

Contextual Overview of Islamic Banking and Shari'a Objectives

* Shakir Ullah

** Amer Afaq

Abstract

Islamic finance is a growing field of financial services industry that has its roots imbedded in the objectives of Shari'a principles. It is an off shoot of Shari'a Muamalat which is expected to achieve Shari'a objectives through fair and just business practices that are free from Riba, Gharrar and all other kinds of Haram and immoral activities. This article presents a contextual review of the Islamic banking and finance and tries to fit in Shari'a objectives within the domain. The paper presents a historical perspective of the field, a review of the basic principles following by Shari'a objectives. It sheds light on how Shari'a objectives can be achieved through Islamic finance.

Key words: *Muamalat, imbedded, Shari'a, Gharrar*

Introduction:

The modern capitalist world view has separated religion from political and economic spheres of life (Rice 1999), however, some literature has found a strong link between business and faith in many countries (Cavanagh and Bandsuch 2002, Giacalone and Jurkiewicz 2003, Angelidis and Ibrahim 2004). The recent ascendancy of the Islamic financial services industry- the application of Shari'a principles to financial practices- is an evident example of the practicality of this link. Some studies have been conducted on this association in Christianity (Jones 1995, Lee, McCann et al. 2003) and Judaism (Pava 1997, Pava 1998) although there is no practical application of the principles of these two religions to modern business transactions except a few faith-based funds e.g. Roman Catholics' Ave Maria Rising Dividend. We have detected, nevertheless, a limited but rising awareness regarding Islamic business ethics in recent scholarly research (Beekun 1997, Wilson 1997, Rice 1999, Graafland, Mazereeuw et al. 2006, Wilson 2006).

Islam is a religion that guides every aspect of life including spirituality, business and social justice by encompassing an entire socioeconomic system (Rice 1999). Being based on clear ethical principles, it restricts a number of business transactions e.g. interest, pornography, gambling, speculation, and alcohol with the justification for such restraints anchored in considerations of social justice, equitable distribution of wealth and overcoming social evils (Usmani 2002). While the capitalist system is based on personal interests and stresses that every possible action should be taken for achieving the monetary interests of the owners of a particular business entity (Fama 1980, Fama and Jensen 1983), there is a great emphasis on trusteeship (*Amanah*) in Islamic teachings and the business is considered as a sacred trust with the managers. Therefore, managers are expected to act in the owners' best interests and not indulge in any activity that can harm the owners. But this does not mean that owners and managers are allowed to use every means in pursuit of profit maximization. Even though the right to personal property and profit-making is not negated in Islam, the Islamic religion does not allow these objectives to be achieved at the expense of other stakeholders (Beekun and Badawi 2005) and unnecessary claims on resources are to be minimized (Chapra 1992).

* Assistant Professor, Institute of Management Sciences, Peshawar, Pakistan

** Deputy Commission of Abbottabad, Pakistan.

This paper starts with a brief history of modern Islamic banking followed by a section on Shari'a objectives. Section 4 then explains the fundamental principles of Islamic finance that lead the realization of Shari'a objectives. The next section explains some of the widely used Islamic financial instruments that are based on the principles of Islamic banking. The final section gives details of the current regulatory and governance paradigms of IFIs.

Historical Perspective:

The history of Islamic finance goes back 1400 years to the start of Islamic religion. There is evidence of free market economy and mercantilism in the medieval ages during the golden period of the Islamic caliphate (Postan, Miller et al. 1987) where business was done according to Shari'a principles. Some researchers have termed this period as the age of "Islamic capitalism" when Baghdad was the "commercial metropolis" (Labib 1969, p. 81) of the Islamic world. According to Labib (1969), this capitalist system grew to a sound monetary economy with Dinar as the trading currency. The present "institutionalized form" (Lee and Ullah 2007, p. 1) of Islamic banking started in the mid-20th century. There are varying views on the birth of the current Islamic banking system but scholars agree on Egypt and Malaysia as the birthplaces of modern Islamic banking (Erol and El-Bdour 1989, Kahf, Henry et al. 2005). Concurrently started in 1963, the Mit-Ghamr Savings Bank of Egypt and the Tabung Haji of Malaysia were the early financial institutions that started working according to Islamic principles. While the Mit-Ghamr Savings Bank did not publicly disclose its Islamic identity due fears of crackdown from the then secular Egyptian government, Tabung Haji received encouragement and support from the Malaysian government (Kahf, Henry et al. 2005).

This was followed by a number of milestone developments in 1970s triggering the double digit growth of the industry. These early developments include the foundation of Dubai Islamic Bank as the first full-fledged Islamic commercial bank and the formation of Islamic Development Bank (Iqbal and Molyneux 2005). Matching with the concurrent foundation of the earliest institutions in Egypt and Malaysia, these two institutions were both incorporated in 1975 in Dubai and Jeddah respectively. This was followed by the formation of Kuwait Finance House and Faisal Islamic Bank of Sudan in 1977 and Dar Al-Maall Al-Islami in 1980 (Khan and Bhatti 2008). Further developments were seen in a number of Muslim majority countries like Pakistan, Sudan, Egypt, Malaysia, Kuwait etc. in terms of Islamization of the banking industry (Iqbal and Molyneux 2005, Khan and Bhatti 2008). Pakistan is believed to be the first country that formally started the Islamization process of its banking industry in the 1980s by transforming some of the government-owned institutions, National Investment Trust (NIT), to operate according to profit-and-loss system instead of interest-based system. However, this new Islamic financial system faced a lot of criticism from Shari'a scholars and academics in its first 10 years leading to a comprehensive decision of the Shari'a Appellate Court in 1991 (Zaher and Hassan 2001). Though this decision was a historical milestone in reformatting the banking system in line with Shari'a principles, it remained un-implemented due to frequent political changes in 1990s. Islamic banking in Pakistan has witnessed noticeable growth only after the year 2000 with the emergence of private Islamic banks in the market.

Being considered as a "wishful thinking" in its early years (Iqbal and Molyneux 2005, p. ix) surrounding the worries of its sustainability in the presence of a well-established conventional banking system, the Islamic finance industry has proved to be a practical alternative to the conventional system over the past 20 years. The total assets currently

managed by institutions operating according to Shari'a principles range between US\$ 700 billion to US\$ 1 trillion. These assets are expected to reach US\$ 1.6 trillion by the year end 2012 (Khan and Bhatti 2008, Richter 2009). Although the total assets of IFIs represent a very small percentage of the banking sector, the average annual growth rate of around fifteen to twenty percent is promising (Yeates 2008). Khan and Bhatti (2008, p.708) claimed that the recent developments in the industry are making it a "truly viable and competitive alternative to the conventional system". The key factors contributing to the growth of Islamic finance are the soaring oil prices and the resulting economic growth in the oil-rich Middle Eastern world, innovation and a favourable attitude towards Islamic banking from the regulators worldwide (El Qorchi 2005, Khan and Bhatti 2008). Some researchers argue that a major reason of the growth of this sector is the demand for Shari'a compliant products (El Qorchi 2005, Abdullah and Kassim 2009, Lee and Ullah 2011). Yet some others claim that the competitiveness, itself, of some of the Islamic financial products has paved the way for the industry's rapid expansion making it attractive to both Muslim and non-Muslim investors alike (El Qorchi 2005).

Fundamental Principles of Islamic Finance:

Shari'a not only gives a list of Shari'a objectives but it also furnishes a number of principles for IFIs to adhere to which could help them achieve those objectives. Islamic finance is a subset of Islamic economic system whose goal is public welfare and social justice (Dusuki and Abdullah 2007). Islam allows capitalism in the form of recognizing market forces of demand and supply, access to private property and the profit motive but these are subject to some restrictions namely the prohibition of interest, gambling, speculations, hoarding, dealing with alcohol, arms, tobacco, pornography etc. (Usmani 2002). Usmani also argues that the very purpose of these restrictions is to maintain justice and equality within societies. The products developed by IFIs are scrutinized based on a set of principles that restricts the free hand of entities in pursuing the profit motive. These principles are briefly discussed below.

Firstly, prohibition of *Riba* (interest) is the most prominent and widely discussed principle of Islamic finance distinguishing it from conventional finance. The literal meaning of *Riba* is 'excess' which technically means any excess amount paid/received for the borrowed/lent money (Khan and Ahmed 2001, Obaidullah 2005). Though Islamic scholars unanimously agree that any predetermined interest rate on loan constitutes *Riba*, the subject is still subject to debate. Islamic finance researchers argue that *Riba* leads to unequal distribution of wealth by rewarding the lender by keeping him/her intact from the associated risks of investments and oppressing the borrower by shifting all risks on to him/her (Usmani 2002, Sultan 2007). Chong and Liu (2009) assert that *Riba* refers to the doubling of debt after failure to pay on its due date in Medieval Arabic practices which could lead to the slavery of the debtors. They, however, argue that prohibition of *Riba* is not relevant in the existence of bankruptcy laws in modern societies, which protect debtors from slavery. This goes against Shari'a objectives and is, therefore, not allowed to IFIs to deal with. The strict prohibition of *Riba* is derived from a number of Qur'anic verses (2:275-280, 3:130, 4:161, and 30:39) that condemn its receipt and payment in very strong words. Therefore, Shari'a scholars do not allow IFIs to deal in any interest-based transaction.

The argument put forth against interest is that it imbalances the distribution of wealth within societies (Usmani 2002) and concentrating it in the hands of a few. This view has also been endorsed by western economist like Robertson (1998, p.54) who said that

“Would it be desirable and possible to limit the role of interest more drastically than that, for example by converting debt into equity throughout the economy? This will be in line with Islamic teachings and with earlier Christian teachings, that usury is sin.”

In fact, the key emphasis in developing Islamic financial instruments, discussed in the next section, is to engineer them in such a way as to avoid interest. It is however difficult to develop Islamic financial products purely based on Shari'a principles and yet meeting the banking needs of the bankers and managers. Therefore, some researchers strongly criticise Islamic financial products for being overburdened with unnecessary contracts and away from Shari'a objectives (El-Gamal 2006).

Secondly, Islam prohibits *Qimar* (gambling), *Gharrar* (excessive risk) and *Maysir* (speculation). Transactions involving gambling and speculations are banned for similar reasons discussed in the above paragraph i.e. these mechanisms “tend to concentrate wealth in the hands of a few” (Usmani 2002). Business transactions that exclude *Gharrar* are “designed to prevent the weak from being exploited and, thus, a zero-sum game in which one gains at the expense of another is not sanctioned” (Chong and Liu 2009, p.128). One reason for this prohibition is that Islam insists on investments in real assets while gambling locks capital in hypothetical assets that do not lead to economic development. Furthermore, they lead to so social problems. Modern research has proved that addictive gambling leads to “financial breakdown, impaired relations with family and friends” in addition to alcoholism and physical harm (Bergh and Kühlhorn 1994, p.275). Gambling also includes elements of *Gharrar* in the sense that the potential outcome is uncertain. *Gharrar* excludes transactions like options and forwards. Similarly, speculations lead to hoarding and bubble markets that collapse leading to financial crises. Thus, IFIs are required to avoid investments in any business or transaction involved gambling and excessive risk/uncertainty and speculations.

Third, certain business sectors are considered to be naturally harmful to the society and therefore categorized as *Haram* (prohibited). Such business sectors include alcohol, tobacco, pornography, pork, arms etc. (Usmani 1998, Usmani 2002). This is not an exhaustive list; any business sector that leads to potential damage to public/social interest is not allowed to be undertaken by IFIs. Again, the reasons for avoiding these business sectors are their associated contributions towards social problems (Caetano, Nelson et al. 2001).

These are the fundamental principles that each financial institution has to observe. The pliability of IFIs to the recent financial crisis is partly due to their adherence to these fundamental principles. The recent Moody's report claims that the reason for Islamic banks' strong resilience to the recent global financial debacle was their adherence to a rather conservative investment policy based on the above principles (Hassoune 2008). The ability of IFIs to weather the storm is embedded within the core principles of Islamic banking: both speculation (*Maysir*) and interest rates (*Riba*) are prohibited. The sub-prime crisis was driven by a number of factors leading to the accumulation of risks, which were again magnified through the use of complex, often highly structured financial products. Such products are ruled out from the portfolio of IFIs based on their tussle with the above-mentioned principles. Some other reports have also supported the claim that IFIs have remained intact from the severe impacts of the financial crisis (Yeates 2008) in which world's financial giants collapsed.

Shari'a Objectives (Maqasid Al-Shari'a):

Islam is a versatile religion guiding Muslims private spiritual and worldly lives. Shari'a embodies the Islam's worldview defining an ethical system governing all facets of life including personal, political, social, economic etc. Therefore, a Muslim's dealings with fellow human beings are deeply intertwined with Islam's basic beliefs, values and objectives. In fact it "reflects the holistic view of Islam, which is a complete and integrated code of life" (Dusuki and Abdullah 2007, p.30). It is thus imperative to understand what objectives Shari'a wants to achieve by regulating all aspects of life.

Perhaps Imam Al-Ghazzali, as quoted in (Chapra 2000, p.118), introduced the best comprehensive definition of Shari'a objectives:

"The objective of the Shari'a is to promote the well-being of all mankind, which lies in safeguarding their faith (din), their human 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."

It is clear from the definition that Shari'a objectives give key prominence to human dignity and prosperity. Shari'a is thus a set of rules designed to protect humanity and expedite the thriving of human life in this world and a reward for good acts in the hereafter. The Shari'a objectives could be achieved through a transparent system of fairness and justice, elimination of prejudice and promotion of cooperation of support across families and societies (Dusuki and Abdullah 2007). Shari'a objectives could be achieved through Maslahah- a juristic tool for promoting public good and preventing harm. Most Islamic jurists allow Maslahah to be used as a source of Shari'a when issuing fatwa's on emerging issues (Dusuki and Abdullah 2007). The use of Maslahah is allowed to promote only public good. It should not be used for individual benefit. On the contrary, Maslahah should be exercised to stop a personal gain in order to prevent public harm. For example, a company should not be allowed to benefit from an environmentally disastrous project because of its public harm. However, it is possible that some Shari'a scholars may use Maslahah to give a benefit to Islamic banks while ignoring a wider public good. Therefore, some jurists, like Imam Al-Ghazzali, do not consider it as a source of Shari'a rulings. He also restricts its use to necessary public good only. Al-Raysuni (1992) quoted Imam Al-Ghazzali as saying:

"Maslahah is essentially an expression for the acquisition of benefit or the repulsion of injury or harm, but that is not what we mean by it, because acquisition of benefits and the repulsion of harm represent human goals..... What we mean by Maslahah, however, is the preservation of the Shari'a objectives."

The recent attention in the western world towards making corporations responsible to society partly resemble to what we call Shari'a objectives. However, Shari'a objectives address the issue of responsibility of not only businesses but also individuals in a rather wider and holistic way (Dusuki 2008). In contrast to western corporations where social responsibility is undertaken as a result of governments' and stakeholders' pressure, IFIs derive this urge from the very principles of Shari'a which establishes that a responsible behaviour would attract reward and irresponsible behaviour would attract punishment in the hereafter. Islam considers an individual as the vicegerent (Halifax) of Allah on this earth who is supposed to prioritize public good against personal gains in order to attain Shari'a

objectives. One's wealth is considered as a trust from Allah and therefore, it should be used to relieve fellow human beings from the troubles let alone damaging others for personal gains.

Emphasis on justice and balance (referred to as *adl* and *qist* in Qur'an) in every aspect of life are explicitly mentioned in the Qur'an¹ e.g. the Qur'an says "... Be fair for God loves those who are fair (and just)". The Qur'anic verse "Be just! For justice is the nearest to piety" (Qur'an, 5: 80) can be interpreted in this context. On another occasion the Qur'an says "Dealt not unjustly and ye shall not be dealt with unjustly" (Qur'an, 2: 279). The above verses also imply that all other stakeholders get what is just for them e.g. customers are entitled to fair prices, quality goods, information disclosure and employees are entitled to salaries, health benefits, education, share in the profits. Similarly, the environment is a natural resource that belongs to all inhabitants and therefore, companies are not allowed to exploit it for their private monetary benefits because doing so is an injustice to other claimants including animals.

The Role of IFIs in Realizing Shari'a Objectives:

As discussed above, Shari'a objectives prioritize public good over personal or corporate goals. Thus one might expect that IFIs should not only achieve Shari'a objectives themselves but also seek them with other companies through their investments. In contrast, capitalist economists argue that the sole reason for corporate existence is maximization of shareholders' wealth (Friedman 1967, Friedman 1970). They further argue that market forces should decide the optimal allocation of scarce economic resources. According to the free market view of modern business, corporations can even deal with drugs, weapons, pornography if that increases their profits despite their server consequences on societies. On the other hand, IFIs are not allowed to indulge even in tobacco, alcohol, weapons, pornography gambling, hoarding and speculations because of their harmful effects on societies. Thus an IFI would straightaway turn down an investment proposal in, say, a tobacco company even if its return is comparatively much higher than other available options. Thus the "ethical principles of Islam do influence the decision-making process in a business situation where such decisions may not be in conformity with decisions made in the economic interests of the firm" (Uddin 2003 p. 26) and thus Islam advocates "overall human well-being through socioeconomic justice". Beekun and Badawi (2005 p. 135) argue that the "corporation as a fictitious entity does not diminish the responsibility of its owners and managers for its actions". IFIs are discouraged to invest in a company that goes against Shari'a objectives. In such circumstances, where the company is involved in activities violating Shari'a objectives, IFIs have two options; i) force the company to align its activities with the broader stakeholder criteria or ii) sell the shares of this particular company and invest in firms that are more socially responsible and are meeting Islamic securitization criteria.

Conclusions:

Islam is more than a religion that guides every aspect of life and so the IFIs are expected to consider the Islamic ethical values in their investment decisions. As Islam seeks to protect the rights of both primary and derivative stakeholders, IFIs have to seek investments in companies that respect the due rights of all the stakeholders and are not involved in any kind of exploitation. IFIs are bound to observe the principles of trust (*Amanah*), equity, balance and fairness (*adl* and *qist*), benevolence and excellence (*lhsan*) in their own operations but also scrutinize the operations of their portfolio companies on the basis of these criteria. It is

argued in turn that these Islamic ethical principles have a great affinity to the concept of Corporate Social Responsibility (CSR). Although IFIs currently manage a very small proportion of the world's wealth, this sector has experienced steady growth in the past few years and is thereby attracting more attention from the global financial community. Therefore the article argues that IFIs can make a difference in the long run by catalysing and mainstreaming the CSR agenda.

Endnotes:

¹ Qur'an is the Holy Book of Islam.

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