشهيد حسن البنا، باب مشكلاتنا الداخلية في ضوء النظام الاقتصادي، ١٩٨٩م، ص٢٥٥).

Īmam Hasan al-Bannā, *Majmu‘ah Rasā'il al-Imām al-Shahīd Hasan al-Bannā"* (1989), p. 255.

leadership before the people, and the greater the freedom of expression and success of the parliament, the courts and the news media in exposing and penalizing inequities and corruption, the more effective the Islamic state may be in fulfilling its obligations. A number of techniques adopted in other societies to safeguard social interest may have to be adopted even in Muslim countries, if indeed such techniques have been found to be effective.

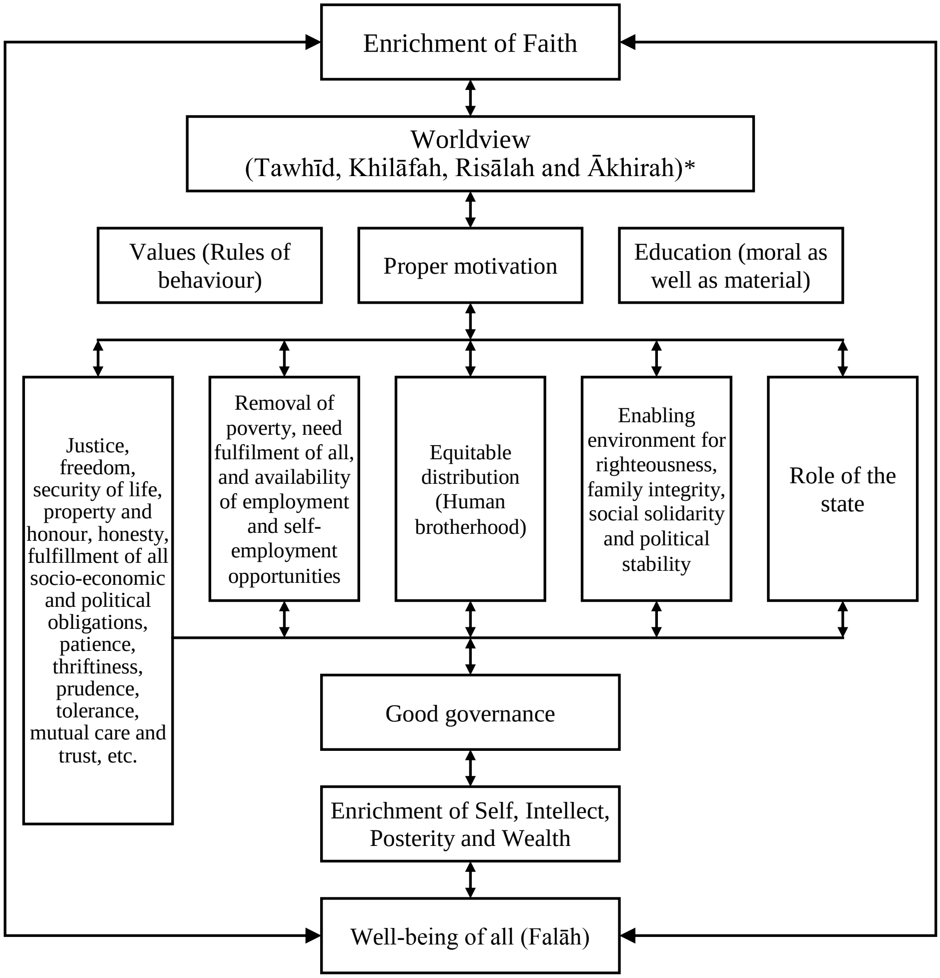

Fig. (3)

*These words stand for the unity of God (*tawhid*), vicegernncy of human beings (*khilafah*), Guidance sent by God though His Messengers (*risalah*) and human accountability before God on the Day of Judgment about how he/she lived in this world and utilized the resources provided by Him (*akhirah*).

Enrichment of Intellect *('Aql*)

Intellect is the distinguishing characteristic of a human being and needs to be enriched continually to improve the individual's own as well as his society's knowledge and technological base and to promote development and human well-being. According to al-Ghazali, "Intellect is the fountainhead, starting point, and foundation of knowledge. Knowledge proceeds from it just like fruit from the tree, light from the sun, and vision from the eye. If so, then why shouldn't it be honoured for being the source of success in this world as well as the Hereafter."(65) The emphasis given to the role of faith in realizing the Islamic vision of development does not necessarily mean the downgrading of intellect. This is because revelation and reason are like the heart and mind of an individual and both of them have a crucial role to play in human life. Neither of these two can be dispensed with if optimum human well-being is desired to be realized.

It is faith which provides the right direction to intellect. Without the guidance of faith, intellect may lead to more and more ways of deceiving and exploiting people and creating weapons of mass destruction. However, while the intellect requires guidance from faith to be of service to mankind, faith also requires the service of intellect to maintain its dynamism, to respond successfully to the changing socio-economic and intellectual environment, to develop the kind of technology that can accelerate development in spite of scarcity of resources, and to play a crucial role in the realization of the *maqāsid.* Therefore, as stated earlier, reason and revelation are both necessary and interdependent. Their harmonious use can lead to development of the kind of knowledge and technology that can promote real human well-being and not destruction. The neglect of any one of the two cannot but ultimately lead to decline. The Qur'ān itself strongly asserts the use of reason and observation (al-Qur'ān, 3:190-91, 41:53).

(65) Al-Ghazali, Ihya', Vol... 1, p.83.

والعقل منبع العلم ومطلعه وأساسه والعلم يجري منه مجري الثمر من الشجرة والنور من الشمس والرؤية من العين، فكيف لا يشرف ما هو وسيلة السعادة في الدنيا والآخرة (الغزالي، أحياء علوم الدين، ج١، ص ٨٣).

This emphasis has become reflected in the writings of most Muslim scholars throughout history. For example, Ibn Taymiyyah (d.728/1328) clearly stressed that the derivation by Muslims of their beliefs, prayers and values from the Qur'ān, the *Sunnah*, and the consensus of the *Ummah*, is "not in conflict with reason, because whatever clearly conflicts with reason stands rejected (*bāt□il*)."(66) He further argued that people do not perhaps appreciate that the texts of the Qur'ān and the *Sunnah* consist of words and that it is possible for them to understand these words incorrectly or to interpret them wrongly. So the problem lies with the interpreters and not with the Qur'ān and the *Sunnah*.(67) Must□afā al-Zarqā, a prominent and respected religious scholar of the 20th century as well as a Faysal laureate, has also clearly declared that "it is well-established among the *'ulama'* that there is nothing in the beliefs and teachings of Islam which is in conflict with intellect."(68)

This shows that faith and intellect are both interdependent and need to be used in such a way that they strengthen each other and help realize the *maqāsid.* Without the active role of intellect, it may not be possible to exercise *ijtihād* and to evaluate rationally all the interpretations of the Qur'ān and the *Sunnah* as well as the *fiqhi* verdicts against their impact on the actualization of the *maqāsid*. Any interpretation or verdict which is not in harmony with the *maqāsid* and is likely to lead to outcomes which may hurt human well-being, needs to be reconsidered carefully and either adjusted or rejected outright. This has been emphasized by a number of prominent scholars of *Sharī'ah*. Imām al-Haramayn, Abu al-Ma'ālī al-Juwaynī (d.478/1085) said that: "Whoever does not

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(٦٦) فيأخذ المسلمون جميع دينهم من الاعتقادات والعبادات وغير ذلك من كتاب الله وسنة رسوله، وما اتفق عليه سلف الأمة وأئمتها، وليس ذلك مخالفًا للعقل الصريح، فإن ما خالف العقل الصريح فهو الباطل، (ابن تيمية، مجموع الفتاوى، ج١١، ص٤٩٠).

Ibn Taymiyyah, *Majmū' al-Fatāwā*, Vol... 11, p. 490.

(٦٧) ولكن فيه الفاظ قد لا يفهمها بعض الناس، أو يفهمون منها معنى باطلا، فالآفة منهم لا من الكتاب والسنة (ابن تيمية، مجموع الفتاوى، ج١١، ص٤٩٠).

(Ibn TaymIyyah, *Majumū ' al-Fatāwā,* Vol... 11, p. 490).

(68)Mustafa al-Zarqa, Al-[-Aql wa al-Fiqh, 1996, p. 14.

"من المقرر الثابت عند علماء الإسلام أنه لا يوجد في عقيدته وأحكامه ما يصادم العقل"(مصطفى د. الزرقا، العقل والفقه، ١٩٩٦م، ص١٤).

comprehend the role of *maqāsid* in the do's and dont's of the *Sharī'ah* lacks insight in its implementation"(69) Shaykh Muhammad al-Tāhir ibn 'Āshūr also stated that: "Most of the issues in *usūl al-fiqh* (principles of Islamic jurisprudence) have become confined to the derivation of verdicts from the words of the Law-Giver rather than being used to serve the purpose or objectives of the *Shari'ah*".(70) The unfortunate result of this is that "many of the *'Ulūm-al-Diniyyah* (religious sciences), including *usul al-fiqh,* have lost the true spirit from which it benefited in the earlier periods. The revival of this spirit is the most crucial imperative for the renaissance of religious knowledge".(71)

Emphasis on the *maqāsid* rather than on just the letter in the interpretation of texts should help in not only restoring the real luster of Islamic teachings but also in reducing the differences of opinion as well as the prevailing conflicts, fanaticism, intolerance, and undue emphasis on appearances. However, such a complementary and harmonious role of intellect and revelation may not be possible without creating in the Muslim countries an educational system which combines the teaching of modern sciences with religious sciences and trains the students to think, analyze and interpret the texts rationally in the light of the *maqāsid* with a view to restore the dynamism of Islam and enable it to face the challenges of modern life.

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(69) Al-Juwayni (d.478/1085), *al-Ghiyathi*, 1400, Vol... 1, p. 295.

"وأن من لم يتفطن لوقوع المقاصد في الأوامر والنواهي ليس على بصيرة في وضع الشريعة". (إمام الحرمين أبو المعالي عبدالملك الجويني، الغياثي (غياث الأمم في التياث الظلم) تحقيق: عبدالعظيم الديب، ١٤٠٠هـ، ج١، ص ٢٩٥).

(70) Muhammad al-Tāhir ibn [Āshūr, *Maqāsid al-Sharī'ah al-Islāmiyyah*, 2nd ed. 2001, p. 166).

"أن معظم مسائل أصول الفقه لا ترجع إلى خدمة الشريعة ومقصدها، ولكنها تدور حول محور استنباط الأحكام من ألفاظ الشارع ..." الشيخ محمد الطاهر ابن عاشور، مقاصد الشريعة الإسلامية، تحقيق محمد طاهر الميساوي، دار النفائس، الأردن، ط٢، ٢٠٠١م، ص١٦٥-١٦٦.

(71) Abī al-Fadl 'Abd al-Salām (1424/2004), pp. 576-7.

"إن هذا الطرح لهذه القضية الجسيمة ليوقظ في النفس شعورًا قويًا بأن كثيرًا من العلوم الدينية، ومنها أصول الفقه، فقد فقدت الروح العالية التي كانت تتمتع بها في عهودها الأولى، وأن استعادة تلك الروح هي اليوم من أعظم الضرورات لتحقيق نهضة علمية دينية". أبي الفضل عبدالسلام بن محمد بن عبدالكريم، التجديد والمجددون في أصول الفقه، القاهرة، المكتبة الإسلامية، ص ٥٧٦-٥٧٧.

It is but natural that a worldview which places so much emphasis on the reform and socio-economic uplift of human beings would attach great importance to education. No wonder the very first Revelation of the Qur'an to the Prophet required him to "Read in the name of the Lord…Who taught man through the use of pen what he did not know" (al-Qur'an, 96: 1-5). Even the Prophet (pbuh), gave a high place to learning in the Islamic worldview by making it obligatory for every Muslim man or woman to seek knowledge, and equating the superiority of a learned man over a mystic to that of the full moon over all other stars.(72) It is only through a combination of religious and science education that a proper grounding can be provided to the people to know the values of their society, raise their skills to enable them to earn their livelihood in a morally lawful (*halāl)* way, and to make it possible for them to contribute fully to the development of science and technology and the realization of the *maqāsid*. In keeping with the emphasis on education in the Qur'an and *Sunnah*, the *fiqh* literature has also done the same. Abū Zahrah, one of the outstanding jurists of the twentieth century, says that it is necessary "to train a person so that he is a source of benefit, and not of harm, to his society".(73)

However, education and research have to be of high quality if they are desired to serve the purpose of accelerated moral, material and technological development of Muslim societies. This purpose may remain a fond hope if proper research and library facilities are not

(72) The two *hadīths* are: "The quest for knowledge is the duty *(faridah)* of every Muslim", and "the superiority of a learned man (*'alīm)* over a mystic *('abid)* is like that of the full moon over all other stars," (Both are reported by Ibn Majah, the first from Anas Ibn Malik and the second from Abu al-Darda', Vol.1, p.81, numbers 223 and 224, *al-Muqaddimah,* Bab: 17- *fadl al-'ulama' wa al-haththh 'ala talab al-'īlm).* For other *ahadīth* on the subject of learning and teaching, see pp. 80-98. See also al-Qurtubi (d. 463/1070). *Jami' Bayan al-'llm wa Fadluhu,* Vol. 1, pp 3-63, and al-Ghazali (d. 505/1111), *Ihya'*, Vol. 1, pp. 4-82)

الحديث الأول عن أنس ابن مالك رضي الله تعالى عنهما قال: قال رسول الله صلى الله عليه وسلم: "طلب العلم فريضة على كل مسلم" (ابن ماجة، مجلد١، ص٨١، رقم ٢٢٤، المقدمة، باب فضل العلماء والحث على طلب العلم). والحديث الثاني عن أبي الدرداء، رضي الله تعالى عنه، قال: قال رسول الله صلى الله عليه وسلم" إن فضل العالم على العابد كفضل القمر على سائر الكواكب" (المرجع السابق، حديث رقم ٢٢٣).

(73) Abu Zahrah, *Usul of-Fiqh*, 1957, p. 350.

provided, there is no freedom of thought and expression, creative work does not get properly rewarded, and appointments and promotions are based on connections and sycophancy rather than on merit and contributions made to society. The lack of financial resources may tend to be a hindrance in promoting high quality education. However, if education, research and technological advancement are considered to be important for development, then corruption must be minimized and resources must be squeezed from wherever it is possible (Figure 4).

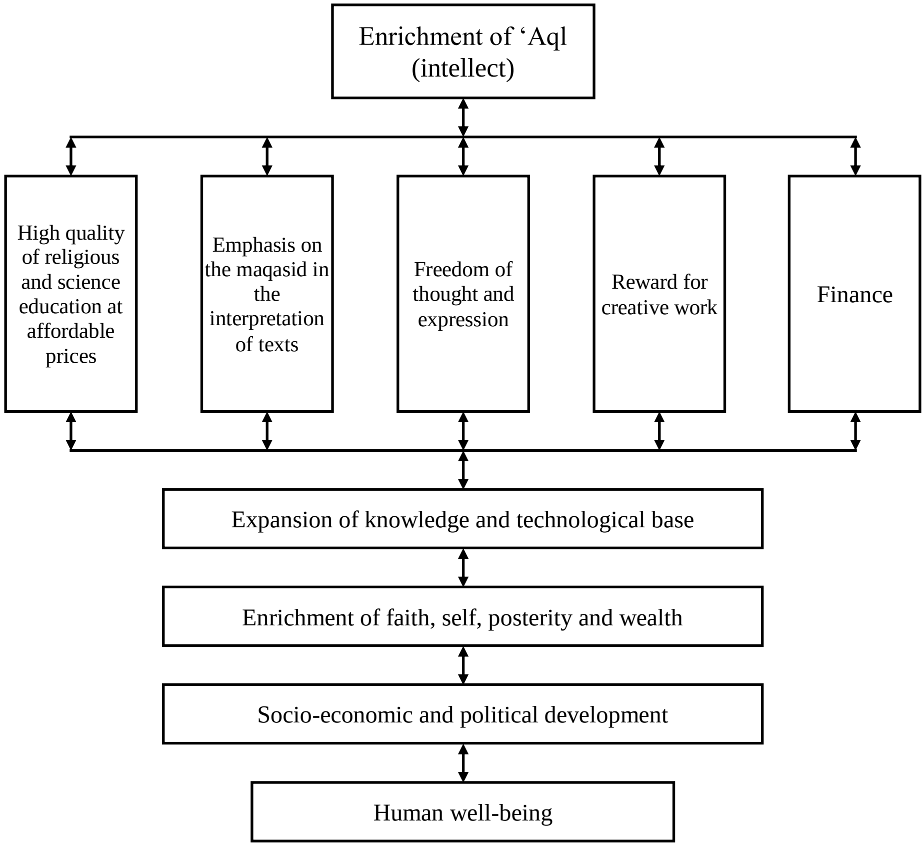

Fig. (4)

Enrichment of Posterity (*Nasl)*

No civilization can survive if its future generations are spiritually, physically, and mentally of a lower quality than the previous ones and are, therefore, unable to respond successfully to the challenges that they face. There must, therefore, be continuous improvement in the quality of the future generation, which depends on a number of factors. One of these is the kind of upbringing that the children are able to get. In order to make them good Muslims, it is necessary to inculcate in them all the noble qualities of character *(khuluq hasan)* that Islam requires in its followers. They should learn from their very childhood to be honest, truthful, conscientious, tolerant, punctual, hard working, thrifty, polite, respectful towards their parents and teachers, willing to fulfill all their obligations towards others, particularly their subordinates, the poor and the disadvantaged, and able to get along with others peacefully.

The family is the first school for the moral upbringing of children and, if this school fails to inculcate in them the good qualities of character *(khuluq hasan)* that Islam expects in its followers, it may be difficult to overcome the setback later on. The family may not, however, be able to fulfill this tremendous responsibility satisfactorily if the character of the parents themselves does not reflect the luster of Islamic teachings. In this case, they will not be able to serve as role models for their children and will not be able to provide them the quality of care and upbringing that they need to be good and productive human beings. In addition, there has to be an atmosphere of love, affection and tranquility in the family as desired by the Qur'ān (39:21). Such an atmosphere will prevail only if the parents fulfill their responsibilities towards each other conscientiously and amicably. Nothing can be worse for the children than the constant bickering of parents. Such a discord may ultimately lead to divorce, which will have a detrimental impact on the children's moral, mental and psychological development.(74) This is the reason why, even though Islam has allowed divorce, the Prophet (pbuh) said: "Of all the things allowed by God, the one despised by Him most is divorce"(75), and

(74) Empirical studies have established that youth raised in highly religious homes are less likely to engage in criminal activity (use drugs or alcohol, or engage in premarital sex (Iannaccon, 1998, p. 1476; see also Bachman, et.al, 2002; Wallace and Williams, 1997; and Gruber 2005). See also, Fukuyama, 1997.

(75) Cited by al-Qurtubī from Ibn 'Umar in his commentary of verse 1 of surah (al-Talāq),Vol.18, p. 149.

that "Get married but do not divorce because divorce leads to the trembling of the Divine throne".[(76)] Therefore, in the interest of children's well-being it is necessary to avoid discord and divorce as much as possible and, in case it becomes inevitable, to do everything possible to save them from it's adverse effects.

In addition to the integrity of the family and the proper moral upbringing of children, a second factor that is necessary for the enrichment of posterity is their proper education to provide them the skills that they need to enable them to stand on their own feet and to contribute effectively to the moral, socio-economic, intellectual and technological development of their societies. For this purpose, it is indispensable to have high quality schools, colleges and universities. This is the area where Muslims have failed badly over the last few centuries after several centuries of commendable performance. Therefore, unless education is given the priority that it deserves and the resources that it needs, Muslim countries may not be able to accelerate development and to meet successfully the challenges that they face. The clear message written boldly on the walls is: 'education', 'education', and 'education'. Education will, however, not spread as desired unless it is provided free and, if this is not feasible, at affordable costs. Without this, only the rich will be able to afford good quality education for their children. This will intensify the prevailing inequalities of income and wealth and, in turn, accentuate social tensions and instability. Lack of resources is a lame excuse because the crucial importance of education in development demands that it be given maximum priority even if this necessitates the diversion of resources from other sectors.

There are two other factors which are indispensable for the enrichment of posterity. One of these is the fulfillment of all their needs, including health care, so that they are physically and mentally healthy and capable of playing their roles effectively in their society. The Prophet (pbuh), said that "A strong Muslim is better and more beloved before God than a weak one."[(77)] If the children do not get proper nourishment

(76) *Ibid*, from 'Ali ibn Abi Talib (تزوجوا ولا تطلقوا فإن الطلاق يهتز منه العرش).

(٧٧) المؤمن القوي خير وأحب إلى الله من المؤمن الضعيف (Ibn Majah, Vol. 1, p. 31:79).

along with a clean and healthy environment and proper medical care, they may not grow up to be strong and healthy adults and may not, thus, be able to contribute richly to their societies even if they are morally upright and well-educated.

The other factor that is also necessary for the enrichment of posterity is freedom from fear, conflict and insecurity as well as the debt-servicing burden created by the present generation's borrowing for consumption purposes. Fear, conflict and insecurity may be reduced by adopting a policy of tolerance and peaceful coexistence. It is also necessary to allocate adequate resources for the cultivation of better understanding among the people and the removal of all irritants. The debt-servicing burden may be reduced by adopting two important measures. One of these is a change in the life-style of the present generation with a view to curb living beyond means. This will not only reduce private sector debt but also help raise saving and expand employment opportunities for the young. The other measure that is also indispensable is to introduce greater discipline in government budget to reduce the deficits which lead to a rise in the debt-servicing burden. This will also help release resources needed for ensuring progress in the realization of the *maqasid*.

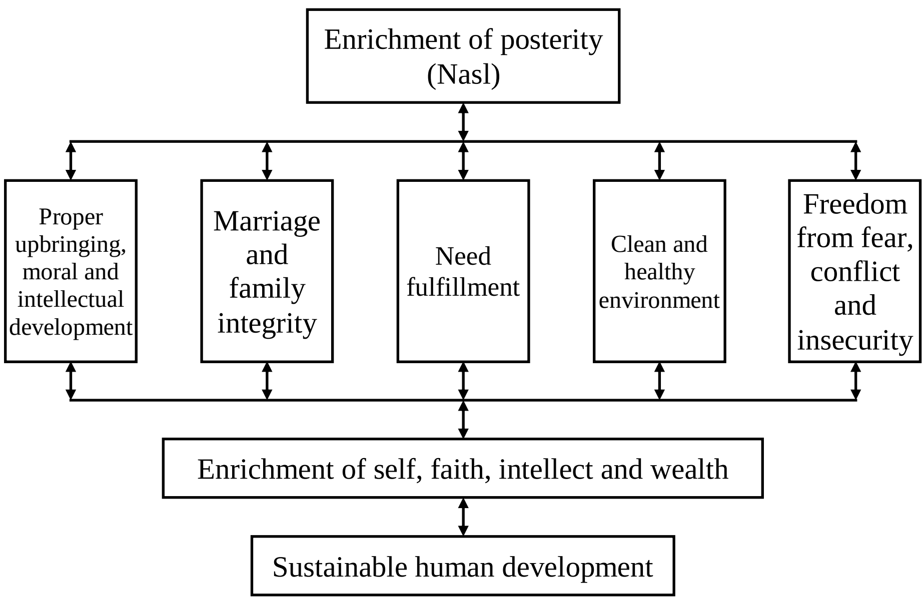

Fig. (5)

Development and Expansion of Wealth

Wealth is placed by both al-Ghazālī and al-Shātibī at the end. This does *not* necessarily mean that it is the least important. It is rather as important as the other four primary *maqāsid* because without it the other four may not be able to get the kind of thrust that is needed to ensure general well-being. No wonder, asceticism and self-denial have been disapproved by both the Qur'ān and the *Sunnah*. The Qur'ān says: "And the monasticism which they have invented, we did not prescribe it for them" (57:27). This may perhaps be the reason why the Prophet, (pbuh) said that "There is nothing wrong in wealth for him who fears God [i.e., abstains from evil]",(78) and that "Whosoever is killed while protecting his property is a martyr"(79) It may perhaps be because of this that wealth (*māl*) has been placed immediately after the human self (*nafs*) in the ordering of the five *maqāsid* by Fakhruddīn al-Rāzī, (d.606/1209), a prominent jurist and Qur'ān commentator.(80)

Wealth is, however, a trust form God and needs to be developed and used honestly and conscientiously for removing poverty, fulfilling the needs of all, making life as comfortable as possible for everyone, and promoting equitable distribution of income and wealth. Its acquisition as well as use need to be primarily for the purpose of realizing the *maqāsid*. This is where faith has a crucial role to play through its values and its motivating system. Without the values that faith provides, wealth would become an end in itself. It would then promote unscrupulousness and accentuate inequities, imbalances and excesses, which could ultimately reduce the well-being of most members of both the present and future generations. It is for this reason that the Prophet (pbuh) said: "Wretched is the slave of dinar, dirham and velvet".(81) Therefore, faith and wealth are both extremely necessary for human well-being. None of these two can be dispensed with. While it is wealth which provides the resources

(78) Al-Bukhārī, *al-Adab al-Mufrad,* p. 113:301, *Bāb Tīb al-Nafs.*

(79) "من قتل دون ماله فهو شهيد" (Sahih al-Bukhari, *Kitab al- Mazalim, Bab man qatala duna malihi fahuwa shahid;* and *Sahih Muslim,Kitab al-Iman).*

(80) Al-Rāzī ,*al-Mahsūl*, 1997, Vol.5, p.160.

(٨١) "تعس عبدالدينار وتعس عبدالدرهم وتعس عبدالقطيفة الذي إذا أعطى رضي وإن لم يعط لم يرض." Sahih al-Bukhari, *Kitab al- Jihad wa al-Siyar.*

that are necessary to enable individuals to fulfill their obligations towards God as well as their own selves, fellow human beings, and the environment, it is faith which helps inject a discipline and a meaning in the earning and spending of wealth and, thereby, enable it to serve its purpose more effectively.(82)

Development of wealth is also imperative for realizing the crucial Islamic goal of minimizing the inequalities of income and wealth. For this purpose, it would be a mistake to place primary reliance on the redistributive methods of *zakāh, sadaqāt* and *awqāf*. While all of these are indispensable, it is also important to enlarge the national pie though economic development. Putting too much burden on the rich through excessively high rates of taxes would be resisted by them, as the Qur’an has been realistic to admit (47:37).(83) Crossland rightly pointed out in the light of the socialist experience that "any substantial transfer involves not merely a relative but also an absolute decline in real incomes of the better-off half of the population…and this they will frustrate".(84) The experience of Muslim countries may not tend to be significantly different even when moral transformation has taken place if excessive reliance is placed on redistributive methods. Therefore, Muslims cannot afford to ignore the role of economic development in reducing poverty and inequalities. This would necessitate the strengthening of human resources through a cultural transformation in favour of education, technological advance, hard and conscientious work, punctuality, efficiency, research, orderliness, team work, thrift and a number of other individual and social character traits which Islam emphasizes but which are at present

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(82) It is for this reason that the Prophet (pbuh) said: “A person will not be able to move on the Day of Judgment until he has been asked four questions : about his knowledge, how much he acted upon it; about his life, how he utilized it; about his wealth, how he earned it and where he spent it; and about his body, how he wore it out” (cited by Abū Yusuf, in his *Kitab al-Kharaj*, p. 4)

قال صلى الله عليه وسلم: "لا تزول قدما عبد يوم القيامة حتى يسئل عن أربع: عن علمه ماذا عمل به وعن عمره فيم افناه وعن ماله من أين اكتسبه وفيم أنفقه وعن جسده فيم ابلاه (أبو يوسف، كتاب الخراج، ص٤).

(83) The verse states: “If He [God] were to ask you for your wealth and press you for it, you would covetously withhold it and, thereby, He will expose your resentment (47:37).

(84) Crossland, 1974.

relatively weak in Muslim societies and which do not even get the desired emphasis in the school and *madrasah* curricula as well as mosque sermons. In addition to the uplift of human resources, it is also necessary to reorient monetary, fiscal and commercial policies in the light of Islamic teachings to ensure accelerated development. There should be no qualms about benefiting from the experience of other countries that have been able to attain high rates of growth in a manner which is not in conflict with the Shari‘ah.

To inject greater justice into the developmental process, it is also necessary to promote micro-enterprises to expand employment and self-employment opportunities for the poor. This may not be possible without promoting vocational training and microfinance, and providing the badly needed infrastructure and marketing facilities in rural areas and urban slums. Experience has shown that interest-based microfinance has not led to as much improvement in the lives of the hard core poor as desired. This is because the effective rates of interest have turned out to be as high as 30 to 45 per cent. This has caused serious hardship to the borrowers and engulfed them into an unending debt cycle.(85) Owning capital is one of the important bases of wealth creation and the poor may not be able to come out of poverty even if they have the necessary skills if they do not have access to capital. It is, therefore, important to provide microfinance to the very poor on a humane interest-free basis. This will necessitate the integration of microfinance with the *zakāh* and *awqāf* institutions.(86) For those who can afford, the profit-and-loss sharing and sales- and lease-based modes of Islamic finance need to be popularized.

(85) See Ahmad, 2007, pp. xvii – xix and 32

(86) See the Islamic Research and Training Institute Report (2007).

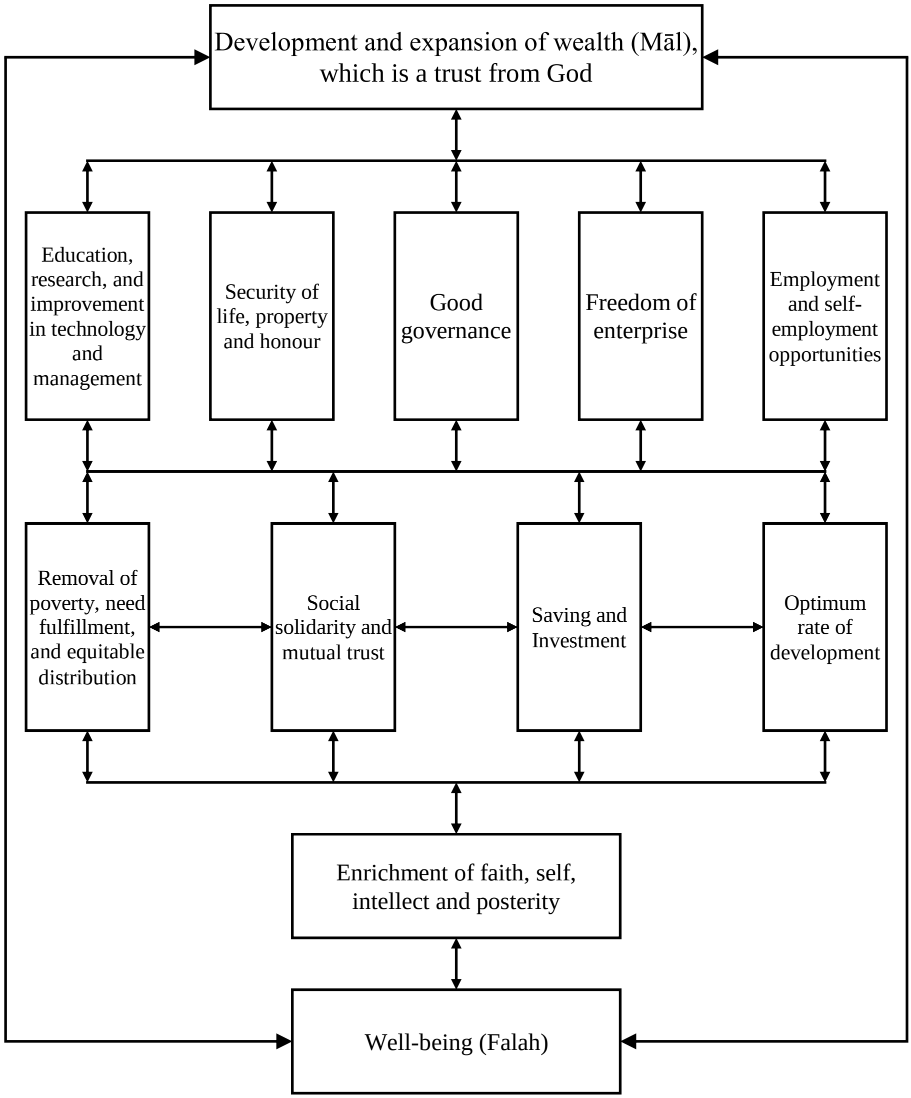
Development and expansion of wealth (Māl), which is a trust from God
Education, research, and improvement in technology and management
Security of life, property and honour
Good governance
Freedom of enterprise
Employment and self-employment opportunities
Removal of poverty, need fulfillment, and equitable distribution
Social solidarity and mutual trust
Saving and Investment
Optimum rate of development
Enrichment of faith, self, intellect and posterity
Well-being (Falah)

Fig. (6)

CONCLUSION

Thus, it may be seen that Islam has emphasized all the ingredients of human well-being, including the human self, faith, intellect, posterity and wealth, along with their corollaries, instead of just wealth. They are all interdependent and play the role of supporting each other. With progress in ensuring the enrichment of all these ingredients, it may be possible for the five-point star of Islam to shine with its full brightness and help realize real human well-being (Figure 7). Only then will it be possible for the Muslim world to be a reflection of what the Qur'ān says about the Prophet (pbuh): "We have sent you as a blessing for mankind" (al-Qur'ān, 21:107)

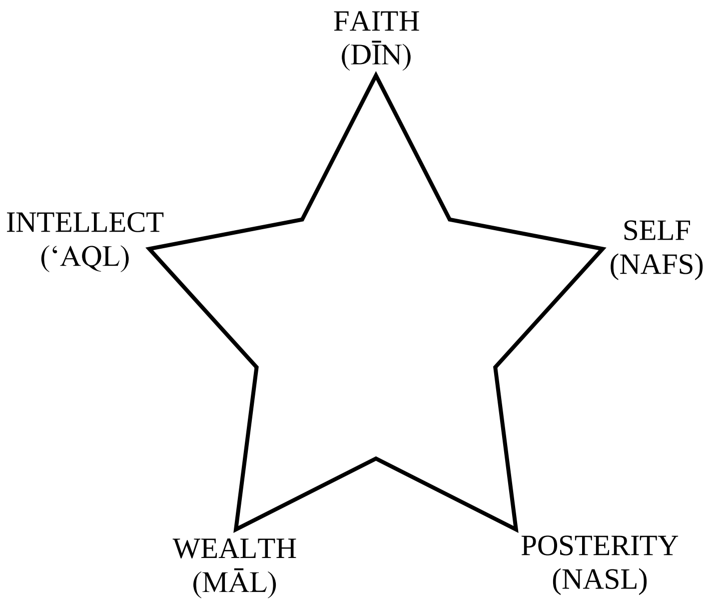

Fig. (7)
Human Well-Being:
The Light of *Muqāsid al- Sharī'ah*

Concentration only on economic development with the neglect of other requisites for realizing the Islamic vision may enable the Muslim world to have a relatively higher rate of growth in the short-term. However, it may be difficult to sustain it in the long-run because of a rise in inequities, family disintegration, juvenile delinquency, crime, and social unrest. This decline may gradually get transmitted to all sectors of the polity, society and economy through circular causation, emphasized by Ibn Khaldun (d.808/1400) in his *Muqaddimah,*[87] and lead ultimately to a further deterioration of the Muslim civilization from the low point it has already reached as a result of centuries of decline.

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(87) For an analysis of Ibn Khaldūn's circular causation model, see Chapra, 2000, pp. 145-159

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الرؤية الإسلامية للتنمية في ضوء مقاصد الشريعة

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مستشار البحوث بالمعهد الإسلامي للبحوث والتدريب

البنك الإسلامي للتنمية – جدة – المملكة العربية السعودية

المستخلص: لقد بين الإسلام لنا جميع مكونات الفلاح الإنساني، وهي الحفاظ على النفس البشرية، والدين، والعقل، والنسل، والمال، بالإضافة للمكونات التابعة، ولم يكتف بالمال فقط. وجميع هذه المكونات يعتمد بعضها على بعض ويدعم بعضها بعضًا. وبإحراز التقدم في ضمان إثراء كل هذه المكونات، يصبح من الممكن لنجمة الإسلام خماسية الأبعاد أن تسطع بتألق كامل وتعين على تحقيق الفلاح البشري. وعندئذٍ فقط يغدو بإمكان العالم الإسلامي أن يصبح انعكاسًا لما يقوله القرآن الكريم عن النبي صلى الله عليه وسلم: "وما أرسلناك إلا رحمة للعالمين". إن التركيز على التنمية الاقتصادية فقط مع تجاهل المتطلبات الأخرى لتحقيق الرؤية الإسلامية قد يمكِّن العالم الإسلامي من تحقيق معدل نمو أعلى في المدى القصير، غير أن استدامة ذلك النمو في المدى الطويل قد لا تصبح ممكنة بسبب زيادة عدم المساواة، والتفكك الأسري، وجنوح الأحداث، والجريمة، والاضطرابات الاجتماعية. وهذا الانحدار قد ينتقل تدريجيًا إلى كل قطاعات السياسة والمجتمع والاقتصاد عبر آلية "عموم السببية" (Circular Causation) التي تحث عنها ابن خلدون في مقدمته، ويؤدي في آخر المطاف إلى مزيد من تدهور الحضارة الإسلامية من المستوى المنخفض الذي بلغته حاليًا نتيجة لقرون من الانحدار.

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The Impact of Basel III on Islamic Banks: A Theoretical Study and Comparison with Conventional Banks

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Abstract. Since the last financial crisis, the Basel Committee on Banking Supervision, (BCBS), an international organization which main objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide, has issued some reforms more know as Basel III new framework.

The major parts of the propositions are included in the document Basel III: A global regulatory framework for more resilient banks and banking systems published in version June 2011.

This document contains all the needed reforms in order to prevent the financial system from future crisis. This framework is only propositions, but it really became a global standard as both the European Union (CRD4[1]) and USA[2] have decided to pass the BCBS regulation proposal into their legal frameworks.

(1) See http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm#crd4

(2) See "**Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies", *Federal Register*,** Vol. 77, No. 3/Thursday, January 5, 2012/Proposed Rules available at http://www.gpo.gov/fdsys/pkg/FR-2012-01-05/pdf/2011-33364.pdf

Basel III will have a major impact on the business plans and the strategy of conventional financial institutions. It will introduce a lot of modifications: new own funds and risk computations, new ratios, modification of the Tier 1 and Tier 2 category, new solvency ratios, introduction of new concepts (Asset Value correlations, Credit Valuation adjustment, PD downturn, Stressed VaR), new buffers (Capital Conservation and countercyclical Buffers), and new limits in terms of leverage and liquidity ratios.

If we consider that Basel III framework was thought only for conventional banks, and as Basel III will be an international standard with regard to the precedent Basel Committee proposals (Basel 1 and Basel II), we can ask whether this new regulation is compliant with the Islamic banks as the financial structure of conventional and Islamic banks are quite different.

Moreover, we will see if, from a theoretical point of view, if the Basel III impact is more or less important in Islamic banks than in conventional one by analyzing each new reform and its potential impact in the structure of the two types of banks.

First, we will review the impact of the new Basel III capital requirements and ratios. In the second section, we will analyze the impact on the risk computation. Section 3 will present the impact of the new buffers. The section 4 will deal with the leverage ratios when the fifth part will be focused on the new liquidity framework.

The last section will be presented as a global conclusion on the capacity of the Islamic banks to face to new Basel III regulation as regard as the conventional financial institutions.

Keywords: *Basel II, Basel III, Islamic banks, risk management, displaced commercial risk, profit equalization reserve, investment risk reserve, liquidity risk, leverage ratio, capital adequacy ratio, profit sharing, regulation*

Category of paper: *Technical*

1. **Section 1: Impact of the new capital requirements and ratios on Islamic banks**

1.1. New definition of own funds and new regulatory ratios

The Basel Committee has decided to increase all the capital ratios with a progressive period from 2013 to 2018. For example, the minimum level of Common equity ratio will pass from 2% to 4.5% when the minimum level of Capital Adequacy ratio will pass from 9 to 12% excluded.

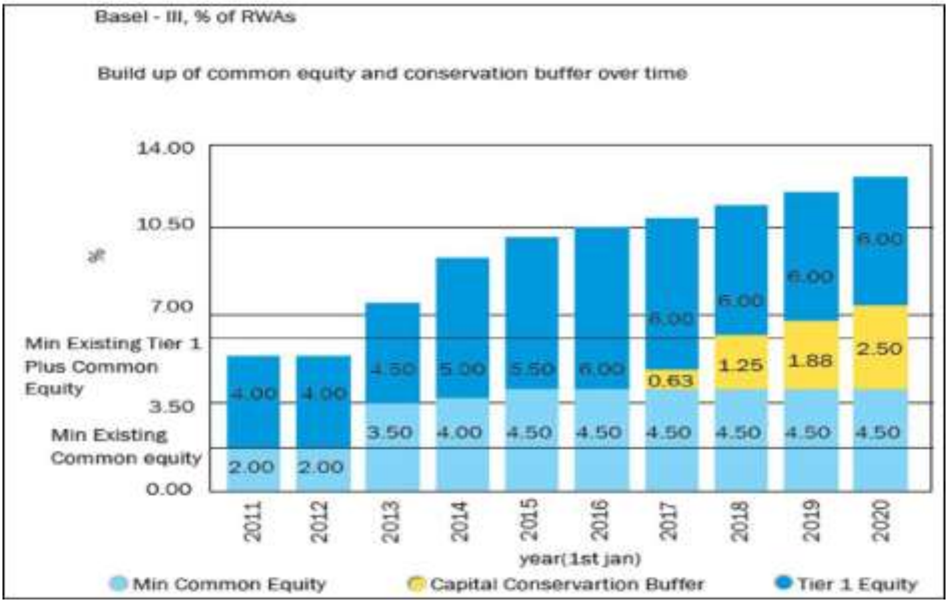


Fig. (1). Basel III new ratios Source: http://www.basel-ii-risk.com/new-basel-iii-common-equity-by-year/

The capital structure defined by the BCBS in Basel II is segregated into three categories: Tier 1, Tier 2 and Tier 3. As we can see in the table 2 below, Basel III has deeply impacted the new definition of the capital under Basel III.

BII (current version)		Proposed new standard	
Tier 1	Common Stock and other forms of Tier 1 (including perpetuals)	Tier 1	Common Equity (common stock plus retained earnings and OCI)
	Disclosed reserves (including from minority interests)		Additional going concern capital
	15% innovative instruments (Annex 1 to BII)		n.a.
	Deduct goodwill and equity from securitizations		Deduct goodwill and many other items 1:1 from common equity
	Deduct 50% of investments in other financial institutions		Transformed into 1:1 adjustment
Tier 2 max 100% of Tier 1	Undisclosed reserves and asset revaluation	Tier 2	Only one form of Tier 2 capital remains
	General loan-loss reserves		Unrealized gains will be reviewed by BCBS until y/e 2010
	Hybrid capital instruments		n.a.
	Subordinated debt (max 50% of Tier 1)		n.a.
Tier 3	For market risk coverage (limitations apply)	Tier 3	n.a.

Table (2) Classification of Capital according to Basel II and III Source: Deloitte

With Basel III, the regulator has decided to increase the importance of what we name the Tier 1 Capital, which is in fact the common equity and some hybrid capital (strict eligibility criteria). The definition of the Tier 2 Capital is reduced consequently (for example, issuances without loss absorbency at the point of non viability are progressively excluded from Tier 2 Capital). The Tier 3 is abrogated.

For Islamic banks, Capital structure is not the same: Islamic banks operate in line with the principles of Shariah. Shariah prohibits, among other things, payment and receipt of *riba* (interest). This means that Islamic banks cannot pay or earn interests on their financial instruments. The consequence is that the banks mobilize and utilize funds using Shariah-compliant instruments or contracts that are not used by their conventional counterparts.

According to Habib Ahmed and Tariqullah khan in their handbook of Islamic banking, the financial structure of an Islamic bank is essentially compounded of Tier 1 Capital (bank's own capital). Having some Tier 2 in the capital of Islamic banks is very rare as in general it is capital or hybrid capital linked to the payment of interest. and when it is the case, tier 2 capital is restricted to 50% of the total of tier1+tier 2 capital.

So, when the redefinition of the capital has a quite important impact on the conventional banks, it is not the case for the Islamic banks because their capital is essentially compounded of common equity (and rarely of Tier 2 products). On this point, Basel III clearly has a positive impact in terms of competitivity for the Islamic banks, as the conventional banks will see their capital (all things being equal) decreased by a larger share than the Islamic banks, hence the former will then experience higher costs of compliance than the latter.

the same phenomenon is likely to happen for Tier 2 ratios of the conventional banks: a strong decrease because of the new regulation. Meanwhile, the Islamic banks will still have a total capital ratio (Tier 1 + Tier 2) approximately equal to their Tier 1 ratio.

2. Basel III impact on the risk computation of Islamic banks

2.1. Impact of the Profit sharing investment accounts (PSIA) on the risk weighted assets and capital adequacy computation.

Basel committee has done its framework for conventional banks and does not take into account specific features of Islamic banks, such as the Profit Sharing Investment Accounts. Although these assets do not imply financial risks for the bank (because the risk was taken by the investment account shareholders) for the bank, they are not considered as equity capital.

According to the BCBS and under Basel III rules, the capital adequacy ratio should be over 8% today according to the following formula:

$$\text{CAD} > \frac{\text{Regulatory Capital}}{\text{Total Risk Weighted Assets for Credit Risk (CR), Market Risk (MR) and Operational Risk (OR)}}$$

IFSB (Islamic Financial Standard Board), an international institution created by Islamic banks and regulators, has issued some regulatory standard that constitute the equivalent of Basel II for Islamic finance. In 2005, IFSB has issued a guideline which help Islamic banks to compute a ratio equivalent to the Basel II capital adequacy ratio by in taking into account the PSIAs specificities of Islamic banks.

In effect, the capital amount of PSIA is not guaranteed by the Islamic bank. Any losses arising from investments or assets funded by PSIA are for the owners of theses PSIAs and so do not require any regulatory capital requirement. This implies that assets funded by restricted or unrestricted accounts of PSIAs should be excluded from the calculation of the denominator of the capital ratio.

The capital adequacy formula defined by IFSB is the following:

$$\text{CAS} > \frac{\text{Regulatory Capital}}{\begin{array}{c}\text{Total Risk weighted Asset (CR + MR + OR)}\\ \text{less Risk weighted Assets funded by restricted PSIA (CR+ MR)}\\ \text{less } (1-\alpha) \text{ Risk weighted Assets funded by unrestricted PSIA (CR+ MR)}\\ \text{less } \alpha \text{ (Risk weighted Assets funded by PER and IRR}\\ \text{of Unrestricted PSIA) (CR+ MR)}\end{array}}$$

CR= Credit Risk; MR= Market Risk and OR = Operational Risk

In contrast to the BCBS capital adequacy formula, the effect of this integration of the PSIA concept is to leave a proportion α (alpha) of RWA(CR+MR) for unrestricted PSIA as part of the denominator, with an adjustment for RWA financed by Profit Equalizations Reserves & Investment Risk Reserves within equity of Investment account holders which absorb risk. The IFSB permit to each national supervisor to determine its α depending on the banking stability and the financial system development of each country.

2.2. Basel III impact on the risk computation

Islamic banks have the same role in the economy as conventional banks: they allow their customers and others investors to earn a potential return on their accounts. They are hence exposed to the same risks as conventional banks. Basel III framework sets out a better risk coverage and develops new supervisory and risk management guidelines according to the Basel III guidelines published by the BCBS with some new tools for the risk computation (Asset Value Correlation, Counterparty credit

Risk in the trading book, CVA for risk Charge ...). These new rules would encourage Islamic banks to reinforce themselves in their Risk, Audit, Compliance and Capital Management functions.

Moreover, as a consequence of the last financial crisis, the Basel committee has decided to increase the amount of Risk weighted assets and specifically for the credit risk and the market risk...

One of the peculiar features of Islamic banks is that they have a credit risk higher than conventional banks. It is due to the importance of *Mudarabah* and *Musharakah, valued at their accounting value and which are* instruments held by the banks in their accounts for investment reasons and in general kept until their maturities. The predominance of credit based products imply for Islamic banks to be more exposed to the credit risk than conventional banks. Basel III will introduce some measures in order to limit the credit risk due to counterparty credit exposures. It is in that perspective that they should stress their portfolio and compute an additional RWA compared to Basel II. They will also add a capital charge for credit valuation adjustment risk associated with deterioration of the credit quality of counterparty.

Moreover, Basel III will improve the coverage of the risks related to capital market activities, especially counterparty credit risk on over the counter derivatives and in the trading book.

Historically, trading book businesses are less important in Islamic banks than in conventional banks because a non negligible part of the derivatives instruments used are not Shariah compliant and short selling is forbidden. So, as logic consequence, Islamic banks will not see their trading book very impacted by the changes in the new regulation.

In the other hand, the products in the quasi trading books (as *Salam* and *istisna* contracts) may be more impacted mainly due to the fact that it is commodity structured products with a price which depends of the volatility of the markets. In the same way, the volatility will have a major impact on the stress test scenarios and will increase the capital requirements due to the price fluctuations of the assets and commodities theses recent years by the way of the Value at Risk.

The impact of these additional requirements (Asset Value Correlation, Counterparty credit Risk in the trading book, CVA for risk Charge, additional requirements for the securitization) in terms or RWA will increase deeply the amount of RWA in the conventional banks. In fact, the larger the trading book of a bank, and proportionally the higher will be the increase of additional RWA specific to Basel III.

Morgan Stanley estimates that the increase of Risk Weighted Assets due to Basel III in conventional European banks will be between 10 and 30% of the RWA under Basel II. This is principally due to the fact that European banks have generally a consequent trading book which is higher than in the major parts of the Islamic banks. It is mainly due to the fact that Islamic institutions cannot invest in all the financial instruments as CDO, CDS, Repo, bonds and all the others derivatives. And in fact, the major part of the additional RWA is linked to such instruments that Islamic banks do not hold in their portfolios, such as CDO, CDS, repos or interest rates swaps...

As regard to this point, we can argue that Islamic banks will experience a far lesser risk weighted assets increase than the conventional financial system. It is nevertheless impossible today to quantify this impact and it depends clearly of the trading portfolio structure of each bank.

2.3. Capital conservation buffer and countercyclical buffer in Islamic banks

Basel Committee has required to setup two buffers: a countercyclical buffer and a capital conservation buffer in order to prevent against a financial collapse.

The volume of the capital conservation buffer should be equal to 2.5% of the RWA. This buffer should be composed of common equity (Tier 1) assets. If the banks has not enough capital for this buffer, Basel 3 restricts the distribution of dividends, share buybacks or bonus payments) until the ratio of 7% is respected (4.5% + 2.5%).

The objective of the Capital conservation buffer is to absorb losses during periods of financial and economic stress: if a bank's buffer falls below 2.5%, the bank will find itself subject to constraints on the payment of dividends and discretionary bonuses, until the buffer is replenished.

A countercyclical buffer within a range of 0% – 2.5% of common equity or other fully loss absorbing capital will be implemented according to national circumstances. The purpose of the countercyclical buffer is to achieve the broader macro prudential goal of protecting the banking sector from periods of excess aggregate credit growth.

In the case of Islamic banks, these buffers should be implemented for the banks that wish to respect Basel III. The objectives of theses 2 buffers are quite different from the investment risk reserve and the profit equalization reserve. But, as usually, the computation of theses buffers should take into account the specificities of the Islamic banks and especially the presence of profit sharing investment accounts.

In fact, as investment account holders take a part of the risk, we should deduct from the total risk weighted assets the parts which depend from the PSIAs and compute, after deduction the required amount for the 2 buffers.

In the same way, if some gains should be retained in order to attains the required ratio for the new buffers, we should not retains neither the earning of the investment account holders or from the two specific Islamic reserves (PER and IRR). The reason is that these two reserves are not compounded from profit of the bank shareholders but from the profit of the investment account holders. So, if retained earning should be done, bank's shareholders should transfer their own profit in theses reserves.

Except this point, the impact for either Islamic or conventional banks are the same and the presence of PSIAs in Islamic banks is not something so relevant which can increase much the competitivity of Islamic banks with regard to the conventional ones.

3. impact of the leverage ratio on the Islamic banks

In December 2010, the Basel III agreement formalized a simple, transparent, non-risk based leverage ratio. The leverage ratio is intended to constrain the build-up of leverage in the banking sector

$$\text{Leverage Ratio} = \frac{\text{Capital Measure}}{\text{Exposure Mesures}} \geq 3\% \text{ Design \& Calibration not yet Final}$$

The leverage ratio requires a definition of capital (the capital measure) and a definition of total exposure (the total exposure or assets measure).

Capital measure will be either realized by the regulatory Common Equity ratio, the Tier 1 Capital ratio or the Total Capital ratio.

Total exposure measure is based on reported accounts but physical or financial collateral, guarantees or credit risk mitigation purchased is not allowed to reduce on balance-sheet exposures and High quality liquid assets are included in total exposure measure. Another important point is that Basel II regulatory netting for on balance sheet derivatives and repo style transactions is allowed, which is clearly a positive point for Conventional banks comparatively to Islamic banks which are not allowed to take that kind of short positions.

Today, the leverage ratio is a very hard requirement for investment banks. French banks have not this problem because they all adhere to the *universal* banking model (retail + investment banking). Those banks that will be much impacted by this new rules are the investments banks which work and deal on the financial markets with a high leverage. Clearly; the Investment Bank model will be more impacted by Basel III than wholesale or universal banks.

Islamic banks should not experience more constraints under the leverage ratio because there are generally limited before by the risk management of their liquidity (Islamic assets and products are generally less liquid than conventional products). But as the business model developed by the Islamic banks is more a universal banking model, and as deposits/loans ratios are higher than in conventional banks according to Morgan Stanley research paper on Qatari banks published in November 2011, we can reasonably anticipate that the leverage ratio will not be a real constraining point for Islamic banks. According to the same Morgan Stanley research paper, leverage ratio for Qatari Banks and Emerging banks is generally between 5 and 10% of the own funds when conventional banks are generally between 2 and 4% (Morgan Stanley Research paper on European banks - April 2011)

Clearly, the leverage ratio is a measure that will increase the competitivity of the Islamic banks as regard to the conventional banks. For example, it was not abnormal in the past to see some banks with a leverage ratio of 1.5 or 2%. With a limit of 3%, these banks should not have a total exposure above 33 times their capital.

4. Basel III new liquidity ratios on the Islamic banks

In order to provide a response to the recommendations of the G20 that called for " ... tools, metrics and benchmarks that supervisors can use to assess the resilience of bank's liquidity cushions and constrain any weakening in liquidity maturing profiles, diversity of funding sources, and stress testing practices", the Basel committee has decided to setup minimal Regulatory standards for liquidity risk and now asks the bank to create new monitoring tools to be used by supervisors in the monitoring of liquidity risks.

The regulatory standards must be supplemented by application of the sound liquidity principles. An individual bank can be required to adopt more stringent standards or parameters to reflect its liquidity risk profile.

Liquidity risk is the risk that the Bank will be unable to meet its payment obligations associated with its financial liabilities when they fall due and to replace funds when they are withdrawn. The consequence may be the failure to meet obligations to repay depositors and financing parties and fulfill financing commitments. Liquidity risk can be caused by market disruptions or by credit downgrades, which may cause certain sources of funding to become unavailable immediately. Diverse funding sources available to the Bank help mitigate this risk. Assets are managed with liquidity in mind, maintaining a conservative balance of cash and cash equivalents.

The core of the framework consists of two ratios, the liquidity coverage Ratio and the Net Stable funding ratio. These two ratios have been developed to achieve two separate but complementary objectives.

The liquidity coverage ratio (LCR) aims at strengthening banks' short-term liquidity profile. It defines the level of Liquidity buffer to be held to cover short-term funding gaps under severe Liquidity stress, under a time horizon of 30 days. The first step consists in calculating the difference between the cumulated outflows on liabilities and the cumulated inflows on the assets. For example, in the conventional system, deposits in the banks are considered as fully unstable in times of stress as the customers have a full access to their deposits, so, Basel Committee considers that the outflow rate of the deposits is 100%. This can be reduced by a potential 100% inflow rate on loans to banks for example, but within a maturity of 30 days. If cumulated outflows are bigger than cumulated inflows, then the difference is a net cash outflow, to be counterbalanced by a liquidity buffer (for example a portfolio of high quality and liquid assets)/ These assets must be selected in a narrow list prescribed by the regulation (sovereign debt, corporate debt), excluding any financial asset like banks bonds or banks certificates of deposits.

The Net Stable Funding Ratio (NSFR) is more a long term liquidity constraint. Its objective is to strengthen banks' medium- to long-term liquidity profile. It defines the minimum acceptable amount of stable funding in a stress scenario with an horizon of one year. The NSFR is problematic because it is not in accordance with the primary activity of banks, which the transformation of the liquidity collected...

The LCR and NSFR are not definitely defined and the Basel Committee pursues its calibration in order to be "absorbable" by the banks and not too much penalizing for the economies financing. The LCR will become binding on January 1st, 2015, and will be observed by national regulators from January 1st, 2013, to December 31, 2014. The NSFR, which will become binding on January 1st, 2018, will also be observed since January 1st, 2013. With this observation period, some substantial modifications can be decided by the Basel Committee.

Table (5). International liquidity framework according to Basel III Source: Deloitte

In Islamic banks, liquidity management is one of the main important obstacles to development of Islamic finance as the debt paper could only be resold under very restrictive condition and at its nominal value.

Basel III liquidity risk requirements will affect Islamic banks for two reasons. The first one is that the lack of a developed Islamic money market and the second one the lack liquid Islamic investment instruments with short term maturities.

Clearly, LCR and NSFR are not calibrated for Islamic Finance and do not take into account the specificity of this industry. For the LCR, it misses to Islamic banks the abundance of Shariah Compliant short term instruments... For the NSFR, there is no profusion of longer term liabilities that can be withdrawn at short term...

Despite this, Basel III, finally, will not penalize more than today Islamic banks for the following reasons:

- Today, if we compare the net impact on both Islamic and conventional banks, we will see the presence of a major competitive distortion due to the lack of short term liquidity instruments in Islamic Finance, but also because conventional banks did not have liquidity constraints and that this new framework will be very penalized for them. Basel III will oblige conventional banks to limit the liquidity appetite.

    - In the first hand, if we refer to the research Paper writed by Laurent Quignon "Basel III: no Achilles' spear", only 46% of the 166 National Banks which had responded to the BCBS Qantitative impact study respect the LCR Ratio and only 43% of them respect the NSFR ratio... So, Basel III new liquidity constraints will impact almost the half of the major banks in the world.

    - In the other hand, as Islamic Banks are limited, since their origin, in terms of liquidity, Basel III impact will be much less important for Islamic banks. For example, the Governor of the National Bank of Malaysia as said in an interview given to the "Global Islamic Finance Magazine "issued in November 2011 that "The majority of Islamic banks in Malaysia already maintain capital levels well above the current regulatory minimum, ..., and the Liquidity Coverage Ratio (LCR) under Basel III is conceptually similar to the liquidity framework adopted by Malaysian Islamic banks".

    However, the NSFR will attract more focus for Islamic banks as it aims to limit over-reliance on short-term but with a limited impact: In general, Islamic banks are largely deposit funded (over 50% in general) with mainly maturities less than one year. As Basel III allows banks to include the portion of the Short term deposits with a 10% haircut, we can expect the NSFR will not be so constraining for Islamic Institutions.

- Moreover, we can underline an initiative that will increase the liquidity possibilities terms of liquidity management for Islamic banks.

IFSB, which is an international regulatory institution and which is established by central banks and supranational institutions, aware that the liquidity is a real problem for the industry, attempt to found some solutions in order to improve liquidity for international Islamic institutions. That why last year was established on 25 October 2010 the IILM (International Islamic Liquidity Management Corporation). The International Islamic Liquidity Management Corporation is an international institution established by central banks, monetary authorities and multilateral organizations to create and issue short-term Shari'ah compliant financial instruments to facilitate effective cross-border Islamic liquidity management. By creating more liquid Islamic financial markets for institutions offering Islamic financial services, IILM aims to enhance cross-border investment flows, international linkages and financial stability.

The corporation was set up by the Islamic Financial Services Board, IFSB, after the signing of the Memorandum of Participation by member countries. A statement issued by the IFSB said: "The primary objective of the IILM is to issue Shariah-compliant financial instruments in order to facilitate more efficient and effective liquidity management solutions for Islamic financial institutions, as well as to facilitate greater investment flows of Sharia-compliant instruments across borders. This initiative is in line with the IFSB mandates (as stated in its Article of Agreement) to enhance and coordinate initiatives to develop instruments and procedures for the efficient operations and risk management, and to encourage cooperation among members-countries in developing the Islamic financial services industry...

Conclusion

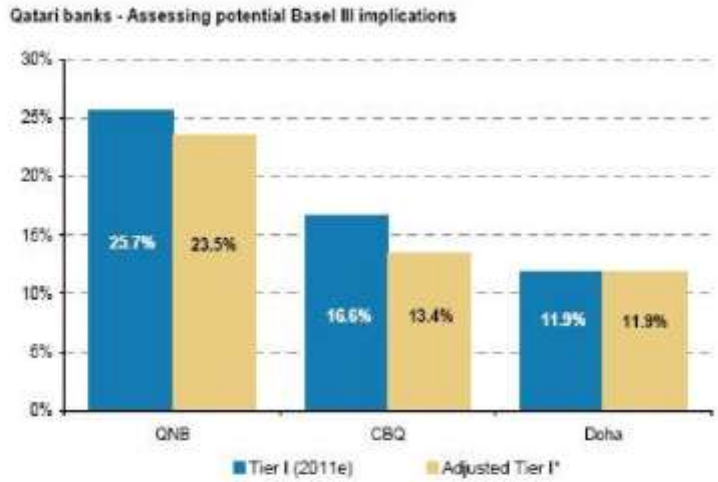
Despite the fact that Islamic finance holds global appeal in its provision of Shariah-compliant financial services for both Muslims and non-Muslims, the Basel III has so far often failed to make a distinction between conventional and Islamic finance. Currently, emphasis seems to been placed on a greater collaboration between the Basel committee and Islamic standard and regulatory bodies such as the Islamic Financial Services Board (IFSB).

The majority of Islamic banks already maintain capital levels well above the current regulatory minimum.

As example, according to the Al Khaliji “Investor guide”, issued in October 2011, the average Tier 1 Ratio of the 18 Islamic banks in Qatar is about 22.8%.

And if we use this information with an a Morgan Stanley Research Department impact study about Basel III in 3 qataris Banks (.Commercial Bank of Qatar, Doha Bank and Qatar National Bank), we can easily see that Basel III will have a limited impact on the risk, own funds and regulatory ratios.

Potential Basel III impact on Tier I appears more sizable for CBQ



Source: Morgan Stanley Research estimates, *adjustment includes full deduction of minorities and the residual 50% of investments in associates.

In the other hand, own funds of conventional banks will be more impacted by Basel III, and especially in Europe and US, until change their business model. The reason is that, generally, a lot of conventional banks will have a lot of difficulties to respect new Basel III requirements.

In effect, these banks have taken higher risks regarding their own funds and in a spirit of maximization their return on equity, have a regulatory ratio, in general, a little bit above the limit (between 8 and 12%). And with the recent crisis, major parts of these banks have initiated a rethink of their business model in order to limit Basel III impact with, sometimes, big consequences as in France, where the local authorities lending market was deserted by the historical commercial banks as the maturities are too high...

Concerning the liquidity, the new ratios, LCR and NSFR, will require Islamic banks to hold more liquid assets for wholesale funding than they are required to under the existing liquidity framework but as for the own funds, we can anticipate that the impact will be inferior than in the conventional system as the Islamic banks are historically constrained in terms of liquidity and as there are historically well capitalized as regard to their exposures.

Clearly, there has been a push for Islamic banks to further support the Basel III standards in order to improve their transparency and capital adequacy.

Comparatively with conventional banks, Islamic banking industry seems to be less impacted by Basel III as the business model is more conservative and derivatives and short selling is forbidden. It is a possibility for them to increase their international competitively as regard as the big impact that Basel III has in the business model of conventional banks.

As Islamic banks cannot adopt Basel III without modification according to their specificities, IFSB should adapt theses new regulations in order to permit to Islamic banks to adopt the new international standards.

Another conclusion could be done, as from a theoretical point of view; Islamic banks are less impacted than conventional banks... Does conventional regulation converge into something more ethics, more linked to the real economy and with less speculation? As Chapra pointed out: “*Since the existing architecture of the conventional financial system has existed for a long time, it may perhaps be too much to expect the international community to undertake a radical structural reform of the kind that the Islamic financial system envisages. However, the adoption of some of the elements of the Islamic system, which are also a part of the western heritage, is indispensable for ensuring the health and stability of the global Financial system.”*

Basel III is just one step forward. (Chapra U. [2008], The Global Financial Crisis: Some Suggestions for Reform of the Global Financial Architecture in the Light of Islamic Finance, Kyoto University, 2008)

The next step of this research now is to stand the last and definitive version of the European transposition of Basel III, that will be voted in June or July 2011, in order to see if finally, Basel III has made Islamic banks more resilient, as the conventional one and what is the impact of this new regulations in both 2 systems in terms of own funds, risks, but also liquidity, leverage and business model because an impact on each precedent criteria has also an impact on the return of the banks, and finally, the strategy...

Before this, a comparative and rigorous analysis should be done in order to see Basel III impacts in Islamic and conventional banks by using a representative panel of conventional (investment and wholesale) and Islamic banks. It will be the topic of the next research paper incha Allah.

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Islamic Microfinance:
Lessons from Good & Bad Practices

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Microfinance and Islamic finance have much in common. As concepts, both emphasize the good of the society as a whole. Both advocate entrepreneurship and risk sharing and believe that the poor should take part in such activities. Both focus on developmental and social goals. Both advocate financial inclusion. Both involve participation by the poor. It is also an interesting coincidence that both ideas[1] witnessed their fruition around the same time, in the 1970s. In terms of practice, once again there have been striking similarities. Over the last four decades of their existence, both are largely believed to have experienced a "mission-drift" with most players ignoring the financial needs of large sections of the ultra-poor. While mainstream Islamic financial services industry is largely observed to cater to the needs

(1) Arguably, roots of Islamic finance are traced to practices during the times of the Prophet Muhammad PBUH and even earlier; Islamic finance as an idea has a much longer history. The present paper refers to the birth of the Islamic financial services industry in its contemporary form, with the establishment of institutions like the Islamic Development Bank, Dubai Islamic Bank in mid-Seventies.

corporate and high-networth clients, the microfinance industry has focused on financing the economically active and not-so-poor. The call for enhancing financial inclusion has coincided with the birth of the Islamic microfinance that involves not just a marriage between conventional models, best practices and Shariah-compliant for-profit modes of finance, but a rejuvenation of the institutions of Islamic philanthropy, cooperation and not- for-profit modes of finance.

There are sound economic reasons why conventional microfinance and especially micro- credit may not be appropriate for the chronically poor and the destitute. Loans to the destitute may in fact make the poor poorer if they lack opportunities to earn the cash flow necessary to repay the loans. While a destitute may or may not be reluctant to incur debt and start a microenterprise because of risk and uncertainty with cash flows, profit-maximizing and risk-minimizing behavior on the part of the microfinance institution (MFI) would lead to exclusion of such clients. Usually such clients do not possess entrepreneurial and technical skills needed for wealth creation. Such an economically inactive individual would find it difficult to obtain financing from the for-profit MFIs. Indeed, more than financial services, these individuals must be provided for their basic needs, such as, food, shelter, or guaranteed employment. Such safety nets may be funded through charity. In order to cross the skill-related barrier, such individuals would also need training for skills- development before they are able to make good use of microfinance. The safety nets may then be linked with microfinance programs, so that the same individuals may move through several stages – from abject penury to a stage where they are able to meet their consumption needs - then to a stage where they come to acquire necessary technical and entrepreneurial skills for setting up microenterprises - and then to a stage where they are able to obtain required funds from micro financing institutions (MFIs) and have the microenterprises up and running. Fighting poverty thus, would require an integrated finance-plus approach or the provision of financial services along with business development services and that is linked to social safety nets. This is possible only by bringing philanthropy and cooperation into the model of microfinance.

There are also sound economic reasons why high-cost microfinance may push the beneficiaries into a spiral of debt. Microfinance entails high administrative charges, monitoring costs and of course, high portfolio risk. As such, it is invariably costlier than the traditional sources of finance. At the same time, both the MFI and its clients may find this an attractive option if they believe that the expected return on the micro-enterprise is higher than the cost of debt. Such expectations may indeed materialize for the successful projects passing through “good times”. However, the same may not be true for all projects at all times. Debt-related liability can compound and accentuate the financial problems of a project experiencing bad times and hasten its failure. The pace, frequency and intensity of such failure is directly related to the levels of cost of debt. In contrast to debt, profit and risk-sharing mechanisms provide for a clear alignment between profitability of the project and cost of capital. The latter rises and falls in line with the realized profits of the venture.(2)

In the following section we seek to demonstrate how the Islamic approach to poverty alleviation addresses the above issues associated with conventional microfinance and shapes the conceptual framework of Islamic microfinance.

CONCEPTUAL FRAMEWORK OF ISLAMIC MICROFINANCE

The conceptual framework for Islamic microfinance extends well beyond the notion of Shariah compliance of contracts and transactions. In line with the goals (*maqasid*) of Shariah, Islamic microfinance seeks to make a dent on the high and rising levels of poverty using an approach that is centered on compassion, benevolence, cooperation, hand-holding, sharing, frugality, solidarity, social cohesion and such other elements.

Integrating Philanthropy

Charity and philanthropy occupy a central position in the Islamic

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(2) In case of Islamic debt financing, the negative effects of financial risk arising out of use of fixed-rate financing are limited as compared to interest-based debt. This is because the former does not allow for compounding of the debt in case of possible default.

scheme of poverty alleviation. The broad term used to describe charity in Islam is *sadaqa*. When compulsorily mandated on an eligible Muslim, *sadaqa* is called *zakah*. When *sadaqa* results in flow of benefits that are expected to be stable and permanent (such as, through endowment of a physical property), it is called *sadaqa jariya* or *waqf*. Payment of *zakah* is an obligation on the wealth of every Muslim based on clear-cut criteria. Rules of Shariah are fairly clear and elaborate in defining the nature of who are liable to pay *zakah*, and at what rate *zakah* must be paid. Shariah also clearly identifies eight categories of beneficiaries who may benefit from *zakah*. Out of these, the potential beneficiaries relevant from the standpoint of poverty alleviation programs are the poor (*fuqara*), the destitute (*masakeen*), the indebted (*gharimeen*) and the *zakah* administrators (*amileen*). Scholars generally agree that *zakah* may be disbursed in the form of a grant or be used to form a revolving credit pool from which micro-loans may be provided. *Zakah* could thus, form the basis of designing a range of programs for the poor, e.g. (i) safety net programs to meet basic consumption needs, health and education; (ii) economic empowerment programs involving skill enhancement and business development services; (iii) programs to provide emergency grants or credit; (iv) programs to provide micro-*takaful*; and (v) programs to provide guarantee against credit default. The administrative costs related to *zakah* management may partially be recovered from the *zakah* collected(3), thus paving the way for a self-sustained *zakah* management institutional infrastructure.

There is total flexibility with respect to beneficiaries of voluntary *sadaqa*. In case of *sadaqa jariya* or *waqf*, perpetuity of endowed assets is an essential condition that ensures that benefits from the assets flow to the beneficiaries on a sustainable basis. *Waqf* similar to *zakah* may form the basis of designing various poverty alleviation initiatives as stated above. While in case of *zakah* the major requirement is that benefits must flow into the hands of the poor, in case of *waqf* the same must flow to beneficiaries as intended by the donor. However, if the intention of the donor is not explicit, the proceeds may be used for general-purpose community welfare projects including poverty alleviation initiatives.

(3) Most scholars place a cap of one-eighth on the costs related to salaries of *zakah* collectors that are recoverable from the *zakah* collected.

Waqf therefore, provides a definitive mechanism with added elements of sustainability and flexibility. The issue of high cost microfinance may now be addressed by creating *waqfs* whose benefits may now be dedicated for absorption of specific cost elements so as to make microfinance affordable to the ultra-poor.

In an Islamic system, far greater priority is given to the needs of the chronically poor than those of the poor or the moderately poor or the not-so-poor. Therefore, an Islamic MFI unlike its conventional counterpart is expected to aggressively integrate the various forms of Islamic philanthropy with for-profit microfinance to address the multiple issues related to poverty alleviation programs.

Economic Empowerment

Provision of charity often throws up the issue of dependencies. Sound Islamic microfinance therefore, requires that charity funds be employed in programs that involve transformation of the beneficiary, from a receiver of charity to charity-giver. While Islam strongly encourages charity from the giver's point of view, it seeks to minimize dependence on charity from the beneficiary's point of view. On one hand, it restricts the benefits to flow to the poorest of poor and the destitute while on the other hand, it also emphasizes on their economic empowerment so that they are able to progress out of poverty. An often-quoted tradition(4) demonstrates how Prophet Muhammad (pbuh) undertook the task of alleviating poverty of one of his companions that did not involve charity-giving, but a series of actions, e.g. (i) careful assessment of his financial health through enquiry blended with empathy; insistence on contribution and beneficiary stake (ii) transformation of his unproductive assets into income-generating ones through rigorous valuation (on the basis of price discovery through auction method); involvement of the larger community in the process (iii) meeting of basic needs on a priority basis and investment of the surplus in a productive asset (iv) direct involvement in capacity building in the run-up to income generation and technical assistance to the beneficiary (v) technical assistance in the form of

(4) For details on this hadith forming the basis of an economic empowerment program see Obaidullah M and Tariqullah K (2008) *Islamic Microfinance Development: Challenges and Strategic Solutions*, IRTI-IDB.

imparting requisite training to the beneficiary for carrying out the business plan/ income-generating project; monitoring through a time-bound schedule and impact assessment; and finally (vi) transparent accounting of operational results and liberty to use part of income to meet higher needs.

Avoiding Debt

Islam permits debt. However, it recommends debt only as a last resort and not as a means to finance one's growing lifestyle needs. Muslims are warned against extravagance. Muslims are also warned against the dangers of incurring heavy debt. Further, Muslims are exhorted to repay their debt in time and avoid deliberate delays. It follows therefore that one may incur a debt only if one is in serious need for it, and also with a clear intention and rational expectation about his/her ability to repay in full and in time. From the standpoint of the microfinance institution, the above has a strategic implication. Clearly, an Islamic MFI should refrain from seeking to entrap a client in ever- rising levels of debt.

Cooperation & Solidarity

Mutual cooperation and solidarity is a norm central to Islamic social behavior and collective ethics. This constitutes an additional basis in favor of equity and partnership-based financing rooted in cooperation in contrast to debt-based financing. While Shariah-compliant debt-based modes are permissible, equity-based modes of financing are clearly preferred. At times group-based financing and mutual guarantee within the group, a common feature of many successful microfinance experiments is also justified on the basis of the Islamic ideal of cooperation. It should be noted however, that group-guarantees tied with financial interests may soon degenerate into group tyranny and oppressive behavior by economically and socially stronger members of the group, unless group formation and activity is accompanied with inculcation of Islamic spirit of solidarity, brotherhood and cooperation. This has already led to rethinking among some MFIs about the merits of group-based financing vis-à-vis financing of individuals backed by external guarantees.

Similarly, this norm appears to favor cooperation as a principle shaping the organizational structure and apparently points to a member-based structure as the preferred choice over other organizational forms in the Islamic framework. Indeed Shariah scholars permit insurance only when it is based on the principles of mutuality and cooperation. Devoid of true Islamic cooperative spirit, however, member-based organizations tend to be characterized by political maneuvers and resultant low levels of professionalism. The idea of cooperation in essence highlights the need to ensure organization-wide good governance irrespective of its form and the importance of taking care of rights of all stakeholders.

Family Cohesiveness

Islam gives utmost importance to family as the nucleus social institution that plays a major role in shaping the future of mankind. It also sees a balanced role for men and women in ensuring the economic and social well-being of the family. Islam promotes the concept of "family empowerment" by exhorting men and women to play their respective roles in seeking economic and social well-being of all members of the family. Indeed, the "women only" approach to conventional microenterprise development and poverty alleviation is alien to Islamic religion and culture.

MODES OF ISLAMIC MICROFINANCE

The conceptual framework for Islamic microfinance in addition to above characteristics requires that the contracts and transactions between the multiple parties involved in the process are Shariah-compliant. Most importantly, they must not violate the prohibitions against *riba* and *gharar*. While there seems to be a consensus on the meaning of these prohibitions, there is less agreement on the interpretation and manifestation of the prohibited elements in real-life situations. Further, Shariah-compliance of the contract in no way provides an insurance against exploitation. Several observations are in order.

a. Rates on micro-*murabaha* and micro-*ijara* financing are deemed Shariah-compliant while interest rates are not. However, both can be and often are exploitatively high.

b. In case of participatory modes e.g. *mudharabah*, *musharakah* and *mudharaa* the sharing ratio could be unfairly biased against the poor beneficiary because of their low bargaining power. Similarly, in case of fee-based modes, e.g. *wakala* and *hawala*, the agent-MFI may charge an exorbitant fee for the same reasons.

c. The permissibility of *salam* (sale of non-existent produce) is linked to the economic benefits it confers on poor farmers in need of pre-cultivation financing. However, *salam* can involve exploitation when the advance price paid to the poor farmer is artificially pegged at low levels due to his/her weak bargaining power.

d. For Islamic modes of finance involving multiple contracts, e.g. *murabaha* and *ijara*, Shariah-compliance often requires careful sequencing of contracts to ensure that profits are associated with risk-bearing. However, in the context of microfinance involving large number of repetitive contracts involving small values, adherence to desired sequencing becomes practically impossible.

e. When MFIs price a benevolent transaction, e.g. *qard* and *kafala* (they are permitted to charge

actual costs without any element of profit) they may actually be passing the costs of their inefficiencies to their beneficiaries.

f. When pawnshops provide *qard* that is backed by collateral or *rahn* and charge custodial fee from the borrower, it may well be a case of disguised *riba*, especially when the quantum of fee moves in direct proportion to quantum of loan.

A mechanism to redress the above undesirable possibilities may be found in the following:

a. Prudential regulation of markets to ensure healthy and adequate competition among the players and thereby, remove abnormal and/or illegal profits through mispricing.

b. Creative *fiqhi* solutions (for instance, replacement of *murabaha* with *istijrar* may bring in the required flexibility in settlement of repetitive transactions in microfinance)

c. Vigilance by Shariah scholars to prevent disguised *riba* (for instance, scholars may ensure that custodial fees are delinked from quantum of loan or that actual administrative costs recoverable from the beneficiary in *qard* are not overstated)

d. Identifying appropriate organizational structure (in case of earlier *salam* example, a farmer’s cooperative may replace the vendor and thus prevent exploitation of individual farmers by the latter).

Notwithstanding the varied nature of Islamic modes for microfinance, the fact remains that *murabaha* remains overwhelmingly popular among IsMFIs. Its popularity is attributable the following reasons:

a. *Murabaha* is simple. The straightforward calculation of the installments for repayment is more easily comprehensible by the beneficiary. In contrast to this, the payments under a partnership-based mode are uncertain and therefore, less favored.

b. In contrast, partnership-based modes are demanding on the part of the beneficiary in terms of the need for proper book-keeping and ascertainment of the financial results of the business. Financial illiteracy acts as a constraint. Further, the beneficiaries may be justifiably reluctant to share information relating to all aspects of their business with the MFI.

c. *Murabaha* is familiar. For conventional MFIs venturing into Islamic MF and using *murabaha*, the transition is least demanding. Among all Islamic products, *murabaha* comes closest to interest-bearing micro loans.

MODELS OF MICROFINANCE

The Islamic microfinance scene is now characterized by varied models, which may be broadly divided into two categories. First, one finds models that exist in both conventional and Islamic domains. The Islamic experiments are essentially replications of successful conventional ones with Shariah-compliant products replacing interest-bearing products. Second, there are models that are essentially indigenous and took shape as a benevolent response to the problem of poverty.

Overview of Islamic Replications of Conventional Models

Joint-Liability-Groups (JLG): More popularly known as the Grameen model, it has witnessed replications far and wide and also in the Islamic domain. The key features of this model are group financing and graduated financing. The notion of joint liability replaces collateral as a mechanism to mitigate risk of default and delinquency. Among the notable replications, the Rural Development Scheme of the *Islami* Bank Bangladesh stands out. It uses a micro-credit product based on *bai-muajjal* (deferred sale) that costs far less than comparable conventional products.

Finance-Plus: More popularly known as the BRAC model, it has witnessed replications in both conventional and Islamic domains. The model recognizes that micro-enterprise development and wealth creation in the micro-economy requires much more that provision of finance. It seeks to provide a comprehensive range of support to micro-entrepreneurs to ensure the success of their ventures. Among the notable Islamic replications, is the Bank Al-Usrah, a microfinance bank based in Sudan.

Village-Banks: The model involves an implementing agency that establishes individual member-based village banks and provides "external" capital for onward financing to individual members. A bank repaying in full is eligible for subsequent loans, with loan sizes linked to the performance of village bank members in accumulating savings. As a village bank accumulates sufficient capital internally, it graduates to become an autonomous and self-sustaining institution.

Credit-Unions: A credit union is based on the concept of mutuality. It is in the nature of a financial cooperative owned and controlled by its members. It mobilizes savings, provide loans for productive and provident purposes and have memberships which are generally based on some common bond. Credit unions or financial cooperatives are quite popular in Asia. Due to relatively lax regulatory framework applicable to cooperatives, such institutions have been established in countries like India, which otherwise restricts Islamic finance in mainstream banking and financial sector.

ROSCAs: A Rotating Savings and Credit Association or ROSCA is a group of individuals who agree to meet for a defined period in order to save and borrow together. Each member contributes the same amount to a common pool or pot at each meeting, and one member takes the whole sum once. As a result, each member is able to access a larger sum of money during the life of the ROSCA, and use it for whatever purpose she or he wishes. ROSCAs are simple and transparent (every transaction is seen by every member during the meetings and since no money has to be retained inside the group, no records have to be kept) and therefore, popular in communities with low levels of literacy and weak systems. A conventional ROSCA usually involves *riba* when the recipient of the pot is determined not by lot but sold to the lowest bidder. Islamic ROSCAs exist, but are rare.

Pawnshops: Pawnshops are traditional collateral-based mechanism for borrowing. The quantum of loan is tied to the value of the asset offered as collateral. While conventional pawning involves interest, Islamic pawnshops charge custodial fees for safekeeping of the collateral. Islamic pawnshops popularly exist in South East Asia.

Good & Bad Practices with Islamic Replications of Conventional Models

Except for ROSCAs, the other models mentioned above are part of the formal financial system. Most of such programs use simple and transparent financing mechanisms and standardized procedures & documentation. These are also characterized by higher staff efficiency and professionalism. These seek to benefit from their accumulated wisdom and replicate best practices from conventional microfinance.

The Islamic replications of conventional microfinance unfortunately bring with them the weaknesses of the parent model. The strategy of retaining the overall model intact while substituting the interest-based products with Shariah-compliant ones like *murabaha* has major pitfalls as discussed earlier. In addition to break-down of conditions relating to sequencing of the contracts, thus pushing the MFI's gains beyond the boundaries of legitimacy, *murabaha* also implies lesser emphasis being accorded to economic viability of the micro-enterprises. Similar to conventional microfinance, such Shariah-compliant *murabaha*-centric microfinance involves high cost and hence, is not meant for the ultra-poor. It perpetuates debt-culture and strikes at the roots of family cohesion with its "women-only" approach.

Overview of Indigenous Islamic Models

Qard Hasan **Funds:** *Qard Hasan* Funds are operating in the Iranian financial sector for over three decades with their current number estimated at more than 3000 funds. These are essentially non-profit institutions in which members of a community set up a savings and loans society. Members deposit their savings with the fund (give *qard* to the fund) in order that other needy members may be extended a *qard* from this fund. In line with the rules of *fiqh* governing the contract of *qard*, members are free to withdraw some or all of their deposits if and when they want (or at short notice). As the members are known to each other, there is less room for default on loans. The operations of the society are run by volunteers, using some free office space. Other overheads, such as, costs for stamps, stationery, transport, communication and so on are covered, in some *Qard Hasan* Funds, through engagement of funds in business activities. In most of the others, the borrowers are charged the actual costs or less.

Baitul-Mal-wa-al-Tamweels **(BMTs):** *Baitul Maal wat Tamweel* (BMT) is an indigenous model of Islamic microfinance in Indonesia. Translated into English, the house of (charity) funds and (for- profit) financing is a financial cooperative. Conceptually, BMT is deemed to be inspired by the institution of *Baitul Maal* existing in early days of Islam. Its uniqueness is said to lie in the marriage of two distinct institutional models. The first is *Bait-al-Maal* or a pool of various kinds of Islamic charity funds, traditionally referred to as *zakah-infaq-sadaqa-waqf* funds (ziswaf). The second is *Bait-al-Tamweel* or a pool of funds directed at profit-seeking financing using Shariah-compliant modes. The latter comprises funds in the form of founder equity, micro-savings and investment deposits. A more recent avatar of this institution is *Baitul Maal wa al-Tamweel wa al-Tamin* (BMTT) with addition of micro insurance (*tamin*) as a third line of activity. The development of Islamic Saving and Loan Cooperatives or BMTs in Indonesia has been impressive. According to a study by the Centre of Business Incubation and Small Business (PINBUK) the number of BMTs in Indonesia stood at over 4000 at end-2007 with assets of about USD150 million (PINBUK, 2008).

Zakah **&** ***Sadaqa*****-Based Institutions:** Rooted in Islamic charity, such institutions have existed since the advent of Islam and are found in all Muslim societies. However, these lie mostly in the informal sector with the exception of a few recent initiatives that have graduated as distinct models, are part of the mainstream and are also being replicated elsewhere. The first is the economic empowerment model developed and practiced by Dompet Dhuafa in Indonesia. The model involves intense involvement and participation by the organization, especially in the initial stages of intervention in formation of groups and provision of technical, managerial and (low-cost) financial services. It also involves a high degree of community participation, development of local cadres and creation of a local member-based organization to provide sustained assistance in meeting the challenge of poverty. A second model that has caught the attention of many is Akhuwat in Pakistan. This model aims to institutionalize charity, good giving and voluntarism and thereby, provide cost- free financial services to the poor. According to recent estimates, over one-third of operational cost of the organization is absorbed by donations made by its own past clients who have successfully progressed out of poverty.

Good & Bad Practices with Indigenous Islamic Models

A very strong positive with Dompet Dhuafa and Akhuwat models is their ability to demonstrate that charity can be a dependable and sustainable source of raising funds. Additionally the institutionalization of voluntarism along with other creative strategies has the effect of drastically cutting down operational costs. Thus, microfinance is now provided at low or zero costs, making it affordable to the poorest of the poor. Further the high degree of involvement of local communities as in case of the Dompet Dhuafa model leads to true and sustainable economic and socio-political empowerment.

While the above initiatives have distinct elements of superiority over the many conventional high-cost microfinance providers, the fact remains that most other indigenous institutions do not share in their dynamism, professionalism and good governance. A large majority of charity-based Islamic institutions operate in the informal sector. Many of these institutions are characterized by lack of transparency, poor accountability and governance structures, low operational efficiency and consequently, high operational costs. They report practices that provide encouragement to continued dependency on charity. Further, most of them have poor linkage with the formal financial system and operate in a regulatory vacuum. A case in point is the Indonesian BMT that does not have a uniform legal status. Most small BMTs function as informal entities without any distinct legal form. Most of medium and large BMTs are registered as Shariah Cooperatives (KJKS) with the Ministry of Cooperatives and SME. Since the rationale underlying the creation of a cooperative is to provide services to its members, the law of cooperatives is not very demanding in terms of accountability, transparency and governance of the institutions and many are able to evade compliance on account of lax supervision.

Combining Philanthropy with Profits

Islamic replications of conventional microfinance as well as the indigenous models are characterized by unique positives and negatives. The former involves a market-driven for-profit approach while the latter is rooted in philanthropy and benevolence. Can these two distinct approaches be combined in a composite model? Can such a composite model retain the efficiency and transparency of the former and the low-cost feature of the latter? Theoretically of course, this is a possibility. In such a model, zakat and charity funds may be applied for provision for basic consumption needs of the poor. Such funds may also be applied for enhancement of skills and provision of other services that the poor need. The organization also raises investment funds that are applied for provision of Shariah-compliant microfinance on a for-profit basis. Indeed, a few recent experiments have important lessons. A case in point is the Deprived Families Economic Empowerment (DEEP) project operational in Palestine. The project envisages creation of an endowment fund in the framework of *waqf* that could provide for a sustainable source funds for provision of safety net. The Indonesian BMTs are also clear examples of composite models.

Mixed models come with their pros and cons. On the positive side, these models could combine access, sustainability and affordability considerations, combine mission-based approach with market-based instruments resulting in use of best-fit instruments and modes and therefore, could go for flexible pricing and product design. On the flip side, however, such models may involve serious problems due to conflicting organizational culture and conflicting policy and regulatory framework. As has been observed in case Indonesian BMTs, most of them have over time, preferred to do away with their philanthropic aspirations (as house of charity) and concentrated on for-profit *murabaha* financing (as house of financing). The twin-track nature of the model seems to have been abandoned for all practical purpose. Last, but not the least, combining Islamic charity, especially zakat collection and application with for-profit financing involves serious transparency and governance issues associated with commingling of funds. A major condition with raising zakat funds requires such funds to be directly channeled into the hands of the eligible beneficiaries or the poor and cannot simply be credited to the organization capital. In the absence of relevant accounting standards and regulatory norms to ensure the above, the Shariah scholars have generally discouraged the use of zakat funds in economic empowerment initiatives preferring the direct channels of distribution for consumption purposes instead.

It appears that successful philanthropy and cooperation-based models of Islamic microfinance are largely micro-level interventions without similar initiatives at the meso or macro levels. The operationalization and mainstreaming of such models though clearly desirable, face serious challenges. At a meso level, there is an urgent need for developing relevant accounting and governance standards for all the key modes, e.g. *zakat*, *sadaqa*, *waqf*, *qard* and *kafala*. There is also a need to develop quality education and training programs for the sector. Further, most Muslim societies have archaic, if at all, regulatory frameworks for zakat, *waqf* and other Islamic nor-for-profit institutions. An enabling macro-economic environment is a sine qua non for development of such models of intervention.

CHAIR FOR ETHICS AND FINANCIAL NORMS
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Creditor-Debtor Relations: Some Issues, Some Proposals[(1)]

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1. Introduction

Taking debt has always been a controversial issue. The decision has historically been viewed differently in different cultures. Perceptions about the extent of its benefits and harms have also varied in various economic situations. In the last fifty years debt-taking has been on the rise due to an increasingly tolerant view by economists, commending its advantages and dismissing its well-known macroeconomic disadvantages. This school of thought considers that leveraging is a useful way of increasing wealth. Debt can open up many opportunities for individuals, corporations and governments to meet the needs or capture opportunities that their present incomes cannot afford and can also increase national income by putting idle resources into use. The 2008 debt crisis has raised a number of questions about this tolerant view and even those who took liberal stands with respect to debt are now reconsidering their opinions.

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(1) This paper is a “work in progress”. It is being distributed only as a handout for this lecture for seeking comments.

Another school has since long advocated that debt (except in very exceptional cases) leads to misery, depression, both mental and economic, and gives others the chance to control your wealth, honor and freedom. Debt creates misunderstandings, malice, enmity between debtors and creditors and even war between nations.

Perhaps both of these are extreme views. However, in the opinion of this author the latter is much closer to reality than the former. My understanding of Islamic rulings about debt inspires me to suggest that those rulings can be of an immense help in determining the proper role of debt and help avoiding situations like the debt crisis of 2008-09 and the Eurozone economic crisis of 2011-12.

This paper makes an effort to determine the role of debt in wealth creation and its appropriate limits. It endeavors to derive some principles that can help creating smoother relations between debtor and creditors, be they individuals, corporations or countries. Before doing that, however, we need to make an important distinction between a ‘creditor’ and a ‘lender’.

1. Creditors versus Lenders: An Important Clarification

It is not a matter of semantics. The distinction between ‘creditor’ and ‘lender’ is important from an Islamic point of view. In modern finance, the difference between a ‘debt’ and a ‘loan’ has been obscured. The terms ‘debt’ and ‘debtor’ are often mixed up with ‘loan’ and lender respectively. For example, if we look for the definition for ‘debt’, we find in some famous dictionaries/resources the following definitions:

The Encyclopedia Britannica’s article on debt reads “debt, something owed. Anyone having borrowed money or goods from another owes a debt and is under obligation to return the goods or repay the money, usually with interest”.

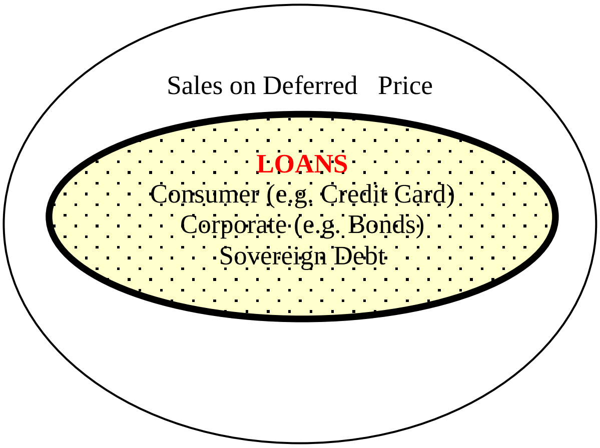
Farlex Financial Dictionary gives the definition of debt as follows:

“Any money owed to an individual, company, or other organization. One acquires debt when one borrows money.”

Another influential source defines the term as:

“An amount of money borrowed by one party from another. Many corporations and individuals use debt as a method for making large purchases that they otherwise could not afford at the time of purchase. A debt arrangement gives the borrowing party permission to borrow money under the condition that it is to be paid back at a later date, usually with interest."

From an Islamic legalistic point of view, debt (debtor) and borrowing (borrower) ought to be distinguished from loan (lender) and credit (creditor). The Arabic word 'dayn' (debt is its close but not exact translation) has a wider meaning than 'loan'. Loan is only one of many contracts/ways that generate debt. In technical parlance, loan is a subset of debt. The idea is shown in the following diagram.



This distinction is important because in Islam loans and other types of debts have different roots. Unfortunately, even many Muslim writers often use the words interchangeably. The distinction is important because Islamic finance derives its rationale from the prohibition of *riba* in Islam. Now there is near consensus among Islamic jurists that modern bank interest falls within the preview of prohibited *riba*.

In a loan contract, the lender cannot earn a return (or obtain any benefit from borrower). However, return of his principal amount is guaranteed. That *riba* (interest) is prohibited in Islam does NOT mean zero rate of return to capital. It may be noted here that the Islamic position on interest is quite different from the position of Lord Maynard Keynes, one of the most influential economists in the history of capitalism. Keynes had suggested zero or near zero rate of interest as a means to ensure continuous full employment and distributional equity.

His suggestion was to promote investment and aggregate demand, which in turn will increase income and employment. Other economists have described many problems that a one-sided increase in aggregate demand can cause. Later in this paper, we will also comment on the deficiencies of such a policy.

What Islamic position DOES, however, mean is that capital given as loan CANNOT earn a return. As against this, capital employed using other contracts, including trading can, and normally does, earn a return. For example, in Islamic finance, if *bay al- murabahah*, a trading contract is used, the seller sells a commodity on a price which includes cost plus an agreed amount of profit. The payment of price can be and is normally delayed. Thus the contract creates a debt. Now, once a debt has been created, the creditor cannot ask the debtor to pay anything more than the deferred price. The seller earns a return on his capital but only once.

The conclusion of the above discussion is that Islamic prohibition of *riba* applies to ALL types of debts, not only to loans. Similarly, the guarantee of the 'principal' applies to ALL types of debts, not only to the debts generated by loans. Loans and debts are treated equally in terms of the principal amount but differently in terms of getting a return on the principal. Another important point to remember here is that the return that the owner of capital gets is against a risk that he has taken in using his capital in a particular way. Similarly, the capital of a lender is guaranteed because he did not take any risk with his capital. Therefore, just as it is unjust for the lender to demand a return with his capital guaranteed, it is equally unjust for the borrower not to return the principal to the lender.

What if the debtor defaults? Knowing that he *connot* be obliged to pay anything more; will he not have a strong incentive to default? These and similar questions are the main focus of this paper. We will start discussing these questions from purely economic point of view. Morally speaking, a good Muslim (a good human being following any faith, for that matter) will fulfill his obligations. However, most human beings, including Muslims, have imperfect morality and they love money. Human history proves what the Holy Quran stated:

وَّتُحِبُّوْنَ الْمَالَ حُبًّا جَمًّا

"And you love wealth exceedingly". [89:20].

Admittedly, both creditors and debtors have a penchant to amassing wealth with as little pain as possible. Therefore, the question is that in a *world of imperfect morals*, how we devise creditor-debtor relations to ensure justice to all concerned parties and to protect them from the greed of one another. Protecting the rights of both groups will also protect the financial system and the global economy from disastrous fluctuations and instability. In this paper we present some principles about debt creation which will hopefully lead to better creditor-debtor relations.

2. Six Principles for Better Creditor-Debtor Relations

The principles that we believe will help improving creditor-debtor relations are:

1. The Principle of 'Principals'
2. The Principle of 'Non-Principals'
3. The Principle of Restraint
4. The Principle of M-R Linkage
5. The Principle of Relief
6. The Principle of Transparency

Let us discuss them one by one.

1. The Principle of 'Principals':

Justice demands that the creditor must get his principal back. If it emerged from a loan contract, the lender did him a favour (expecting a reward only from God) and if it emerged from a sales contract he earned a profit once but thereafter his money has the same status as that of a lender.

The guarantee of principal in debt instruments increases the supply of credit in the economy. It can open the door for risk-averse investors wishing to protect their investments while participating in gains from their investment. In modern finance, a parallel is a Principal Protected Note (PPN). A PPN as stated in Canadian Principal Protected Notes Regulation (SOR/2008-180) "means a financial instrument that is issued by an institution to an investor and that:

(a) provides for one or more payments to be made by the institution that is determined, in whole or in part, by reference to an index or reference point, including

(i) the market price of a security, commodity, investment fund or other financial instrument, and

(ii) the exchange rate between any two currencies; and

(b) provides that the principal amount that the institution is obligated to repay at or before the note's maturity is equal to or more than the total paid by the investor for the note.

The regulation states that "A principal protected note does not include a financial instrument that specifies that the interest or return on the instrument is solely determined on the basis of a fixed rate of interest or return or a variable rate of interest or return that is calculated from the institution's prime lending rate or bankers' acceptance rate".

We have quoted PPN as an example from modern financial instruments that comes close to Islamic instruments designed for risk-averse investors, e.g., *bay al-murabahah*. However, since the investor in a PPN does not share in the natural risk of investment, yet expects 'some' return, it violates the Islamic principle of "no pain, no gain".

The Principle of Principals that we are discussing is meant to ensure justice between the fund providers and fund users.

The holy Quran states:

وَاِنْ تُبْتُمْ فَلَكُمْ رُءُوْسُ اَمْوَالِكُمْ ۚ لَا تَظْلِمُوْنَ وَلَا تُظْلَمُوْنَ

"If you repent, you are entitled to your principal. Deal not unjustly nor shall you be dealt with unjustly"

This is part of verse [2:279] of the Holy Quran. The real significance of this statement will become apparent after we have discussed the second principal on our list.

The principle of principals is also established from the following Hadith:

قَالَ رَسُولُ اللَّهِ صَلَّى اللهُ عَلَيْهِ وَسَلَّمَ: «الْعَارِيَةُ مُؤَدَّاةٌ، وَالْمِنْحَةُ مَرْدُودَةٌ، **وَالدَّيْنُ مَقْضِيٌّ**، وَالزَّعِيمُ غَارِمٌ» [سنن أبي داود (٣/ ٢٩٦)]

"Anything given for benefitting from its usufruct is to be returned, a she-camel given temporarily for milking must be given back, **a debt must be discharged**, and one who stands surety is responsible to honor it". [Sunan Abu Dawood]

2. The Principle of 'Non-Principals'

While we believe that the principal amount due to any creditor must be protected, we also believe that the greed of creditors must also be restrained. Once a capital owner has earned a return having exposed his capital to risk, that should be the end of the deal. If an investor wants to earn continuing returns, he must continue to participate in the risk as well. So the real issue is not only bringing the interest rate down to zero, as a Keynesian policy prescription will like us to do. As a matter of principle, capital must earn a return in order for the economic growth to be sustainable. As a matter of principle also, the 'capitalist' must participate in risks which are part and parcel of everyday business. Insisting on the first principle and disregarding the second is a sure recipe for economic instability.

It is an established economic fact that in case of interest-based debts, the debtor in most cases returns to the creditor more than the principal through debt-service payments. The creditor does not share any risk, (except the risk of default, which is one of the issues under discussion). Claiming the total amount of debts (principal plus compounded interest) by the creditor without risk-sharing is unjust. Economic history tells us that this injustice causes pains and panics.

If the purpose is to establish justice, principals and non-principals must be treated differently. It is not only the careless (or carefree) debtor alone who is to be blamed, the insatiable (reckless) creditor must also share part of the blame and the results. Non-Principals need not be guaranteed. Economics tells us that and history gives us that lesson. Now read the full verse of the Holy Quran [2:279]

فَاِنْ لَّمْ تَفْعَلُوْا فَاْذَنُوْا بِحَرْبٍ مِّنَ اللّٰهِ وَرَسُوْلِهٖ ۚ وَاِنْ تُبْتُمْ فَلَكُمْ رُءُوْسُ اَمْوَالِكُمْ ۚ لَا تَظْلِمُوْنَ وَلَا تُظْلَمُوْنَ

"But if you do not (give up interest), then listen to the declaration of war from Allah and His Messenger. However, if you repent, you are entitled to your principal. Deal not unjustly nor shall you be dealt with unjustly".[2]

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(2) One of the famous translations of the Holy Quran (by Mohsin and Hilali), makes the point very clear. They interpret the verse as: "And if you do not do it, then take a notice of war from Allah and His Messenger but if you repent, you shall have your

One of the prominent writers in Islamic finance, Umer Chapra, comments on this verse as follows:

“The principal reason why the Quran has delivered such a harsh verdict against interest is that Islam wishes to establish an economic system where all forms of exploitation are eliminated, and particularly, the injustice perpetuated in form of the financier being assured of a positive return without doing any work or sharing in the risk, while the entrepreneur, in spite of management and hard work, is not assured of such a positive return. Islam wishes to establish justice between the financier and the entrepreneur”.(3)

3. The Principle of Restraint

This is perhaps the most important of the six principles. Today we witness a debt explosion. It is worse than a ‘bomb explosion’. Its spread is wider; it dishonours, disables and kills more people. Worst, it enslaves people. In the full paper we will document this. For the time being suffice to draw attention to books/stories and terminology that has gained currency, e.g., “Debt is Slavery(4)”; “Debt is Virus(5)”; “Debt Bondage”, “Debtor’s Prison”; “Wage Garnishment”, etc.

Let me, however, give you a couple of examples that debt forces people to make different decisions in their life. Consider a person Zaid, who has no debts to pay. He is laid off. He has to find a job. But his friend Bakr is also laid off. Unfortunately, he has a lot of debt to pay. He also have to find a job, but his need for a new job is much more urgent that that of Zaid. He will most likely accept a job that may not fit his career ambitions. Urgency of his debt instalments will force him to accept something that he does not like. Zaid also has to find a job, sure, but he can wait for something that he likes to come up.

Buying a house on mortgage has many pluses and minuses. We cannot discuss that here. The point that I wish to make is that with cash

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capital sums. Deal not unjustly (by asking more than your capital sums), and you shall not be dealt with unjustly (by receiving less than your capital sums).

(3) Chapra, Umer (1985), p.64.

(4) Mihalik, Michael (2007).

(5) Jacques S. Jaikaran (1992);

(6) The Independent, Friday, April 13, 2012.

you have more options. You can negotiate a deal better. It is an established economic fact that people like to have money now than three years later. Put $25,000 on the table and you may get the house which had been bidden for $30,000. Your decision making and bargaining power is in your hands rather than your mortgage handler.

The time of sending your daughter to college comes. You start counting your pennies. You find that after making monthly payments out of your salary, there is not enough left to pay for her education. You begin thinking that had you not bought that fluffy little cat for $500 and not spent $50 per month on cat food; had made do with your 21" perfect-running television instead of buying on credit that Wega 32" Trinitron; etc., you could perhaps spare so money for her education. However, it is too late now. Debt has snatched away your decision making and limited your options. You either go for another loan or delay sending her to college until she works to save enough money. It is not sure whether she will ever be able to complete her education.

Banks only tell us of their 'bad debts'. What I am trying to tell you is that *almost* all debt is bad. If "living beyond one's means'" is bad for an individual, it is equally bad for corporations and for governments. In resorting to debt finance, restraint is the rule for ALL, individuals, corporations and governments alike. 'Easy money' leads people to ignore the precautions that one must take even when taking debt is considered to serve some useful purpose or becomes inevitable. One must *never* forget that once incurred, debt must be discharged, except in very exceptional circumstances that we will mention under the next Principle.

The school of thought that advocates leveraging as a mean of increasing wealth often advocates using OPM (other people's money) to prosper. We are told that it is smart to "use other people's money" to start a new business. You will get rich, no pains. This may sound great in theory. When you enter into practice, you find it to be quite different. The fact of the matter is that debt is not OPM. It is opium! Debt is habit-forming. Easy access to credit has some benefits, but once one lifts the guards, debt sneaks in like a snake, grows into a serpent that ultimately crushes one's bones. The worst part of it is that most, if not all, debt is unnecessary and can be avoided.

Hardly anyone will question the undesirability of what is known as 'gambling debt'. Yet the volume of such debt runs into billions. The average (gambling) debt is between $63,000 and $110,000[(6)] and is increasing. Just in one State, Wisconsin, the average gambling debt in 2011 more than doubled the previous record of $62,000.[(7)] Trend in other states of US and other Western countries is the same. Easy access to debt plays an important role in making a person pathologically addicted to debt. Let us now see some of the effects that such debt may lead to:

- Uncontrolled spending, the resulting debts and access to more money to gamble has a significant impact on health and can cause marital conflict, child neglect, poor work performance, multiple addictions, stress related physical ailments, crime and even suicide.[(8)]
- The rate of attempted suicide among compulsive gamblers is 200 times the national average.[(9)]
- Canada has up to 360 suicides a year by gambling addicts.[(10)]
- Twenty per cent of gamblers file for bankruptcy.[(11)]
- Studies show that two out of three pathological gamblers commit crimes to pay off debt or to continue gambling. These include, among others, embezzlement, cheque forgery, stealing credit cards, tax evasion, fencing stolen goods, insurance fraud, bookmaking, and/or employee theft, in some cases they involve violence and armed robbery.[(12)]
- The problems are not limited to individuals. "When you're dealing with one addict, you're dealing with 8-10 other people that get affected because of the addiction";[(13)] and the society in general suffers a lot. Society's cost per pathological gambler per year is

(6) CT Department of Mental Health, USA.
(7) Statistics compiled by the Wisconsin Council on Problem Gambling.
(8) Topp, Sawka, Room, Poulin, Single and Thompson, 1998.
(9) Arnie Wexler, the former executive director of the New Jersey Council on Compulsive Gambling and now head of a consulting firm that specializes in compulsive gambling.
(10) Canada Safety Council.
(11)Warren Kindt and John K. Palchak, Bankruptcy Developments Journal, volume 19, No. 1.
(12) Report of the National Council on Welfare, 1996, p.28.
(13) Ed Looney: the Council for Compulsive Gambling. March 21, 2006 Gambling at an All Time High www.family.org/cforum.

$13,586. These costs include, crime, suicide, illness, business and employment costs, bankruptcy, social services, and direct government regulatory costs.[14]

- News paper stories relate many stories that due to gambling debt, many persons have forced their daughters and wives into immoral activities and in primitive societies even sold them.

Let us speak about a more ‘benign’ type of debt; credit card debt, whereby you can charge your dinner(s) and holidays to credit cards, not to speak of furniture, televisions and almost every consumer durable even pets. Wise people once used to say, “it is better to go without dinner the night before, than waking up in debt the morning after”. Now there are sales people who tell you that what they are offering you to buy is part of the ‘normal’ way of life. So many people in your neighbourhood bought it and they are so happy that they did. You can easily afford and join the club of your ‘happy’ neighbours. One will tell you how you can pay for this timeshare plan to finance your ‘annual’ vacations in a splendid resort city. Other will tell you that trading in your old and out-dated car with this new one with awful convenient features at so low interest rate is a such a wonderful buy that you will regret for years if you did not take it. Yet another will tell you, even if you already have two credit cards, you must buy this one. It will enhance your credit score. It is the best defence in emergencies, and who doesn’t have emergencies.

Now among the 185 million card-holding U.S. consumers, the average person carries three bank-issued credit cards, four retail credit cards and one debit card, according to CardWeb.com. According to a survey by the American Bankers Association and Dove Consulting, plastic payments now account for 53 per cent of consumer purchases, compared to 43 per cent in 1999. In 2011, credit card purchases crossed $2 trillion. The average credit card debt per card holder is estimated to be more than $6500 and it is one of the most expensive types of debt. Access to easy money, does not let people to make their calculations right. You are told that with credit card you can track your expenses more easily. That may be true. But what it makes easy is your past expenses. At the moment of making the expense, you hardly think

(14) Casino Watch.

whether you can afford that $200 purchase or not. It is like putting your car on ‘cruise’, without having your foot on the brakes. Would that not put you to a big risk of crash?

The annualized rate of interest on credit card debt is more than 50%; (that’s why the credit card issuers are keener to create such debt than the consumers). Consumers do not realize that they pay higher prices using credit cards. Transaction fees that the merchants pay are ultimately added to the prices. Now merchants, led by retailers like Wal-Mart, Sears and Safeway are set on lowering transaction fees. They're pushing for more debit card transactions which, pulled directly from a buyer's bank account, cost merchants much less.

Using debt causes people to spend more. They do not even notice many ‘hidden’ costs. A ‘small’ courier fee does not even enter into household budgeting. When you buy a new car on credit, you pay; say $1000 as down payment to the dealer. A ‘few’ bucks to the middleman and a ‘few hundred’ to the car care shop next door (most likely owned by the same dealership) to install some fantastic ‘optionals’. These dollars do not record the same way in household budget as groceries do. One of the biggest harms of debt is that people do not watch their spending like they do with out of pocket spending. More than two million households in US carry more than $20,000 in credit card debt.[15] Such huge consumer debts create tensions in households. Have we not heard stories of divorces taking place on not taking out enough for dinners and holidays? A recent study printed in the New York Times[16] showed that money fights are a predictor of divorce in marriage. A study, by Jeffrey Dew at Utah State University, tried to quantify that risk. His findings show that couples who reported disagreeing about finance once a week were over 30 per cent more likely to get divorced than couples who reported disagreeing about finances a few times a month.

Compare this to the Islamic position on debt. In an Islamic system, it is one of the five compulsory duties for a Muslim to undertake a journey to Mecca to perform pilgrimage once in one’s life time. However, this *compulsory* duty is condoned for those who cannot afford to undertake

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(15) Business Insider, May 23, 2011.

(16) “Money Fights Predict Divorce Rates”, Catherine Rampell, *The New York Times*, May 4, 2012.

this journey. If someone is in debt, payment of debt takes precedence over performing the pilgrimage.

In the area of corporate debt, the mention of the famous Modigliani-Miller Theorem (MMT) is inevitable. This theorem states that a firm's value is independent of how it is financed, i.e., leveraging does not affect the value of a firm. It only determines the distribution of cash flow from operations among creditors and owners. In the literature the MMT has been extensively studied. Even though, the results are not conclusive, the debt proliferators have conveniently ignored its main message. Without any conclusive evidence, they have relied on some partial and conflicting results to justify borrowing as heavily as their credit rating would allow. However, after the financial crisis of 2008-2009, there have been influential voices questioning the usefulness, or at least the level of, leveraging that we see today.

Let me quote here from the statements of an on-going dialogue that started from the discussions at the Brookings Panel on Economic Activity 2010. At that forum Alan Greenspan's, the famous former Chairman of Federal Reserve of the United States (1987-2006, the second longest tenure in that position), presented a paper "The Crisis". He made a number of reform proposals in that paper. One of those was raising capital requirements and reducing leverage. However, he suggested that there are limits to how much we can do so. He was of the opinion that if we reduce leverage too much; financial intermediaries will be not be sufficiently profitable to remain viable. His proposals have generated a lot of debate. In brief, a large majority agrees on reducing the leverage and there are a number of influential voices which question his reservation on the limits to such reduction.

One such voice is that of Harvard economist Greg Mankiw which is worth quoting. He says, "Indeed, I think it is possible to imagine a bank with almost no leverage at all. Suppose we were to require banks to hold 100 per cent reserves against demand deposits. And suppose that all bank loans had to be financed 100 per cent with bank capital. A bank would, in essence, be a marriage of a super-safe money market mutual fund with an unlevered finance company. (This system is, I believe, similar to what is sometimes called "narrow banking"). It seems to me that a banking system operating under such strict regulations could well perform the crucial economic function of financial intermediation. No leverage would be required.”

Another recent study by Anat R. Admati, Peter M. DeMarzo, and Paul Pfleiderer of the Graduate School of Business, Stanford University, states:

“It is also incorrect to translate higher taxes paid by banks to a social cost. Policies that subsidize debt and indirectly penalize equity through taxes and implicit guarantees are distortive. Any desirable public subsidies to banks’ activities should be given directly and not in ways that encourage leverage. And while debt’s informational insensitivity may provide valuable liquidity, increased capital (and reduced leverage) can enhance this benefit. Finally, suggestions that high leverage serves a necessary disciplining role are based on inadequate theory lacking empirical support. We conclude that bank equity is not socially expensive, and that high leverage is not necessary for banks to perform all their socially valuable functions, including lending, deposit taking and issuing money-like securities. To the contrary, better capitalized banks suffer fewer distortions in lending decisions and would perform better. The fact that banks choose high leverage does not imply that this is socially optimal, and, except for government subsidies and viewed from an ex ante perspective, high leverage may not even be privately optimal for banks”(17).

I am sure these views will be contested. However, abstracting from the ‘value of a firm’ and considering the interests of the economy in general, we believe that if we factor in the above-mentioned risk factors (and not all have been mentioned), in contemporary world, they will far outweigh the benefit that could be gained by leveraging not securely linked to the real sector in an economy. If and when leveraging is to be considered, it must be considered keeping in view ‘sustainable’ growth in the real economy. Islamic injunctions with respect to the role of debt in economic matters provide useful insights. Position Statement on the financial crisis of 2008-2009, in a gathering of more than 250 economists

(17) Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig, Paul Pfleiderer, “Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive”, The Rock Center for Corporate Governance at Stanford University Working Paper Series No. 86, September, 2010.

under the umbrella of the International Association for Islamic Economics, states the problem of uncontrolled debt expansion ardently: "The current crisis stemmed from excessive indebtedness resting on a relatively small base of equity and real wealth, 'the inverted debt pyramid'. A significant chunk of finance became merely the selling present for future money. Besides, poor regulations have encouraged over indebtedness. The Statement goes on to say that "Heavy reliance on debt intensifies economic instability, hence human insecurity, and generates significant negative economy-wide externalities, as painfully exemplified by the present crisis. The collapse of financial institutions inflicts harm upon shareholders, employees, and a host of innocent bystanders. Common economic sense suggests discouraging debt financing and encouraging benign alternatives. However, the exact opposite (e.g. preferential tax treatment of personal and corporate debt) is still the rule"(18). Bankruptcy laws, such as America's Chapter 11, thwarted attempts by creditor for foreclosing on companies, well in time to prevent bailout using tax payers money later.

The current situation wakes us up to some Ahadith of Prophet Muhammad (pbuh), related as a frequent prayer that he used to ask of Allah (SWT):

٥٤٨٨ – عَنْ عَبْدِ اللَّهِ بْنِ عَمْرٍو، أَنَّ رَسُولَ اللَّهِ صَلَّى اللهُ عَلَيْهِ وَسَلَّمَ، كَانَ يَدْعُو بِهَؤُلَاءِ الْكَلِمَاتِ: «اللَّهُمَّ إِنِّي أَعُوذُ بِكَ مِنْ غَلَبَةِ الدَّيْنِ، وَشَمَاتَةِ الْأَعْدَاءِ»[سنن النسائي (٨/ ٢٦٨)]

Prophet (PBUH) used to frequently pray: "O Allah! I seek YOUR refuge from being overcome by debts and from anything that would make my enemies happy."

٦٣٦٩ – سَمِعْتُ أَنَسَ بْنَ مَالِكٍ، قَالَ: كَانَ النَّبِيُّ صَلَّى اللهُ عَلَيْهِ وَسَلَّمَ يَقُولُ: «اللَّهُمَّ إِنِّي أَعُوذُ بِكَ مِنَ الهَمِّ وَالحَزَنِ، وَالعَجْزِ وَالكَسَلِ، وَالجُبْنِ وَالبُخْلِ، وَضَلَعِ الدَّيْنِ، وَغَلَبَةِ الرِّجَالِ» [صحيح البخاري (٨/ ٧٩)]

(18) Economic Solutions from Islamic Finance: Position Statement of the International Association for Islamic Economics, Issued at the occasion of the Eight International Conference on Islamic Economics, Qatar, November, 2011.

Prophet (PBUH) used to frequently pray: “O Allah! I seek YOUR refuge from distress and sorrow, from helplessness and laziness, from miserliness and cowardice, from being heavily in debt and from being prevailed over by men "

It is well-known that the prayers of the Prophet (PBUH) were an important way of teaching people what is desirable and what is not. The importance of the two Arabic words used here, i.e., ‘غَلَبَةِ الدَّيْنِ’ and ‘ضَلَعِ الدَّيْنِ’ needs to be noted. The first refers to a situation where one is overcome by debt. In other words his freedom of action becomes impaired. This we notice in case of individual, corporate and sovereign debt today. In many ways, the debtor is under creditor’s control.

The second word ‘ضَلَعِ الدَّيْنِ’ indicates a situation where the debtor feels as if he is in shackles. He feels and suffers the pain but is stuck and sandwiched. Again we notice that this is the condition that the debtors find them in when debt becomes excessive.

4. The Principle of M-R Linkage

If there is a grain of truth in the argument that leveraging can be a mean to increasing wealth, it *must* necessarily be qualified. Money creation, whether through borrowing from the central bank by a government (running the printing machine) or through credit creation by commercial banks must be linked to the real sector. In the words of the Position Statement of the International Association for Islamic Economics, “to build a sustainable system, debt must grow in tandem with real (as opposed to financial) wealth; leverage must be capped by productivity potentials. This allows for real wealth to grow without being hurdled with too heavy debt”. One of the most prominent Islamic economists, Khurshid Ahmad explains the issue more clearly:

“The delink between money and production activity has led to the emergence of two parallel economies, a money economy and other the real physical economy. Money that was an instrument of exchange and a measure of value became the sole embodiment of value. An instrument that was designed to facilitate exchange and production became an object in itself. Real economy slumbered but financial economy expanded beyond all limits, enriching those alone who were engaged in the business of finance. This created a fiduciary world of its own. Money generating more money without producing Goods and Services in the economy, without increasing the stock and flow of assets in the society. In this new fangled economic order money became the main player as well as the prize. The process of real value-addition in the economy has been slowed if not disrupted. Money and creation of fiat money became the real game, resulting in the creation of wealth that only produces billionaires without adding much to the well being of the people. The result is that the system has succeeded in creating an economy wherein presently while the world GDP in current prices is around $60 trillion, we have an ever expanding realm of fiduciary money, wherein annual trade in derivatives now exceeds $900 trillion. In this game the real players and also beneficiaries are only a few thousand pseudo-investors while the whole global economy is at the suffering end. The same is true of the foreign exchange markets where daily trade in foreign currencies is fifty times more than the volume of daily movement of trade and tourists. The present day vulnerability and instability of the capitalistic economy owes much to this fatal delink."[19]

5. The Principle of Relief

As stated above; once incurred, debt must be discharged, except in very exceptional circumstances. In general, creditors' right to get their principals back must be protected, but they cannot go beyond a certain limit, e.g. enslaving the debtors. An important distinction must also be made between a "delinquent debtor" and a "distressed debtor". The former is a debtor who has enough assets or fairly certain flows of future income or wealth to discharge his debts. Such debtor must be dealt with strictly. Later in the paper, we will mention legal measures to do that. The latter is a debtor who despite his willingness to pay and sincere efforts made to discharge his debt, is not in a position to honour his payment liabilities. Such a debtor deserves to be provided relief.

This principle is well-established in Islamic law. Here I quote two *nusus* (Islamic texts).

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(19) Ahmad, Khurshid, "Global Economic Crisis and the Role of Islamic Economics", IDB Prize Laureate Lecture, April 21, 2012.

1. “And if the debtor is going through a hard time (has no money), then grant him time till it is easy for him to repay, but if you remit it by way of charity, that is better for you if you did but know.” [Al Quran 2:280]

2. “During the time of Prophet (PBUH), the fruits of one Companion’s garden got destroyed due to which his debts piled up. Prophet (PBUH) asked the Companions to collect funds to help him pay his debts. They did, but the collection was not enough to pay the debts. Upon that he told the creditors “take this and you do not have any more claim against him.” [Sahih Muslim]

Some important points that emerge from the Hadith quoted above need to be noted. These are:

1. The right of the creditor to his principal was recognized [Principle of principals].
2. All possible efforts were made to discharge the debt in full. For this purpose, even charity was collected.
3. Having done that, when ‘available’ money was not enough, debt write-off was granted.

For a distressed debtor, there are even more measures in Islamic system. These are:

A. Prohibition of Interest

That the amount of debt cannot be increased, whether it originated from a loan or an exchange transaction, gives the debtor time to put his house in order. Tolerance shown to the distressed debtor by not increasing the amount of debt and extending the period of repayment is good not only for the debtor. It is also good for the creditors and the economy in general. It has both ethical and economic justification. When markets turn down, decline of collateral value triggers downward spiral as creditors try to protect their positions. However, this would make the market self-destructive, transforming a downturn into a crash. Forbearance relieves debtors, giving them better chances for repayment which will go to the advantage of the creditors. Preserving the value of collaterals and preventing market crash will benefit the entire economy and the society.

B. Hawalah (Reassignment of Debt):

This is voluntary and charitable act where someone undertakes to pay the debts of another person. No fee, compensation or benefit can accrue to the one taking up this responsibility.[20] In this regard it is stated in Sahih Bukhari that Prophet (pbuh) said, "Procrastination (delay) in paying debts by a wealthy person is injustice. So, if your debt is transferred from your debtor to a rich person, you should agree."

C. Share of gharimeen (those in debt) in zakah

As is well-known, zakah is a compulsory levy imposed by God on every Muslim who has a net-worth above a minimum level called ‘nisab’. Of the five ‘pillars of Islam’, zakah is the second one. It is an earmarked levy. Its beneficiaries are fixed who are grouped in eight categories. One of these eight relates to those who have debts that they are unable to pay. In this way, the rich people in the whole society contribute to payment of debts, in case of distress.

D. Given enough available resources, the state is responsible to discharge the debt. Prophet stated (as a head of the state) that:

«أَنَا أَوْلَى بِالْمُؤْمِنِينَ مِنْ أَنْفُسِهِمْ، فَمَنْ تُوُفِّيَ مِنَ المُؤْمِنِينَ فَتَرَكَ دَيْنًا، فَعَلَيَّ قَضَاؤُهُ، وَمَنْ تَرَكَ مَالًا فَلِوَرَثَتِهِ» [صحيح البخاري (٣/ ٩٧)]

"I am more rightful than other believers to be the guardian of the believers, so if a Muslim dies while in debt, I am responsible for the repayment of his debt, and whoever leaves wealth (after his death) it will belong to his heirs. " [Sahih Bukhari]

It is important to note here that the Prophet (pbuh) made this stateman when the public exchequer got rich. Earlier, the state did not take this responsibility. Therefore, such obligation is subject to availability of enough resources in the public exchequer.

(20) This may not be confused with ‘money transfer’, whereby an institution transfers money from one place to another against a fee. Charging such a fee is permissible.

The benefits

In contemporary law there are some parallel measures including write-offs, debtor protection laws, bankruptcy/insolvency acts and bailouts. In most legal jurisdictions there are bankruptcy and/or insolvency laws. These are designed to settle creditor-debtor disputes in amicable manners. In most such laws, some sort of relief to debtors is built in. For example, the Canadian Insolvency Act (1986), there is a provision called “A Company Voluntary Arrangement (CVA)”. This is a legal agreement between a company and its creditors, based on paying fixed monthly payments by the company to its creditors, the total amount of payments being less than the actual total debt. At the end of the agreed term, and given regular payment of agreed installments, the remaining debt is written-off.

Unfortunately, these provisions are often misused. Bankruptcy fraud is so rampant that calls for reform are loud and clear. Such fraud may take the form of concealment of assets by the debtors, multiple bankruptcy filings in different legal jurisdictions, intentional inaccuracies in bankruptcy petitions in order to prolong the proceedings to the disadvantage of creditors and similar other acts of camouflaging. In the full paper we will analyze some case studies of bankruptcies declared in recent years.

Bailouts like the one of Fannie Mae and Freddie Mac raise the expectations of future bailouts. That would lend support to the “too big to fail” theory. In this and other similar cases, rescue operations by central banks by reducing interest rates encouraged corporations to ‘make hey while the sun shines’. They are tempted to delay putting their house in order in time to avoid eventual collapse. The creditors will get deeper in the abyss by advancing further loans to them considering them safe. The financial institutions will take a happy ride on their low cost debt to leverage even more. That vicious cycle has no bright side to it. It is an established fact that enterprises like Fannie Mae and Freddie Mac expanded substantially their holdings of subprime mortgages, due to misguided public policy. Tax payers were the ultimate losers.

Another adverse macroeconomic effect has also been witnessed. Since a large share of private debt is secured against assets (usually real estate or stocks); while the burden of the debt keeps increasing, the value of the assets can fall. Debtors are forced to sell assets to avoid delinquency, driving prices further down. This happened in Japan when the bubble created by real estate and stock prices burst in 1999-2000 and the asset prices started plummeting with Nikkei stock index reaching a bottom in 2003.[21] It happened to Dubai in 2008-9 when property prices slumped as much as 60 per cent. The Real Estate Regulatory Authority (RERA) after a review of 450 projects, determined that the properties were unlikely to be completed.

As a practical example of the principle of relief in contemporary world, we would like to state that if this principle was adhered to, the ‘debt forgiveness’ initiative of the United Nations for the poor indebted countries would not have faced such stiff resistance from the creditor nations and institutions. Such debt forgiven is called for more than one reason. Firstly, these countries in general have paid more than the principal amount through debt service payments. Secondly, the creditor nations have taken a good share back through conditional ties of importing from them, high price consultancies and such other measures[22]. In many cases it involved exports of sub-standard, even obsolete products by the creditors. Thirdly, such debt was in most cases used for reasons other than it was granted for. This was done with the knowledge, even connivance of the creditors. This was done to gain political influence and for the protection of creditor national interests. Fourthly, such debt is known to have involved huge kick-backs on both debtors and creditors sides. This is criminal activity, and in case of sovereign debt it is crime against the people of debtor nations. Fifthly, the instability created by this debt, threatens the entire global economy.

6. The Principle of Transparency

If the greed of creditors is insatiable, that of debtors is obsessive. ‘Debt Handlers’ make billions out of this cheating game. Therefore, the sixth principle is very important. Transparency will benefit both sides. It MUST be ensured that relief is not misused. It requires strict laws to punish unscrupulous debtors, especially those who manipulate evidence

(21) It dropped further amid the global crisis of 2008.

(22) It may be pertinent to note that such borrowing, in addition to violating the Islamic prohibition of *riba*, also violates another Islamic prohibition, that is, loan cannot be combined with trade in a contract.

to win relief from the courts. For example, in the case of the Lehman Bankruptcy in September of 2008, the largest ever in US history, it became clear that Lehman had manipulated its balance sheet. Accounting of financial risks, were stuffed with fictitious valuations through Hudson Castle, an entity set up to get the bad stuff off Lehman's balance sheet. In 2006, Merrill Lynch used a technique known as a total return swap; to hide it's riskier than declared CDOs(23) through firms like Pyxis. Citigroup used similar arrangements that the Security Exchange Commission now says should have been disclosed to shareholders in the summer of 2007. In all these cases the CEO admitted the facts in court proceedings but pleaded making mistakes and being wrong is no crime. The court appointed 'Examiners' have been alleged to have been bribed to help these concealments. The "buy now, pay later (or never)" culture plagues consumer and corporate borrowers alike.

The principal of transparency is also an established Islamic value. In the Annexure on *nusus*, we will include some verses and Ahadith in this respect. Here, we quote just one Hadith:

قَالَ رَسُولُ اللهِ صَلَّى الله عَلَيْهِ وسَلَّمَ : لَيْسَ مِنَّا مَنْ غَشَّ

"One who cheats, does not belong to the community of Muslims." [Sunan Abu Dawood].

4. Legal Measures for Protecting the Rights of Creditors

Creditor rights deserve to be protected by the force of law. However, while laws can help, ethics is more important. We will talk about ethical measures later. First, let us see how far the legal measures can take us. In Table 1, we present two packages of legislation. Some pieces are explicitly shown to be common between the two. Others may have parallels. The point we wish to make is that long before contemporary laws addressed these issues, Islamic laws had incarnated several measures to protect the fair rights of the creditors.

(23) CDO stands for 'Collateralized Debt Obligation'. It is a security; backed by a pool of bonds, loans and other assets. It includes different types of debt, often referred to as 'tranches' or 'slices'. Each slice has a different maturity and risk associated with it. The higher the risk, the more the CDO pays.

Table 1

Legal Measures for the Protection of the Rights of Creditors

Package 1	Package 2
1. Creditors are ensured Annual Compound Interest Payments in addition to the principal amount of the debt.	1. Creditors cannot charge anything more than the principle amount of the debt.
2. They can take collateral which they can sell in case of default.	2. They can take collateral which they can sell in case of default
3. If the debtor declares bankruptcy, all creditors will share his assets according to some predetermined priorities.	3. If the debtor declares bankruptcy, all creditors will share his assets proportionately
4. Delinquent debtor can be jailed (given physical punishment by a Judge).	4. Delinquent debtor can be jailed (given physical punishment by a Judge).
5. A lien can be put on his assets.	5. Delinquent debtors will be stopped to use their assets for buying or selling, gifting, transferring through will or in any other manner until they pay their debts.
	6. Delinquent debtors will be declared “Persona non Grata”.
	7. Names of delinquent debtors will be published every month in the Wall Street Journal.
	8. Names of delinquent debtors will be included in the "Exit Control List".
	9. Creditors will have the FIRST claim over the inheritance of the debtor.

Source: Compiled by the author.

Before going into a discussion of these measures, let me state that some of these measures apply to only individuals, but most apply to corporations as well either in the same form or in a somewhat modified form. However, it is pertinent to note that most bankruptcy filings are made by individuals. As shown in Table 2, generally speaking, non-business bankruptcy filings are more than 96% of the total bankruptcy filings in the US.

Table 2
US Bankruptcy Filings (2006-11)

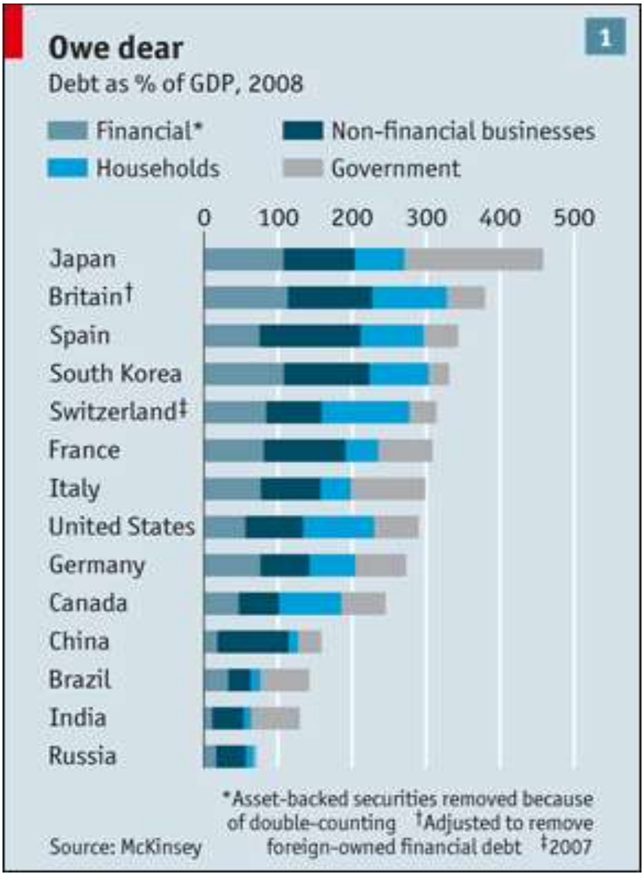
Year (1)	**Totals Filings (2)**	**Business Filings (3)**	**Non-Business Filings (4)**	**Column (4) as % of Column (2) (5)**
2006	617,660	19,695	597,965	96.8
2007	850,912	28,322	822,590	96.7
2008	1,117,771	43,546	1,074,225	96.1
2009	1,473,675	60,837	1,412,838	95.9
2010	1,593,081	56,282	1,536,799	96.5
2011	1,410,653	47,806	1,362,847	96.6

Source: American Bankruptcy Institute

A Digression on Sovereign Debt

The case of sovereign debt is different and these legal measures cannot apply to governments. In case of government debt discipline and governance structures are most important. These can be, and in many cases have been, legislated. The problems that arise in that area emerge from flouting those laws. It is largely a political affair. In dictatorial regimes, the rulers, in general, have been exploiting their people throughout the human history. In democracies, voters can theoretically 'punish' and discipline the rulers. History, however, tells us that it is more in theory than in practice.

There is an economic justification for governments to borrow. It is the growth-boosting potential of debt. However, it seems that many rich countries have exhausted that potential. With ageing populations and shrinking workforces, their economies may grow more slowly than they have done in the past. They may have borrowed from the future, using debt to enjoy a standard of living that is unsustainable. Greece provides a stark example. Standard & Poor's, a rating agency, estimates that its GDP will not regain its 2008 level until 2017. According to Leigh Skene of Lombard Street Research, each additional dollar of debt is associated with less and less growth. From early 2007 onwards there were signs that economies were reaching the limit of their ability to absorb more borrowing. Debt-addition prevented them to return to economic fundamentals. The debt pile up went on too long. A survey by the McKinsey Global Institute found that average total debt (private and public sector combined) in ten mature economies rose from 200% of GDP in 1995 to 300% in 2008[24].



The six principles given in this paper equally apply to governments as they do to individuals and corporations. It is interesting to note that in the Corruption Perceptions Index (CPI), prepared annually by the Transparency International, many Eurozone countries, particularly those affected by the financial crisis, including Greece and Italy, are doing worse and worse. Many of the lowest-scoring European countries are those hardest hit by the financial and debt crises.

(24) The Economist, “Repent at Leisure”, June 24, 2010.

Besides tackling corruption, the need for fiscal reform is a major issue in US, Europe and other countries around the globe. Reducing budget deficits is the most important issue in elections in the US and European countries including France. Political parties; Right, Left and Center, all agree on the need to reduce budget deficits in the shortest period of time. French President Nicolas Sarkozy, seeking re-election went to the extent to promise that he intended to insert the "balanced budget" rule into the French constitution, subject to approval by French electorate in a referendum on the issue. Even though, possibilities of budget deficits are not completely ruled out, there are calls for austerity measures and fiscal discipline. Talking of the recent Europe's fiscal pact, German Chancellor, Ms Merkel has said that the pact, which binds eurozone countries to keeping their deficits below 3pc, was "non-negotiable" and would "last forever". This author believes that that is wishful thinking. With growth prospects not very bright, it will require either more taxation or austerity measures. Both are unpopular measures with voters. Sarkozy's defeat makes him the 11th euro-zone leader who fell prey to sovereign-debt crisis. Francois Hollande won the French Presidency on an anti-austerity platform. He has pledged to pursue efforts to trim the country's budget deficit to avoid fueling the euro-zone sovereign-debt crisis. However, once his honeymoon in power ends, he will have to face the tricky balance between appeasing the tax payers and the benefit seekers. If he stands firm on his election platform, this author suspects that it could be the end of euro-zone. With France's sluggish economy, the euro-zone's second-largest after Germany, running short of growth-stimulating power of its own, he plans to seek help from the European Central Bank. I doubt that Germany will let that happen easily, at least not on a level that would help Hollande balance the budget any time soon.

Across the Atlantic, worried about the reaction of the electorate who consider budget deficit to be their top worry, both front runners, Barak Obama and Mitt Romney, are trying to lure voters promising to cut the Federal deficit, though through different plans. They were forced into this by a public outcry after Standard & Poor's downgraded the US credit rating and raised the fears that the United States may default on its obligations. If that can happen to a "currency issuer", who pockets billions of dollars annually in 'seigniorage', simply by running the printing press, the other countries are much more vulnerable.

Election promises aside, balancing the budget in present situations of these countries is easier said than done. It requires austerity measures that the electorate cannot digest after they have got used to public supports. Dissenting voices are already being heard, because of political expediencies, rather than economic fundamentals. From an economic point of view budget deficits, *except in very special cases and for short periods of time,* are bad economics. However, as we hinted above, the shackles of debt once on, are not easy to break out from. Strong lobbies are created as is evident in most Western countries. American President, and the author of ‘United States Bill of Rights’, James Madison, once said, “I go on the principle that a public debt is a public curse, and in a Republican Government a greater curse than any other”. Today the US national debt stands at $15.7 trillion. The Democrats hold Republicans responsible for the massive increase and blame them to be big ‘spenders’, but the fact remains that total Federal debt has grown by about US$4.6-trillion under Obama’s regime. Everyone knows it has not grown for economic reasons. The average American citizen, who shares around US$ 50,000 in the national debt is crying, “It is the War, stupid! Not the economy”. The English wisdom states that, “Nip the evil in the bud”. Therefore, the principle of restraint is perhaps the most important principle to be adhered to, if later problems are to be avoided.

Reverting to the legal measures available to protect the genuine interests of creditors, let me take the nine measures given in Package 2 and give some details with respect to their roots in the Islamic system. Out of the nine measures I included in Package 2, the first three are well known as basics of Islamic finance. I do not need to make any comment. The fourth and fifth are derived from the following Hadith:

عَنْ عَمْرِو بْنِ الشَّرِيدِ، عَنْ أَبِيهِ، عَنْ رَسُولِ اللَّهِ صَلَّى اللهُ عَلَيْهِ وَسَلَّمَ قَالَ: «لَيُّ الْوَاجِدِ يُحِلُّ عِرْضَهُ، وَعُقُوبَتَهُ» [سنن أبي داود (٣٦٢٨)]

“Delaying payment of debts by one who has the means to discharge his debts makes it permissible to dishonor and punish him”

The Hadith permits two things over the delinquent debtor: (i) dishonoring him and (ii) punishing him. With respect to the first one there is consensus that such a debtor can be punished through imprisonment. Whether or not he can be punished through financial penalty is a controversial issue. The fatwa so far is that he cannot be but I have some points that I will discuss later.

Secondly, the Hadith makes it permissible to discredit the delinquent debtor in public. Now in modern times if this is done through putting their names on media and internet, you can imagine how effective this measure would be. The corporations will know that if their names appear in such a list, their share prices will sharply decline and they will not get additional funding since their credit rating will also decline. The individual debtors will also suffer a decline in their credit rating. Therefore, such a measure will be a strong inducement for them to pay up.

The sixth measure allows that the delinquent debtor can be prohibited from travelling. In this respect there is some detail. The opinion of Ibn Qudama quoted below is very revealing:

….وَجُمْلَةُ ذَلِكَ أَنَّ مَنْ عَلَيْهِ دَيْنٌ إذَا أَرَادَ السَّفَرَ، وَأَرَادَ غَرِيمُهُ مَنْعَهُ، نَظَرْنَا؛ فَإِنْ كَانَ مَحَلُّ الدَّيْنِ قَبْلَ مَحَلِّ قُدُومِهِ مِنْ السَّفَرِ، مِثْلُ أَنْ يَكُونَ سَفَرُهُ إلَى الْحَجِّ لَا يَقْدَمُ إلَّا فِي صَفَرٍ، وَدَيْنُهُ يَحِلُّ فِي الْمُحَرَّمِ أَوْ ذِي الْحِجَّةِ، فَلَهُ مَنْعُهُ مِنْ السَّفَرِ؛ لِأَنَّ عَلَيْهِ ضَرَرًا فِي تَأْخِيرِ حَقِّهِ عَنْ مَحِلِّهِ .فَإِنْ أَقَامَ ضَمِينًا مَلِيئًا، أَوْ دَفَعَ رَهْنًا يَفِي بِالدَّيْنِ عِنْدَ الْمَحَلِّ، فَلَهُ السَّفَرُ؛ لِأَنَّ الضَّرَرَ يَزُولُ بِذَلِكَ. وَأَمَّا إنْ كَانَ الدَّيْنُ لَا يَحِلُّ إلَّا بَعْدَ مَحَلِّ السَّفَرِ، مِثْل أَنْ يَكُونَ مَحِلُّهُ فِي رَبِيعٍ، وَقُدُومُهُ فِي صَفَرٍ، نَظَرْنَا؛ فَإِنْ كَانَ سَفَرُهُ إلَى الْجِهَادِ، فَلَهُ مَنْعُهُ إلَّا بِضَمِينٍ أَوْ رَهْنٍ؛ لِأَنَّهُ سَفَرٌ يَتَعَرَّضُ فِيهِ لِلشَّهَادَةِ، وَذَهَابِ النَّفْسِ، فَلَا يَأْمَنُ فَوَاتَ الْحَقِّ المغني لابن قدامة (٤/ ٣٤٢)

"… If any debtor intends to go on an outstation journey and his creditor wants to stop him from travelling, then in our view if the debt falls due before his expected date of return, for example, he intends to travel for Haj and he will not return before the month of Safar (2nd month in Hijrah Calendar) whereas his debt falls due in Muharram (1st month in Hijrah Calendar or Dhulhijja, i.e., the month before), then the creditor can stop him from travelling because he will suffer due to delay in payment. However, if someone rich enough to pay the debt stands surety or the debtor tenders a collateral that would cover the amount of debt, then he can proceed on his journey because the damage (to the creditor) will thus be covered. If the debt does not fall due until the expected date of his return; for example, the due date is in Rabi (3rd month in Hijrah Calendar) and his expected date is in Safar, then he can be stopped from travelling if his journey is for *jihad* (Islamic expedition for fighting enemies), unless someone stands surety or he tenders a collateral. This is so because there is a possibility that he may be killed in the fighting, and the creditor's right will not have been protected."

This passage has a number of very important points relevant to our subject. Most importantly, it supports the sixth measure in my proposed list i.e., putting the names in the “Exit Control List”. I think such a measure will be very effective. It is pertinent to note that many countries have regulations similar to this. Among them are GCC countries. Reports confirm that a travel ban on delinquent debtors has helped the banks and other companies to recover their debts. It is interesting to note that Australia has a somewhat similar law. In Australia, tax officers can issue a Departure Prohibition Orders (DPO) against persons having unpaid tax (i.e., debt to treasury).

The seventh measure that the delinquent debtor can be declared as “Persona Non Grata” is based on the opinion of a majority of Islamic scholars who argue that Prophet Muhammad (pbuh) declared delinquency as *zulm* (injustice).(25) Now *zulm* is a major sin (*kabirah*). Anyone who commits a *kabirah* sin is *fasiq* (sinful or abominable person). A *fasiq* is persona non grata in Islamic society so much so that according to the opinion of the majority of Islamic scholars even his testimony is not accepted in an Islamic court.

The eighth measure in my suggested Package is derived from the following Hadith:

Imam Hakim and Dar Qutni report that Prophet (pbuh) imposed *hajr* on Hazrat Muaz and paid off his debts by selling his property

Imposition of *hajr* means suspension of all rights of debtor with respect to his property, including buying and selling, transfer by gift or will, and even making charity.

Similar measures exist in many legal jurisdictions today. For example, in US and most common law countries a creditor can put a lien (through courts) on the property of the debtor. It involves a passive right to retain (but not sell) property until the debt is discharged. In some jurisdictions other encumbrances on the use of the property under lien can also be imposed. In case of employees bearing debts (of government or companies), in many legal jurisdiction the creditor can obtain a court

(25) Relevant Hadith along with some other *nusus* will given in an Annexure to be attached to the final paper.

order whereby regular deductions, called ‘wage garnishment’, will be made directly through the payroll and passed on to the creditor.

The ninth measure implies two things: (i) That payment of debt has priority over implementation of will. This is based on the following Hadith

عَنْ عَلِيٍّ، «أَنَّ النَّبِيَّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ قَضَى بِالدَّيْنِ قَبْلَ الوَصِيَّةِ»، وَأَنْتُمْ تَقْرَءُونَ الوَصِيَّةَ قَبْلَ الدَّيْنِ [سنن الترمذي (٤/ ٤٣٥)]

Prophet (pbuh) said, “Pay debts (of the deceased) before implementing his will, though (in the verses of Holy Quran you read) implementation of will is mentioned before payment of debts. [Sunan al Tirmizi]”(26)

(ii) Debts must be settled before inheritance is distributed. There are many verses in the Holy Quran that make it compulsory. One of those is:

يُوْصِيْكُمُ اللّٰهُ فِيْٓ اَوْلَادِكُمْ لِلذَّكَرِ مِثْلُ حَظِّ الْاُنْثَيَيْنِ ۚ فَاِنْ كُنَّ نِسَاۤءً فَوْقَ اثْنَتَيْنِ فَلَهُنَّ ثُلُثَا مَا تَرَكَ ۚ وَاِنْ كَانَتْ وَاحِدَةً فَلَهَا النِّصْفُ ۗ وَلِاَبَوَيْهِ لِكُلِّ وَاحِدٍ مِّنْهُمَا السُّدُسُ مِمَّا تَرَكَ اِنْ كَانَ لَهٗ وَلَدٌ ۚ فَاِنْ لَّمْ يَكُنْ لَّهٗ وَلَدٌ وَّوَرِثَهٗٓ اَبَوٰهُ فَلِاُمِّهِ الثُّلُثُ ۚ فَاِنْ كَانَ لَهٗٓ اِخْوَةٌ فَلِاُمِّهِ السُّدُسُ مِنْۢ بَعْدِ وَصِيَّةٍ يُّوْصِيْ بِهَآ اَوْ دَيْنٍ ۗ اٰبَاۤؤُكُمْ وَاَبْنَاۤؤُكُمْ لَا تَدْرُوْنَ اَيُّهُمْ اَقْرَبُ لَكُمْ نَفْعًا ۗ فَرِيْضَةً مِّنَ اللّٰهِ ۗ اِنَّ اللّٰهَ كَانَ عَلِيْمًا حَكِيْمًا

“Allah commands you as regards your children's (inheritance); to the male, a portion equal to that of two females; if (there are) only daughters, two or more, their share is two thirds of the inheritance; if only one, her share is half. For parents, a sixth share of inheritance to each if the deceased left children; if no children and the parents are the (only) heirs, the mother has a third; if the deceased left brothers or (sisters), the mother has a sixth. (The distribution in all cases is) after the payment of legacies he may have bequeathed or debts. You know not which of them, whether your parents or your children, are nearest to you in benefit, (these fixed shares) are ordained by Allah. And Allah is Ever All Knower, All Wise.” [Al-Quran 4:11]

(26) Interpreters of the Holy Quran have explained that there is no contradiction between this Hadith and the order mentioned in the verses of the Holy Quran. There it is a stylistic matter. The emphasis is the same as mentioned in this Hadith.

5. Ethical Measures Relating to Debt and Creditor-Debtor Relations

Islamic system there is four layers of means to achieve any objective. These are:

1. Moral Exhortation
2. Legal Injunctions
3. Role of the Society
4. Role of the State

We have talked about the last three in one way or the other. Last, but not the least, moral values play a very important role. Morals take time to ingrain, but once entrenched they are a much stronger force for achieving desired goals. Let me therefore, present Islamic morals that will set a proper role and attitude towards debt and help creating smoother relations between the debtors and creditors. There are three kinds of such measures:

A. Measures Encouraging Payment of Debts
B. Measures Discouraging Non-Payment of debts
C. Measures Discouraging Overburdening Debt

Let us take them one by one:

A. Measures Encouraging Payment of Debts

Firstly, debtors are morally motivated to pay their debts. Some nusus in this respect are quoted below:

(i) In Surah Al-Nisa Ayah 58, Allah (SWT) orders as follows:

اِنَّ اللّٰهَ يَاْمُرُكُمْ اَنْ تُؤَدُّوا الْاَمٰنٰتِ اِلٰٓى اَهْلِهَا ۙ وَاِذَا حَكَمْتُمْ بَيْنَ النَّاسِ اَنْ تَحْكُمُوْا بِالْعَدْلِ ۭ
اِنَّ اللّٰهَ نِعِمَّا يَعِظُكُمْ بِهٖ ۭ اِنَّ اللّٰهَ كَانَ سَمِيْعًۢا بَصِيْرًا

Verily! Allah commands that you should render back the trusts to those, to whom they are due; and that when you judge between men, you judge with justice. Verily, how excellent is the teaching which He (Allah) gives you! Verily Allah is ever Hearing, ever Beholding.

(ii) Preparing Oneself to Pay Debts:

The following Hadith of Prophet (pbuh) sets an example for the debtors:

قَالَ رَسُولُ اللَّهِ صَلَّى اللهُ عَلَيْهِ وَسَلَّمَ: «لَوْ كَانَ لِي مِثْلُ أُحُدٍ ذَهَبًا مَا يَسُرُّنِي أَنْ لاَ يَمُرَّ عَلَيَّ ثَلاَثٌ، وَعِنْدِي مِنْهُ شَيْءٌ إِلَّا شَيْءٌ أُرْصِدُهُ لِدَيْنٍ »[صحيح البخاري (٢٣٨٩)]

Prophet (pbuh) said, " If I had gold equal to the weight of mountain uhad, I would not like that anything from that remains with me for three days, **except something that I would save to pay off debts**."

(iii) Prophet (pbuh) used to refuse leading the funeral prayer of anyone who had debts and had nothing left to settle them.

عَنْ سَلَمَةَ بْنِ الأَكْوَعِ رَضِيَ اللَّهُ عَنْهُ، قَالَ: كُنَّا جُلُوسًا عِنْدَ النَّبِيِّ صَلَّى اللهُ عَلَيْهِ وَسَلَّمَ، إِذْ أُتِيَ بِجَنَازَةٍ، فَقَالُوا: صَلِّ عَلَيْهَا، فَقَالَ: «هَلْ عَلَيْهِ دَيْنٌ؟»، قَالُوا: لاَ، قَالَ: «فَهَلْ تَرَكَ شَيْئًا؟ »، قَالُوا: لاَ، فَصَلَّى عَلَيْهِ، ثُمَّ أُتِيَ بِجَنَازَةٍ أُخْرَى، فَقَالُوا: يَا رَسُولَ اللَّهِ، صَلِّ عَلَيْهَا، قَالَ: «هَلْ عَلَيْهِ دَيْنٌ؟ » قِيلَ: نَعَمْ، قَالَ: «فَهَلْ تَرَكَ شَيْئًا؟ »، قَالُوا: ثَلاَثَةَ دَنَانِيرَ، فَصَلَّى عَلَيْهَا، ثُمَّ أُتِيَ بِالثَّالِثَةِ، فَقَالُوا: صَلِّ عَلَيْهَا، قَالَ: «هَلْ تَرَكَ شَيْئًا؟ »، قَالُوا: لاَ، قَالَ: «فَهَلْ عَلَيْهِ دَيْنٌ؟»، قَالُوا: ثَلاَثَةُ دَنَانِيرَ، قَالَ: «صَلُّوا عَلَى صَاحِبِكُمْ » [صحيح البخاري (٢٢٨٩)]

This is a story related by Salam bin Akoo, telling an incidence when three funerals of his companions were brought to Prophet (pbuh) requesting him to lead the funeral prayers. Each time he asked, did he left an unpaid debt? If the answer was in the affirmative, he asked a second question, did he left enough bequest to pay off the debt, if the answer/evidence was affirmative, he would lead the prayer. Otherwise, he would tell his companions to pray on their own.

Now we know that Prophet (pbuh) loved his companions beyond our imagination. Not leading funeral prayers for anyone is an indication how seriously he disliked **NOT** paying one's debts.

(iv) Reward for those who Pay Debts in Nice Manner which first and foremost includes payment on time.

قَالَ رَسُولِ اللَّهِ صَلَّى اللهُ عَلَيْهِ وَسَلَّمَ: « إِنَّ خِيَارَكُمْ أَحْسَنُكُمْ قَضَاءً »

[صحيح البخاري (٢٣٠٥) صحيح مسلم (١٦٠١)]

Prophet (pbuh) said, “The best among you is the one who is best in payment of his debts”

(v) Personal Practice of the Prophet (pbuh).

Prophet (pbuh) used to pay ASAP. And pay more than borrowed almost always.

There are too many incidences of this practice. One of these in brief was:

عَنْ جَابِرِ بْنِ عَبْدِ اللَّهِ، قَالَ: «كَانَ لِي عَلَيْهِ دَيْنٌ فَقَضَانِي وَزَادَنِي» [صحيح البخاري (٤٤٣) صحيح مسلم (٧١٥)]

Jabir relates that Prophet (pbuh) owed him a debt. When he demanded it from him, Prophet gave it to him and gave more.

(B) Measures Discouraging Non-Payment of Debts

We must remind the readers that unlike conventional system, Islam makes a distinction between two types of debtors: (i) Those, who are in real difficulties and despite their best efforts they are unable to pay. (ii) Delinquent Debtors. For the first category, Islam encourages to take a lenient attitude while the second category is dealt with strict measures.

Here we are concerned with the second category. Let us see the Islamic position and measures for this category of debtors. There are many *nusus* on this. Here we quote just one. That alone is sufficient to describe how seriously Islam takes the matter of pay back one’s debts.

عَنْ مُحَمَّدِ بْنِ جَحْشٍ قَالَ: كُنَّا جُلُوسًا عِنْدَ رَسُولِ اللَّهِ صَلَّى اللهُ عَلَيْهِ وَسَلَّمَ فَرَفَعَ رَأْسَهُ إِلَى السَّمَاءِ، ثُمَّ وَضَعَ رَاحَتَهُ عَلَى جَبْهَتِهِ، ثُمَّ قَالَ: «سُبْحَانَ اللَّهِ، مَاذَا نُزِّلَ مِنَ التَّشْدِيدِ» فَسَكَتْنَا وَفَزِعْنَا، فَلَمَّا كَانَ مِنَ الْغَدِ، سَأَلْتُهُ: يَا رَسُولَ اللَّهِ، مَا هَذَا التَّشْدِيدُ الَّذِي نُزِّلَ؟ فَقَالَ: «وَالَّذِي نَفْسِي بِيَدِهِ، لَوْ أَنَّ رَجُلًا قُتِلَ فِي سَبِيلِ اللَّهِ ثُمَّ أُحْيِيَ، ثُمَّ قُتِلَ ثُمَّ أُحْيِيَ، ثُمَّ قُتِلَ وَعَلَيْهِ دَيْنٌ، مَا دَخَلَ الْجَنَّةَ حَتَّى يُقْضَى عَنْهُ دَيْنُهُ» [سنن النسائي (٤٦٨٤)]

In this incident the companion relates that once they were sitting with the Prophet (pbuh). He raised his head towards the sky and then said “…what a strict warning has been revealed to me.” Companions kept quite because they were stunned due to revelation of a strict warning.

Next day they asked about it. The Prophet (pbuh) swore by God and said, “if a person was killed in the path of Allah, then raised again and killed again, then raised again and killed again, and he had unpaid debt, he will not enter paradise unless his debt is paid off.”

6. The Issue of Financial Penalty on Delinquent Debtors

In the beginning of the paper, we raised the issue that a delinquent debtor, knowing that he cannot be obliged to pay anything more will have a strong incentive to default. For Islamic banking, where a lot of transactions result in debts owed to the banks in future, this creates a big problem. Since they cannot charge anything more once the debt has been created, can they impose a financial penalty to recover the damage caused to them due to delay in payments?

The current religious verdict is that it is not allowed. The argument is that once something becomes debt, the creditor cannot take anything from the debtor that he will benefit from. Therefore, even those who allow putting penalty on delinquent debtor make it conditional that the money is given to charity. That does solve part of the problem, that is, the incentive to default is removed. But what about the damage caused to the banks. The suggestion that they claim damage through courts is not a good solution. The civil suit procedures are so slow in most countries that it is said that to get your rights through courts you need ‘the age as of Noah (may peace be on his soul), the patience as of Ayub (may peace be on his soul), and the wealth of Qaroon. In Pakistan an experiment was made by setting up special Banking Tribunals for speedy settlements. However, the experiment did not succeed.

In my view the problem deserves further thought. Since Islamic banks cannot charge anything what they do is to treat “bad debts” as a cost item and hence charge a higher markup than they would otherwise do. That has created a bad impression about Islamic banks.

My submission to Islamic jurists is to revisit the issue from the point of view of Maslahah Aamah (public interest). Just as due to Maslahah Aamah traffic regulations have been designed and in case of violation a financial penalty is imposed, can we consider the issue that a well-functioning banking system is in broader public interest. Therefore, can the government legislate that financial penalty will be imposed on delinquent debtors. The money will be put into a “Trust Fund” designated for research and promotional activities for Islamic banking and finance.

7. Summary and Conclusions

There are circumstances when taking debt either becomes necessary or if wisely used can be a mean to creation of additional wealth. In principle, taking loans (debts) is permissible in Islam. Nejatullah Siddiqi has documented historical evidence[27] that Prophet (pbuh) himself and the rulers in early period of Islam incurred debts. Actions taken during that period are considered as a valid justification to follow in later periods by a majority of Islamic jurists. Several Ahadith quoted in this paper also confirm that Prophet (pbuh) and his companions did incur debt. The very fact that in *zakah*, a portion has been kept for those who are unable to discharge their debts and in Quranic verses relating to distribution of inheritance, discharging debt *after* one's death has been mandated proves that circumstances do exist when debt has a role. However, taking debt is not encouraged. Many supplications of Prophet (pbuh) seek refuge of Allah from falling into debt which is a clear indication that it should be avoided as far as possible.

What are the circumstances under which debt can be incurred? What precautions are needed? What are the limits? What are the dangers if excessive reliance is made on debt? What responsibilities fall due once debt is incurred? What are the rights of the creditors? What legal and ethical measures are available to protect them? These are some of the questions addressed in this paper.

Our general conclusions are:

1) That in some special cases and for a limited period of time, debt can have some beneficial effects. However, the general rule is to avoid it. Individuals should try their very best to live within their means. Corporations and governments should operate within resources available to them or fairly assured to be generated from the use of borrowed money.

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(27) Siddiqi, Nejatullah, "An Overview of Public Borrowing in Early Islamic History", Paper presented in the Third International Conference on Islamic Economics held in Kuala Lumpur, Malaysia, in January 1992. The paper has since been revised and is available on his web site, www.siddiqi.com/mns/.

2) In contemporary world excessive involvement in debt seems to have far outweighed any benefits that debt creation would have. The habit forming nature of debt has caused distress in households, delaying putting their houses in order in corporations and slavery type conditions for heavily indebted countries.

3) Lending based on interest coupled with conditionalities and corruption has overburdened developing countries. Heavy debt servicing has caused a return capital flow from poor to rich countries. These countries *must* be provided relief.

4) The dichotomy of real and monetary sectors is one of the basic causes of unsustainable growth on the one hand and repeated economic crises on the other.

5) Financial stability of many countries including some of the richest countries and the global financial system, have been and will remain at stake due to excessive debt, most of which is not supported by economic fundamentals.

6) Creditor-debtor relations cannot improve until the basic reasons for debt default, structural problems in economies and rationalization of legal and ethical measures are not properly addressed.

7) This paper, deriving inspiration from centuries old provisions available in the Islamic system, has attempted to make a humble contribution by deriving some principles for this purpose.

8) As a special case of the problems caused by debt delinquency, the issue of imposing financial penalty on those who owe money to Islamic banks and do not make payments on time has been studied. The author makes a suggestion that the matter be dealt by the government from the perspective of protecting public interest. Since in modern times, a well-functioning financial system is a need of the public, the government may impose financial penalty on delinquent debtors. Proceeds from these penalties should go into a specially created *waqf* (trust). The income from that *waqf* should be reserved for research and promotion of Islamic banking and finance. In this way the problem of any incentive to delay payments by the debtors will be solved. Islamic financial institutions will be ‘indirectly’ compensated by the activities of such a trust.

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AN INTRODUCTION TO ISLAMIC ECONOMIC THOUGHT (IET)

VERRIER Ramon

Introduction à la pensée économique de l'Islam
du VIIIe au XVe siècle, Ed. L'Harmattan, Paris

Whit this item, I intend to present a few points, more largely developed in a work published in 2009 on the IET(1). Then, my one purpose was to expose the main features of the IET, a topic, practically unknown to the public, and even too many scholars in France. I did not pretend to give a thorough analysis of the IET, which I would have been, and I am always, still today, incompetent to do, because I am not an Arabic-speaking person. It was mostly an overview of the IET made from translations of original texts, but also from articles or books on this topic, existing in French, English or Spanish, essentially available in France, systematically reported in the work. This is the reason why it was simply an "introduction" to the IET presented briefly but however methodically, replacing the thought of the authors into their historical, economic and social context.

My purpose today is the same, but it is presented in a still more limited way, in two parts, exposing initially why the IET is relatively unknown (Part I), and then examining the various contributions of this thought by setting as example of innovative analysis, among others, cycles theory by Ibn Khaldûn (Part II).

(1) VERRIER Ramon, *Introduction à la pensée économique de l'Islam du VIIIe au XVe siècle*, L'Harmattan, Paris 2009.

I - A RELATIVELY UNKNOWN THOUGHT

Islam is an outstanding civilization brilliant in many well known fields:

- Astronomy: Bagdad school of astronomy
- Mathematics: Al-Khwarizmi, Al Battani…
- Physics, Hassan Ibn Al-Haytham…
- Life and Earth Sciences: Al-Malik Ibn Yusuf, Ibn Wafid, Al-Ansari,…
- Medicine: Razes, Ibn sina, Abu cassis, Ibn Zohar…
- Philosophy: Al-Kindi, Al-Farabi, Ibn Sina, Ibn Rochd…
- Literature: Ibn Hazm…
- History and Geography: Ibn Battuta, Al-Idrisi, Al-Biruni, Tabari, Miskaway, Makkari…

But what about economics? This field is not really covered in the works on the contributions of Islam, or is put aside, except of course, by Islamic Economics Research Center King Abdulaziz University. Even in works expressly written to underline the contribution of the Muslims to civilization, no trace of any contribution in economy is find. For instance:

- "*Muslim contribution to civilization*", Haidar Banmate, Tawhid,
- "*A universal muslim civilization*", Tajeddine Kenani Karim, Tawhid.

1. The relative absence of contributions in this field

It would be wrong to say that nothing was written on this topic. There are papers and works, of limited number certainly, dealing with IET.

1.1. Some papers and works

Among the most interesting items to be quoted at random, are the following scholars: S.M. Ghazanfar and A.A. Islahi (1990), S.M. Ghazanfar (1991), Hamid Hosseini (1995), Yassin Essid (1992), or A. El Cohen (1994), etc.

In the same way, there are certain works, or parts of books, about one scholar or group ofscholars, and often dedicated to one or a few specific topics. Among these, we can distinguish:

- The monographic essays, like many books on Ibn Khaldûn (Yves Lacoste, A. Cheddadi, Himmich B., K. Pomian, S. Goumeziane…), on Ibn Sina/Averroes or Ibn Rochd/Avicenna. But the economy is very little discussed.
- Contributions in the field of history or philosophy are very numerous: E. Renan and M. Asin Palacios Y. Lacoste, M. Arkoun, R. Arnaldez, M. Urvoy or M. Hernandez Cruz, for example.
- But in the simple economic field, few scholars have distinguished themselves from the tradition initiated by J.A. Schumpeter. History of economic thought textbooks mentioning, or a fortiori presenting a synthesis of the economic contributions of Islam, are very few.

In addition to K. Pribram[(2)] and T. Lowry[(3)], some scholars did not want to reduce the economic thinking of Islam to an ignored link of the history or useless intellectual turning. They fully integrated it, although to differing degree, in their works. Those will be briefly presented, by distinguishing the European contributions on one hand, and the Arab contributions on the other hand.

1.2. Europeans contributions

No exhaustive census of the books on History of the Economic Thinking, or comparable works, excludes the monographs or works devoted to only one scholar, like that from Yves Lacoste[4] devoted to Ibn Khaldûn for example. The objective is to help the reader to find a synthesis or a synoptic table, even incomplete, of the literature concerning the economic thinking of Islam.

(2) PRIBRAM K, *A history of Economic Reasoning*, The John Hopkins Univ. Press, Baltimore, 1983.

(3) LOWRY S, Todd, *Pre-Classical Economic Thought*, Kluwer Academic Pub., Boston, 1987.

(4) LACOSTE Y., *Ibn Khaldun, naissance de l'histoire, passé du tiers monde*, F.Maspero, Paris, 1966, réédité en 1998, éd. La Découverte, Paris.

- **“*Early Economic Thought in Spain 1177-1740*” by Marjorie Grice-Hutchinson (1978)**[(5)]

In a paragraph entitled “Some early Islamic economists”, Marjorie Grice-Hutchinson approaches, perhaps too briefly, Al-Fârâbî, Al-Ghazâlî, Al-Dimashqî, Al-Turtûshi, Averroès. Many schomars are absent from the roll call, owing to the fact that M. Grice-Hutchinson is only interested in the authors with an influence on the Spanish thought. Although of a remote Andalusian origin of which he was very proud, Ibn Khaldûn does not appear in the list.

- **“*The Economic Thoughts*" by Jacques Wolff (1988)**[(6)] **“*Les pensées économiques*”**

It is probably the only book of history of thought in France with ten (great) pages devoted to Islam. The aim of the author is to consider all phenomena, facts and political, social, demographic thoughts, and psychological techniques to understand the evolution of economic thought. Islamic thought, continuator (following) of Greek founders thought, naturally finds its place. One by one he presents works, excerpts and short biographies of scholars as Al-Farabi, Ibn Sina, Al-Biruni, Al-Ghazali, Al-Dimashqi Ibn Khaldûn and Al-Maqrizi. He exclusively focuses on the analysis and policy of the authors, distinguishing between those of the 10^{th}–13^{th} ("partial notions and overviews"), and those of the 14^{th}-15^{th} ("new visions”).

- ***"The Mediteranean Tradition in Economic Thought"* by Louis Baeck (1994)**[(7)]

In this book, L. Baeck argues that the pre-classical economic thought is the "Mediterranean tradition" as opposed to the "Atlantic tradition" that will prevail from the Classics. He studies the Greek philosophers to the

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(5) GRICE-HUTCHINSON M., *Early Economic Thought in Spain 1177-1740*, Allen & Unwin, London, 1978.

(6) WOLF J., *Les pensées économiques, tome1, Des origines à Ricardo*, Montchrestien, Paris, 1988.

(7) BAECK L., *The Mediterranean Tradition in Economic Thought*, Routledge, London and New-York, 1994. We can also read : La pensée économique de l’Islam classique*, Storia del Pensiero Economico, Bolletino di informazione,* XIX, 1990.

classical school, and includes a chapter on the thought of classical Islam. After outlining the main sources of this thought, he reviews without lingering the authors concerned with law and public finance, as Zaid Ibn Ali Ibn Taymiyyah, Ibn al-Qayyim, Al-Maqrizi, and then authors under the Persian tradition as Al-Muqaffa, Al-Biruni and Al-Dimashqi, and finally the philosophers and theologians such as Ibn Sina, Al-Farabi, just quoted, and a little longer (two pages maximum), al-Ghazali and Ibn Rushd, to conclude on the overall vision of Ibn Khaldûn.

- **"*Spanish Economy and Economists*" (*Economia y economistas españoles)* directed by E. Fuentes Quintana (1999)**[(8)]

Volume II, entitled "Origins in Mercantilism," devotes a hundred pages to economic thought in Muslim Spain, and approaches three themes: - "The meaning of Al-Andalus in Spanish economic thought", by Antonio Garcia Lizana and Maria Isabel Calero Secall,

- "The Andalusian economic thought", by Antonio Garcia Lizana, where many Islamic writers are much more quoted than studied, such as Al-Satibi, Al-Farabi, Ibn Sina, Ibn Rushd, Ibn Bayya, Ibn Hazm, Al-Turtûshi Ibn Al-Jatib, Ibn Jaldun (Spanish spelling for the last two), and some others. The objective is basically to understand the foundations of economic andalusian thought, and to give an overview of the contributions of the authors.
- "Ibn Jaldun: an economist of the fourteenth century" by Fabian Rodriguez Estape that delivers a somewhat more exhaustive analysis, but based on papers (articles) of J.D. Boulakia (1971), S. Andic (1965) and L. Haddad The analysis is very interesting and well documented, even though, except that of Ibn Jaldun, and to a lesser extent, that of Ibn Rushd, we may regret that the thought of islamic scholars is insufficiently developed, and that, like M. Grice Hutchinson, it is exclusively oriented towards Spain because of its objective (hence the absence of some Arab and Muslim scholars).

(8) FUENTES QUNTANA E. (dir), *Economia y Economistas Espanoles*, T.1 et T.2, Galaxia Gutemberg, Barcelona, 1999.

1.3. Muslim and Arabic contributions

The selection criteria are identical to those of the preceding paragraph. However, are only retained books in non Arabic language, i.e. translated books, thus limiting the scope of the survey.

- **"*Political economy, a social science*" by M.H. Dowidar (1977)**[(9)]

  Its aim (purpose) is to present political economy as a science, and especially a social science, and then the writer presents a summary of the history of economics as a science, He does not write a history of economic thought in general. The author discusses economic thought in its pre-capitalist stage that will lead to its status as a real science. On this occasion, on fifteen pages, he deals with Arabic economic thought of the14th; however, he limits it to that of Al-Maqrizi and Ibn Khaldûn only.

- **“*The Great Gap of Joseph Schumpeter*" (1991)**[(10)] **and"*History of Economic Thought in Islam from the 8th to 12th Centuries*" (1998) by Omar Akalay**[(11)]

  Both books are entirely devoted to the economic thought of Islam. The first one is, as mentioned in its subtitle, "A Short History of Economic Thought in Islam" which the author denounces as the "great gap" of Schumpeter with great conviction and with some sense of humor. In the second one, the "Brief History" has become a short history of economic thought in Islam, much less controversial, but much more complete in terms of sholars. It is therefore a very personal work in which we will not find a systematic and orderly "French" presentation of the theories or systems of explanation of the authors. The subtitle of his "History" is eloquent: "*The Merchant and the philosopher*" evokes more the tale or the fable than the arid philosophical university textbook. Scholars studied by O.Akalay are

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(9) DOWIDAR M.H., *L’économie politique, une science sociale*, François Maspero, Paris, 1974.

(10) AKALAY O., *Le grand vide de Joseph Schumpeter. Brève histoire de la pensée économique en Islam,* Wallada, Casablanca, 1991.

(11) AKALAY O., *Histoire de la pensée économique en islam du 8e au 12e siècle,* L’Harmattan, Paris, 1998.

quite different and even surprising in comparison to those usually quoted in other books: Al-Muqaffa, Al-Jahiz, Miskawayh, Hariri, Al-Ghazali, Al-Mawardi, Ibn Rushd, without forgetting Aladdin and Sinbad! He stopped his survey about the 12th, and scholars such as Ibn Khaldûn and Al-Maqrizi are not included.

- **"*The Economic Thoughts*" by Abdelmajid El Cohen (1994)**(12)

  In this general work, covering the period from Antiquity to Keynes, the author proposes to examine the Arabic contribution to economic thought. He makes use of O. Akalay works when dealing with the Arabic economic thought until the 12th century, and in turn denounces "the great gap of Schumpeter," but he usefully adds the study of Ibn Khaldûn and Al-Maqrizi. However, the first volume of the new edition of "Economic Thought" begins in 2002 with mercantilist.

- "***History of Economic Thought*" by Brahim Rachidi (2002)**(13)

  The book deals with the pre-scientific phase and begins with the economic ideas in Mesopotamia (4000-2000 BC). In part two (the book includes eight parts) twenty-five pages are devoted to "the problem of Arabic-Muslim economic thought in the 16th century," but it is dedicated, exclusively and curiously, to two scholars of the 14th and 15th: Ibn Khaldûn and Al-Maqrizi before considering the mercantilist thinking in a third part.

All the history textbooks of economic thought, or equivalent, have not totally ignored the contribution of Islam. However, the objectives of the authors are often quite different and complementary. Consequently, none of them deals completely with the contribution of Islam to economic thought.

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(12) EL COHEN A., *Les pensées économiques*, Marrakech, 1994.
(13) RACHIDI B., *Histoire de la pensée économique*, IDGL, Rabat, 2002.

2. Reasons of the discretion

Despite efforts by some scholars since the years 1960, the Economic Thought of Islam remains, even today, relatively, if not largely, unknown. Why so many scholars have been induced to overshadow such a chapter of history of thought?

2.1. A non scientific thought

2.1.1. The IET is not an economic science in the strict sense

For a majority of economists, the origin of economic science is linked to autonomy, not only in relation to other sciences (sociology, demography, geography, history), but also in relation to ideologies, doctrines or philosophical systems or political ones, through the use of specific methods of approach (rationalism, empiricism, critical positivism, dialectical logic). In its pre-capitalist stage there was no independent economic thought, Islamic or not Islamic:

- Greek thought is closely related to philosophy;
- The thought of the Middle Age in Europe is inseparable from theology;
- Islamic thought is also inseparable from theology, history and philosophy of history.

Until the mid-18th century, the economy has never been perceived as a discipline. It is only on the beginning of the industrial revolution, or at best with the mercantilists, it started to become a science in itself, conscious of itself, its methods and its goals. That's because, some European and Arabian authors (M.R. Amrani[14] as example), in strict accordance with their conception of economics as a science, do not hesitate to eliminate any thought previous to European Mercantilists, even previous to the18th, because of non-scientific or non-concordance of the object studied, whether of Islamic thought, or thoughts of ancient Greek or Roman, or medieval scholasticism.

(14) AMRANI M.R., *Histoire de la pensée économique et théorie économique contemporaine*, Toubkal, Casablanca, 1988.

2.1.2. The IET is a pre-scientific thought

A broader conception of economic thought led some authors to back up their studies of Ancient Greece for two reasons: the intellectual contribution of the former seems indispensable, or at least useful to understand better the path that led Classic to the economy which is its first heir. So many books mention at more or less the contributions of Greek and Roman antiquity and the medieval scholastic period. Such are, for example, the approaches of J.A. Schumpeter whose study began in Ancient Greece, K. Pribram in his history that recognizes the influence of the Arab contribution to the Scholastics, or M.H. Dowidar who however, begins his study at the 15th century with Al-Maqrizi and Ibn Khaldûn.

The fact remains that, while recognizing the contribution of “prescientific" economic thought and by mentioning them, most authors are silent on the IET.

2.2. The influence of "*great gap*" of Schumpeter?

"*As regards our subject, we can safely cross a bound five hundred years, until the time of Saint Thomas Aquinas (1225-1274) whose Summa Théologiqua is for the history of thought what the southwest arrow of the Cathedral of Chartres is for the history of architecture* " In these lines, Schumpeter(15) simply eliminates five centuries, of economic thought in Islam, and even more. This sentence brings to an end to the first section of chapter two, entitled "*The Great Gap*," a very short section indeed (less than one page), because of great gap, of course!

Already in 1957, G.H. Bousquet(16) was pointing this oversight about “non European-Christians" authors of past centuries. In 1964, J. Spengler(17) published a paper on Ibn Khaldûn quoting some Islamic

(15) SCHUMPETER J.A., *Histoire de l’analyse économique*, nrf, Gallimard, Paris, 1983.

(16) BOUSQUET G.H., L’économie politique non européano-chrétienne. L’exemple de Dimachqi, *R.H.E.S.*, Paris, 1957. We can read also La monnaie selon un mystique musulman du XIe siècle, *R.E.P.*, 1953 ; *Les textes économiques de la Mouqaddima*, Maisonneuve, Paris 1962.

(17) SPENGLER J., Economic Thought of Islam: Ibn Khaldun, *Comparative Studies in Society and History* VI, n° 3, Cambridge UP, 1964.

authors. First survey of muslim economy seems to fall to M.N. Siddiqui in 1980[18]. In 1991, in Morocco, Omar Akalay[19], specifically in his essay entitled "The great gap of Joseph Schumpeter," in his turn, denounced the heavy silence that missed out the economic contribution of Muslim civilization. Other voices had also raised to challenge the thesis of "great gap", for example, SM. Ghazanfar and AA. Islahi (1990)[20], SM. Ghazanfar (1991)[21], Hamid Hosseini (1995)[22], Yassine Essid (1992)[23], or A. El Cohen (1994)[24]. The problem is not new, but it is not yet really settled. The few lines, or omission, on this theme in most histories of economic thought textbooks, particularly in France, even recent ones, show the persistence of this oversight. But is it just really an ordinary omission?

The fact is that, hiding behind the reputation of J.A. Schumpeter, all the authors, or almost, have chosen to overlook the IET. As it is difficult to put forward a transmission defect in time and space of knowledge of Islam, can we hide behind the argument of lack of originality of the IET to justify ignorance of the Islamic link?

2.3. A single Muslim mediation of Greek culture?

The insufficient consideration of economic thought of Islam could be explained by its lack of originality. This thesis would follow a "tradition" developed in France in the 19th by scholars such as Hegel or Renan. For Hegel, Islam thought would be a "pre-knowledge or recovery of Greek

(18) SIDDIQI M. N., *Muslim Economic Thinking*, Jeddah, International Center for Research in Islamic Economics and Leicester (UK), Islamic Foundation, 1980.

(19) AKALAY O., op. cit.

(20) GHAZANFAR S.M. and ISLAHI A.A., Economic thought of an Arab Scholastic: Abou Hamid al-Ghazali, *H.O.P.E*. vol.22, n°2, 1990.

(21) GHAZANFAR S.M., La science économique scholastique et les savants arabes. Une remise en question de la thèse du »grand vide », *Diogène*, n°154, avril- Juin, 1991.

(22) HOSSEINI T., Understanding the market mechanism before Adam Smith: thought in medieval Islam, *H.O.P.E.*, vol.27, n° 3, fall1995.

(23) ESSID Y., Greek economic thought in the Islamic milieu: Bryson and Dimashqi, in *Perspectives on the History of Economic Thought*, vol. VII, éd. S. Todd Lowry, 1992.

(24) EL COHEN A., op. cit.

which nothing would have been brought."[25] E. Renan says the same thing by writing that "philosophy among the Semites was never without a foreign loan and without high fecundity, an imitation of Greek philosophy"[26]. For D. Villey[27], Arabian and Jewish philosophers are mere intermediaries of ancient pagan thought, came to renew the teaching in the universities.

Heirs to the Greeks, the Arabs would not therefore build on the inheritance. So why dwell on it?

The table below summarizes the key ideas and themes taken from Greek thought (Plato, Aristotle) by the Arabian-Muslim authors.

So, economic thought of Islam would only resume ideas already developed by the Greeks. Reduced to a simple mediating role, why go through this "useless turning"? Should we extend with a few more pages history of thought textbooks? A question may arise under the following observation: the economic and trade relations between different groups are factors that determine the economic thought and reflection. But the ancient Greek cities had little trade with the rest of the world, while Islamic countries had large flows. Caravans could reach up to five or six thousand camels (freight on a cargo ship!), says M. El Faiz[28]. Is it therefore reasonable to imagine that economic thinking of Islam is strictly identical to that of Ancient Greece?

Therefore we may think that the economic contribution of Islam goes beyond simple mediation of Greek culture. Going on would be give credence to the thesis of European ethnocentrism or to the thesis of the" *European cultural gene*". "*Cultural gene that blocks the intelligence when it is a question of Islam*" wrote O. Akalay. That is why it seems worthy to emphasize the contributions of the IET.

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(25) Rapporté par El Cohen, op. cit. p.45.

(26) RENAN E., *Averroès et l'Averroïsme*, in *œuvres complètes* de E. RENAN, T.3, préface, p. 17.

(27) VILLEY D., *Petite histoire des grandes doctrines économiques*, M-T.H., Genin, Paris, 1964.

(28) EL FAIZ M., *Précis d'histoire des faits économiques*, Librairie papeterie El-Badii, Marrakech, 2000.

Greek culture and Muslim mediation

Themes and ideas	Greek scholars	Arabian Muslims « takers » and followers
Production of goods necessary for satisfaction of human needs	Aristotle	Al-Fârâbî, Ibn Sînâ, Al-Ghazâli
Life in society, specialization and division of labor to make production growth	Plato, Aristotle	Al-Dimashqî, Al-Ghazâli, Ibn Khaldûn
Exchange from specialization is facilitated by money	Aristotle	Ibn Rushd/Averroès
The three functions of money	Aristotle	Al-Dimashqî, Ibn Rushd, Ibn Taymiya, Ibn Khaldûn
Disapproval of wealth or poverty excess	Plato	Miskawayh, Ibn Taymiya
Justice in exchange and middle way society *(société du juste milieu)*	Plato	Miskawayh
Equality identity and reciprocity by the money	Aristotle	Miskawayh, Ibn Rushd
Developments on use and exchange value	Aristotle	Ibn Taymiya, Ibn Khaldûn
Sentence of monopolist practices	Aristotle	Ibn Taymiya, Al-Tilimsani
Disapproval of salaried activities	Aristotle	Ibn Khaldûn
Sentence of interest	Aristotle	Tous les auteurs
The birth of the society and state because of the incapacity of the man to meet his needs alone	Plato	Ibn Khaldûn
Organization in the ideal city	Plato	Al-Fârâbî

II. CONTRIBUTIONS AND IMPROVEMENTS OF THE IET

1. Contributions of the IET

1.1. Main scholarsand works to the 15th century

Can we distinguish different characteristic periods in the history of economic thought in Islam? While there are in the legal field, that of *fiqh,* many schools, it is difficult to detect trends in the economic field, let alone schools of thought. The scholars take up, in varying degrees, features themes of the various currents of European thought

- They are Scholastics by their theological-religious speculation and by their concern for a just price;
- They are Mercantilists by the importance of the place given to the enrichment by trade;
- They are Physiocrats when they seek to liberate agriculture from an oppressive tax system to make it more productive;
- They are Classics when they make labor as the most important production factor

In fact, whether these scholars are more Mercantilist than Classic or Scholastics, that does not make sense in the case of Islam. Any division is arbitrary and opens to criticism. HOET can't be divided into simple periods in accordance to simple criteria. One solution may be that adopted by J. Wolff who distinguishes between two major periods: the notions and partial views of the whole 10th to the 14th century, and new visions of the 15th. The option chosen in our presentation is to operate sections according to major areas of concern and the main topics discussed by the scholars, leading to the following distribution:

a) Precursors (8th - 9th)

- Ibn Al-Muqaffa or *how to get rich*
- Abu Yousuf or "*too much tax kills tax*"
- Al-Jahiz or *how to keep his wealth and redistribute wealth?*
- Ibn Hanbal or *ideas of a theologian - lawyer*
- Al-Dimashqi or *the merits of trade*

b) Enrichment and Society (10^{th} - 12^{th})

- Al-Farabi or *solidarity and specialization in the City*
- Ibn Sina / Avicenna *or how to manage domestic life*
- Miskawayh or *how to find a happy medium in society ("fair society"? Soc du juste mil)*
- Al-Biruni or *another precursor of Malthus*
- Al-Mawardi or *how to support the caliphate and economic activity*
- Ibn Hazm or "*to each according to his work*"
- Kay Kavus or *advices for home economics*

c) Theorists and practitioners prices (12^{th} – 13^{th})

- Al-Ghazali or *Natural Order and the economic and social order*
- Al-Turtûshi or *no prosperity without justice and security*
- Ibn Rushd / Averroes or *market economy and theology*
- The Andalusian muhtasibs or *market practitioners*
- Ibn Taymiyyah or *market economy and role of the state*
- Ibn Al-Qayyim or *popularizer of Ibn Taymiyah*

d) Economy and dynamic of Societies (14^{th} – 15^{th})

- Ibn Khaldûn or *the economy, factor and product of social evolution*
- Al-Tilimsani or *bad money and inflation*
- Al-Maqrizi or *bad money drives out good money*

These divisions are only a convenient framework for the study.

1.2. Approach and originality of the IET

Beyond simple mediation of Hellenic thought, what could be the contributions of Islam to economic thought? Are they really original? Are they going beyond religious norms in home economics? These questions need to be examined. With this aim in view, we can consider three stages in the contribution of Islam to the economy:

- Rediscovery and translation of Greek texts (briefly discussed above)
- Adaptation and islamization of Hellenic thought,
- Improvement by innovative contributions.

The first movement is the rediscovery and translation of Greek texts, briefly discussed in first part.

The second movement is an interpretation of the Greek texts, which resulted in an Islamization of thought, that is to say an adaptation to Islamic values. While the Greek thought is closely related to philosophy, the thought of Islam is inseparable from theology and religion. The Qur'an, and Sunnah, which collects the sayings and acts of the Prophet (*hadiths*), contain revelations and rules of conduct which, at the same time, by their comments, have provided economic thinking, and served as a pretext for research in this field. Imbued with these sacred texts, the Arab-Muslim scholars approach could not be entirely based on that of their Hellenic predecessors. Three economic themes, among others, can attest to this Islamization of thought (not examined in this paper): monetary nominalism, freedom of market prices, and enrichment by trade.

The third movement is a step forward of the first two by innovative contributions.

2. The innovative contributions of the IET

Early Islam was facing major economic and social problems, which had a distant relationship with those known in Greece. Tax revenues were insufficient; the financial Administration of an empire stretching from the borders of India to the Atlantic Ocean was not an easy task! Economic and political cycles began to worry some scholars. Recurring phenomena of rising prices drew the attention. These various economic and social phenomena lead to considerations at the origin of innovative contributions in the economic field, particularly in the areas of public finances (not discussed here), cycles and economic growth, inflation and currency.

2.1. Economic cycles

One of the most notable examples of this new contribution is the theory of cycles and growth. It is true that Plato had described the golden age, then the era of decadence of the city. The Arab-Muslim thought resumes this theme, but by deepening it significantly.

2.2.1. The perception of cycles

- **Miskawayh** (932-1030) in "History of Buyids" already sensed the existence of such cycles.
- **Al-Biruni** (973-1048/1050)(29) clarifies the concept a little further. Just like the transformation of the continents he observes as a geographer and geologist, the social history of man is experiencing cyclical repetitions. After the murderous disaster (influence of Plato) for the inhabitants of a region overpopulated compared to its provisions, life goes back and civilization develops again, leading to a new solidarity that links and strengthens men face to adversity, and removes any conflict. The end of each period is characterized by high materialism, important corruption, causing the destruction of the culture cycle. Another cycle of history will begin with a new prophet sent by God.

- **Al-Turtûshi** (1059-1126)(30), begins to describe, but very briefly, the phases of the cycle. In an era of prosperity, the Sultan is fair and equitable, laws are respected, mutual trust favor trade and business, with the help of weather conditions (Heaven) agriculture produces in abundance, cropland extend, multiply the goods, prices are low, the standard of living increases, taxes fit easily and alms are easily distributed. In a period of decline, the Sultan becomes unfair, and his tyrannical behavior is growing, laws are no longer respected, fraud grows in the market and in business, bad money appears. Moreover, the weather conditions (Heaven) begins to reduce agricultural production, goods become scarce, taxes no longer paid, prosperity fled when everyone just wants to increase its material wealth. Each phase is characterized first by a pulse effect (the behavior of the Sultan), then followed by an effect of imitation on the part of his subjects. Al-Turtûshi does not indicate explicitly the causes nor the terms of the reversal, depriving us of a real cyclical analysis.

(29) Al-BIRUNI, *Le livre de l'Inde*, extraits choisis, trad. Fr. V.-M. Monteil, Unesco, Sindbad, 1996.
(30) AL-TURTUSHI (ABUBEQUER de TORTOSA*), Lampara de los principes* (Siraj al-muluk), trad. esp. et éd. par M. Alarcon, Madrid, 1930.

The author puts together the necessary elements, but does not use them to build a dynamic of economic evolution. Ibn Khaldûn will do it.

2.2.2. The dynamic analysis of cycles by Ibn Khaldûn[31]

Ibn Khaldûn is considering the future of civilization in its economic, political, social and cultural totality. Cycles of population-production and those of public finances he describes are reintegrated into a remarkable overall dynamics. That's the reason why I chose Ibn Khaldûn as example of advanced and innovative economic analysis.

- **The cumulative process of expansion**

First, the interdependence of phenomena results in a cumulative and expansionary process composed of interrelationships between population and production. "*Prosperity is due to demographics*," wrote Ibn Khaldûn. The abundance of labor allows the division of labor, which generates productivity, and social surplus. This increased production must profit to the people: indeed, the increase of productive activity in turn requires a greater demand for labor. During this first phase of expansion, the lightness of the tax burden encourages productive activities, including agricultural ones and accordingly, the tax yield is high, providing sufficient public revenues to finance public spending still modest, but whose action benefits the whole society.

The analysis of Ibn Khaldûn therefore meets all the key elements of an explanatory theory of growth: population growth, division of labor, technical progress, productivity gains, and the need for the State to respect freedom of everyone both in terms of private profit as private property.

- **The cumulative process of depression**

Conversely, however, these same elements can cause a downward cumulative process: it is the phase of economic and political degradation. Ibn Khaldûn neglected nothing in his study the relationship between

(31) IBN KHALDUN, *Discours sur l'histoire universelle, Al-Muqaddima*, trad., présenté et annoté par V. Monteil, Sindbad, 1997.

prosperity and population. With the increase in government spending, tax revenues become insufficient, and the state is forced on to increase them by all means; the fiscal inequities and damage to private property are growing, and will eventually return against their sponsor, State: reduction of agricultural production and trade (the most profitable activities for tax purposes), and therefore the tax base and tax revenues to come decrease. To cope whit, the State is forced to increase further the tax burden ... The same causes produce the same effects, this vicious cycle goes on until the fall of the dynasty in place.

• The reversal phase

Ibn Khaldûn even offers a very modern explanation of the reversal occurring at the end of the boom. Indeed, he notes that economic growth has negative effects (negative externalities), leading to unbalanced development, manifested in several ways:

- <u>Unbalanced development process</u> in favor of large cities that attract workers and businesses to the detriment of small towns (a kind of agglomeration effect by Krugman).
- <u>Unbalanced growth</u> between the sector of consumer goods and that of public and private investment. In the analysis of Ibn Khaldûn the economist can still discern elements of a theory based on the unbalanced growth of both sectors, consumer goods and producer goods. Indeed, after the expansion process, we observe:
  - Insufficient growth of urban public spending, that is to say, investments, compared to the population, as well as private investment.
  - An uncontrolled growth of final consumption, both private and public, linked to the development of luxury, in fact the result of the delay investment.
- <u>Relative overpopulation</u> and epidemics in large cities, which have not developed enough public investment or infrastructure (to be differentiated from an absolute overpopulation).

But the explanation of the reversal by Ibn Khaldûn is also, and essentially, psychological and sociological. We have not time to develop it here, but in a few words the reversal lies in changing human behavior, lost of “esprit de corps” (*assabiya*), untoward effects of the taste for luxury (imitation effects, lavish spending fool increasing private and public deficits and debts).

This unbalanced growth between the sector of consumer goods and that of public and private investment, coupled with the disintegration of public finances, eventually precipitating the decline phase of economy and policy, and ultimately the fall of the dynasty in place. The theory of growth and cycles developed in the late 14th by Ibn Khaldûn, is miles away from considerations of Plato and the Greek.

Examining these themes (but it would have been the same with other themes as public finance, or money inflation), shows how the Arab-Islamic thought, especially from the 13th, could achieve an inclusive vision of economic and social phenomena. In contrast, Plato or Aristotle had only vague idea (zero in the opinion of Schumpeter!) of relationships between economic phenomena.

It is surprising that the scholars closest to Greek philosophy, like Ibn Sina / Avicenna and Al-Farabi seem relatively few concerned about interdependencies and effects of economic phenomena, in comparison with scholars such as Ibn Khaldûn and Al-Maqrizi, further away from the Peripatetic.

These numerous advances in economics illustrate how difficult it is today to defend simply the idea of “great gap" of J.A. Schumpeter, or even the "simple mediation" of Greek thought. The contribution of Islam to the development of economic thought is real and innovative in many areas, but the Christian West does not seem to have incorporated it in his quest for knowledge, as it did for philosophy. Reflection of Islam in the economic field will begin to fade away, unfortunately from the 13th to stay off in the early 15th. The "deep sleep" will take place after this "great gap" that has never existed.

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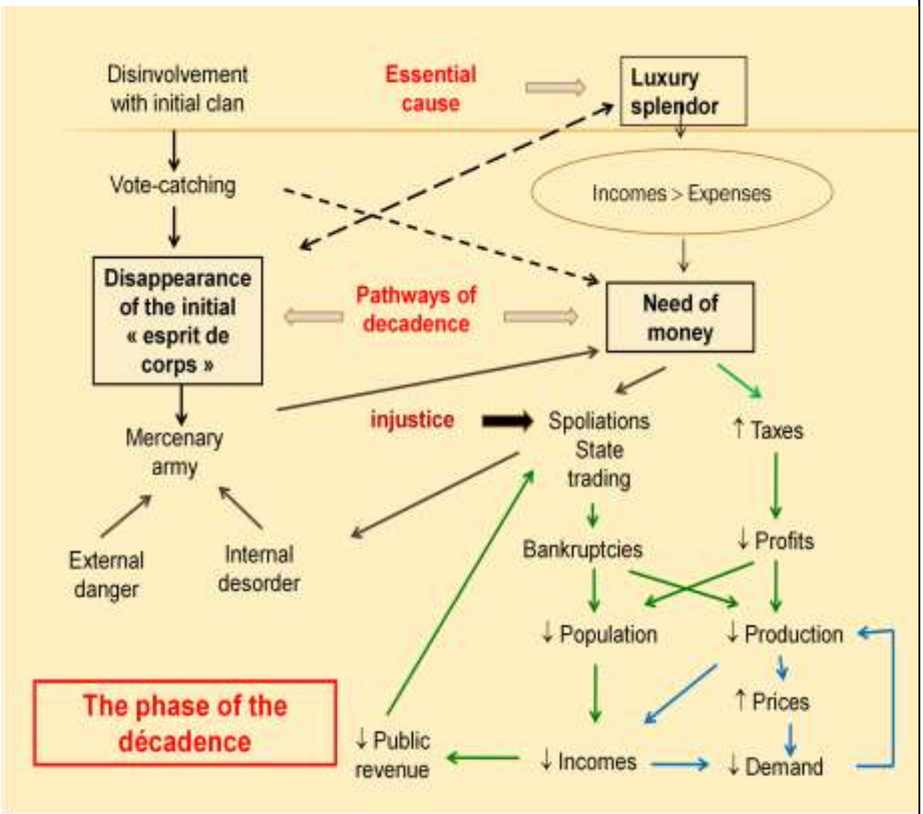
Diagram of the phase of decay according to Ibn Khaldûn



VERRIER Ramon
Introduction à la pensée économique de l'Islam du VIIIe au XVe siècle
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A Critical Study of

The Long Divergence: How Islamic Law Held Back the Middle East
Timur Kuran (2011)

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About the author and his book

Timur Kuran, an American of Turkish origin, born in 1954 in New York City, grew up in Ankara and Istanbul, graduated from Robert College in Istanbul in 1973, and obtained Ph.D from Stanford University. He taught at the University of Southern California from 1982 to 2007, holding the King Faisal chair in Islamic Thought and Culture from 1993 onward. Presently he is Professor of Economics and Political Science, and Gorter Family Chair in Islamic Studies at Duke University.

Kuran is an author well-known in the circle of Islamic economists for his relentless attempts to correct certain courses of development in the discipline. Although it is not necessary to agree with him, one can learn some lessons from his writings.

The Long Divergence: How Islamic Law Held Back the Middle East is his recent work published in 2011 by Princeton University Press, Princeton, New Jersey USA. 'The entire project was supported by the King Faisal Professorship in Islamic Thought and Culture at the University of Southern California', which the author held between 1993 and 2007, and by 'the Gorter Family Professorship in Islamic Studies at Duke University' (p. xv).

The book consists of 4 parts containing 14 chapters in total and spread over more than 400 pages:

In the first part he introduces the puzzle which he aims to solve in this book. In the second part he deals with legal institutions which are responsible in his opinion for the economic backwardness and organizational stagnation of the Middle East. In the third part, the author visualizes how foreign and local Jews and Christians benefitted economically from Islam's legal pluralism. The final part is conclusion in which the author summarizes his arguments and presents his claim of solving the puzzle at hand - the reason for the long divergence between the economic achievements of the West and backwardness of the Middle East.

Kuran focuses mainly on 'commerce and finance, two areas in which the Middle East fell conspicuously behind' and blames Islamic law for this failure (p. 7). Occasionally he commends certain provisions of Islamic Law, especially its egalitarian aspect and relevance in the first millennium, but more often than not he is unable to hide his disgust. To him Islam is "a religion now widely viewed as a source of backwardness, ignorance, and oppression" (p. xiv)! It may be noted that similar picture of Islam was presented in Medieval Europe. The author must be aware of the motive behind such painting.

What is the book about?

Up to the middle of the 16th century Middle East, represented by the Ottoman Empire, was at par with Europe, if not superior to it, in the field of politics, economy, science and technology. But after that the graph of Europe started going up and that of the Ottomans began to slide downward and the gap became wider and wider. There is no doubt that an investigation into the causes of divergence between the West and the Middle East in economic, political and scientific spheres is a pertinent theme to be pursued. In his recent work *The Long Divergence*: *How Islamic Law Held Back the Middle East* Timur Kuran first presents this 'reversal of fortune' as a 'grand puzzle'. Then he tries to solve this 'mystery'.

Following is the summary of his arguments: The Islamic inheritance system tended to fragment the estates of successful business. So was the effect of polygamy, under which the wealth was dispersed among numerous claimants. The ban on usury made it difficult for merchants to obtain credit and suppliers to lend money. The bar on interest also meant that banks could not emerge. The punishment for apostasy made it impossible for Muslims to do business with non-Muslims. The *mudarabah* and Islamic partnership could be terminated at will by any partner. The death of a partner also dissolved the partnership. To him, *waqf* institution could solve the problem of wealth fragmentation but it created other problems. 'The inflexibility of *waqf*s became an obvious handicap only with industrialization, whose new technologies created a need for reallocating vast resources quickly'. The hajj, the Islamic pilgrimage foreclosed 'stimulus to economic modernization'. 'Considered a sacred tradition, the Islamic pilgrimage could not have evolved as freely as secular fairs. An attempt to modify its location, duration, frequency, or timing according to the solar year would have provoked charges of sacrilege.' (p. 7).

The flaw in his book

Mr. Kuran's diagnosis and remedy of the long divergence can convince only those readers who are not aware of the economic, political and intellectual history of the two regions – the Middle East and the West. It is not correct to say that the existence of commercial institutions like business corporations and banks caused the development of the West, and their absence in the Middle East resulted in the decline of the region. In fact these economic institutions were effects of some other stronger factors. They may have enforced and reinforced themselves later.

The Real Cause of Divergence

What were those factors? Scientific discoveries, use of machines, and improvements in production techniques and changes in composition of crops, rapid increase in production, availability of surplus product for trading purpose, invention of printing press, discovery of a new world that provided new markets, establishment of colonies as a source of raw material and ready market for finished products, and a newly discovered all water route of European trade through the Cape of the Good Hope are some of the important factors that boosted Western economies, and directly or indirectly helped them establish corporations, maritime trading companies and banks. From all these fronts the Middle East was completely absent. Over and above, in the West, it was the state that supported emergence of business corporation and mercantilism in every possible way. Western governments encouraged foreign trade, provided it protection, granted monopolies to the native trading companies and supported them with a number of legislations. Protection provided by the government to industry and foreign trade and capitulation obtained in Muslim governments provided a strong support to mercantilism. On the contrary, some of the Muslim rulers engaged in trading. They monopolized it for their personal gain which had a discouraging effect on common traders. Remaining more than two centuries active in maritime trade before the European Mercantilism started rising in the 16th century, the Kārimī merchants of the Middle East, who had wealth like kings (Labib, 1990, 4: 641), were wiped out due to these policies of the government, not because of distribution of their business among children and wives. Sources of the period state that whenever a business man grew bigger and stronger, he was suppressed and his property was confiscated (Ibn Iyas, 1960, Vol. 4, p. 443).

The Middle East lacked surplus produce to run any corporation (Cahen, 1970, p. 35). The Ottoman state did not encourage surplus production. Sometime it did not hesitate to punish such producers, because they caused reduction of import duty (Çizakça, 2000, 17).

The maritime exploration was stopped. The ship building industry of the Muslim government could not match their Western rivals (Lewis, 1982, p. 38). Whatever navy force the Ottomans had, they used it for war purposes. They could not spare it for navigations and explorations.

While Europe swept forward in trade, science and technology, Middle East governments did not pay attention to developing and modernizing their agriculture, industry, and trade. The main concern of major European countries was how to acquire the largest share of what was commonly seen as a more or less fixed volume of international trade and how to obtain a favorable balance of trade and a net import of bullions and precious metals. But the Ottomans were content with the war booty, tributes from European suzerainty, government domain, taxes and remittance (*irsaliyat*) from rest of the Middle East. The truth is that when 'the English, the Dutch and other west Europeans were on their way to developing modern commercial organization' (p. 65) with the support of their governments, Muslim rulers, be it Ottoman, Safawid or Mughals, did not realize the growing power of Europe and its economic , political and scientific foundations. They did nothing to modernize their own economic and intellectual institutions. It is the strong Ottomans who blocked the development of incorporation. This is also clear from Kuran's observation that incorporation movements were stronger in the West because following the collapse of the Roman Empire 'states were relatively weak' (P. 101).

There is hardly any information found in the relevant sources of the period whether agriculture made any change over the years in Egypt, the biggest agricultural economy in the Middle East, or for that matter anywhere in the Muslim ruled countries. The condition of industry was also not very different. Industrial revolution was nowhere in sight in the Middle East.

In the declining phase of intellectual exercises the dominating features were imitation, repetition, reproduction, writing commentary, commentary-over-commentary, emphasis on traditional education, etc. Printing press was little by little introduced in the Middle East after passage of two centuries on its invention in Europe. When the West was establishing Oxford and Cambridge Universities, the East was busy in construction of palaces, Taj Mahal and Red Forts. The rulers of the region built several magnificent mosques but they did not establish an institution of the level of Jami` al-Azhar or Jami` al-Zaytunah for advanced education of Islamic sciences, not to speak about the scientific education.

Ottomans who controlled the Middle East did not keep an eye over what developments were taking place in the West in the field of scientific development, exploration, intellectual development, mechanization of the economy. They did not think to establish institutions for research and development (R and D). They bestowed upon the European merchants the capitulation but got no such concession for their own subjects (Hurewitz, 1987, Vol. I. P.1). The author rightly states: "If in 1680 Turkish merchants were absent from Marseille, one reason is that Ottoman sultans did nothing significant to facilitate their ventures into western Europe" (p. 270) and "When economic modernization took off in the nineteenth century, states were in the lead on various fronts" (p. 299). Had the state played its role in economic and scientific development of the region three centuries earlier, it would not have seen the ‘long divergence’.

In fact, development of business incorporations, banks, and other commercial institutions in the Middle East cannot be separated from overall development in the region. Thus, Mr. Kuran's analysis is partial and defective. He confuses between the cause and effect. To find out real causes of the fall of Middle East and the long divergence a holistic approach is needed.

Twentieth century developments in the Middle East prove inaccuracy of Kuran's thesis. Now the Middle East has big corporations, banks, investment trusts, industries, commercial exhibitions, etc. and all these without any amendment in the Islamic Law.

The author's analysis is based on deficient understanding of the Islamic Law. There is no doubt that if an established corporation is divided among a number of inheritors, it is likely to disintegrate. But in the Islamic Shariah there is provision of joint ownership (*shirkat al-amlak*). In the case where distribution of inheritance could harm an established business, joint ownership might have been maintained. Such a practice in landed property was existing since long time. Also a person entitled of a share in an inheritance could have been persuaded to relinquish his/her right by accepting a compensation. The author himself notes that the Islamic inheritance system was circumvented through different ways (P. 80).

As far hajj is concerned, it is a form of worship and one of the five pillars of Islam. The author is unable to understand its spirit. Let it remain worship. The Islamic Law never prohibits holding commercial fairs at different occasions, at different places, and in different seasons if there is such a need.

Most of the rules of partnership and *waqf* are based on *ijtihad*. They could have been amended and adjusted as it has been done at present. But during the period of the Middle East's decadence, firstly such need did not arise. Secondly, the door of *ijtihad* remained closed (Ibn Nujaym, 1980, p. 87). The author mentions one possibility of stagnation as "closing of the gate of innovation (*ijtihad*)", but immediately he ignores this cause saying that " In fact, Islamic law never became literally frozen (p. 125). True, examples of some adjustment in Islamic *fiqh*, and a low profile *ijtihad* may be found. It was exercised only when it was inevitable, but to a very limited extent within a particular school of jurisprudence, not like the one we find today at individual and collective level. Of course, its ground was prepared by scholars like Shah Wali-Allah (d. 1762) of Delhi, Muhammad Ibn Abd al-Wahhab (d. 1792) of Arabiah, Ali al-Shawkani (d. 1834) of Yemen and their followers.

The author takes the meaning of apostasy very lightly. Socio-economic and legal reform within the permissible limit is never considered as apostasy. The author has rightly criticized the capitulation system (p. 209). But it has nothing to do with the Islamic Law.

The desire and effort on the part of practicing Muslims to avoid interest and have Islamic banking is not a product of 'the mid-twentieth century for reasons of identity protection' (p. 300). This is oft repeated assertion of the author in his writings. Dr. Muhammad Hamidullah (1955) reports that by the end of nineteenth century Muslims of Hyderabad had interest-free credit society which continued till the fall of Hyderabad in the mid twentieth century. Again, it was not 'for reasons of identity protection'. Rather it was an attempt to practice economic life in the Islamic way. One should not belittle its importance by calling it "a commitment to traditional economic life".

It is not correct to say that "Mercantilism was indifferent to faith" (P. 262). In fact rise of Mercantilism was marked with Muslim enmity, protection of Christian faith and desire to re-conquer the Holy Places (Islahi, 2008). Historians of economic thought have explored the factors that helped the development of mercantilism. It started with religious zeal, missionary spirit and crusading objectives (Kirk, 1964, pp. 63-64; Heaton, 1948, p. 241; Lewis, 1976, p. 203; 1982, pp. 33-34), though later it transformed into an economic movement. It was the religious objective and missionary zeal that provided support for the growth of mercantile activities in Europe.

Typographical accuracy is, no doubt, of the Western standard but the word 'privileges' has been mistyped as 'priviledges' on page 22. Similarly, '*diyya*' (blood money) on page 106 should be '*diya*' [*diyah*] (like '*hiba*' or '*hibah*'). This error betrays the author's unfamiliarity of Arabic language, the most important language of the Middle East and the Islamic Law - the focus of this book. This is also clear from the very long list of references which includes no original work in the Arabic language. This handicap leaves rooms for doubt about the authenticity of some of the author's statements regarding Islamic law. Many such examples can be presented.

About *waqf* he says that "it appears to have been made about a century after Muhammad" for projects involving huge start-up costs to provide certain durable social services (p. 110). This is perhaps his sheer ignorance or negligence of early history of *waqf* in Islam. (There are many examples of *waqf* during the Prophet's time (peace upon him). 'Static perpetuity" (P. 113) could have been made 'dynamic' had the scholars applied *ijtihad*, as most of the provision of *waqf* are based on *ijtihad*.

Contradictions in the book

At occasions, the style of the book turns polemic, sarcastic and provocative, typical of "anti-Islamist". Inconsistency and contradictions are also noticed in some statements. On P. 113, he says: "profit oriented businesses were not yet organized as corporations even in Europe. The first business corporation emerged in the Middle of the second millennium" (P. 115). Again on P. 116 he reiterates: "It was in the late sixteenth century that European commercial enterprises started being organized as corporation". "The first two successful banks of the Middle East, the Bank of Egypt and the Ottoman Bank, were founded in 1850, In each case, the capital and organizational template come from abroad, and the administration was foreign dominated' (P. 143).

On P-148 the author observes:…..an Ottoman sultan limited the annual rate of interest to 11.5 percent throughout the empire, though only on transactions that satisfied the letter of the ban through stratagems; this order was duly ratified by a legal opinion (*fetva*). Now the question is what prevented the Ottoman sultan to establish banks if he could fix interest within a certain limit. Why did the Ottomans wait for banking till 1850s? The author does not realize the contradiction in arguing that interest prohibition affected trade and banking and then stating that it was legalized. He does not document his statement properly. It appears that he bases his arguments on some of the cases of violation of interest prohibitions in Ottoman courts and makes it as a general case (P.149). No reference has been provided for his statement that ' a cash waqf produced income by lending at interest' (p. 158).

It is not correct that the partnership formed under Islamic law consisted of just two members (P. 64). There is no such instruction in Islamic *fiqh*. Even is pre-Islamic period one person traded goods with the capital of many individuals. Only *ijtihad* was required to give it a shape of corporation. According to his own statement in Istanbul, only 77.1 Percent of the partnerships mentioned in court records consisted of just two persons’ (ibid).

The author ends his work with a "good news" that "the region borrowed the key economic institutions of modern capitalism sufficiently long ago to make them seem un-foreign, and thus culturally acceptable, even to a self-consciously anti-modern Islamist" (P. 302). But the copying of some capitalist institution cannot mend this divergence, unless the region surpasses the West in spirit of investigation, scientific experimentations, work ethics, and regain many other qualities which it have lost during the long period of decadence. What is revealing at the end is that under his thesis of the long divergence and holding Islamic law as responsible for it, he wants to promote a debate regarding Islam's "relevance to the present" (P. 302). In our opinion, twenty-first century developments in general and the recent changes in the Middle East in particular have taken the question of Islam's "relevance to the present" beyond any debate.

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