CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

The Islamic law prohibits charging and paying of interest but allows earning profits on the basis of participation in the market. This legal injunction has motivated the establishment and successful operation of a number of Islamic financial institutions. These institutions include Islamic banks, and non-banking Islamic financial intermediaries, namely, Islamic insurance companies, Islamic investment funds, *mudarabah* and *ijarah* (leasing) companies. In addition, a secondary market for Islamic financial instruments and an inter-bank Islamic money market are also emerging.

The evolution of a complete interest-free Islamic financial system is thus, not far from reality. At the present, the international financial community seems ready to consider any viable alternative financing arrangement. Given this readiness, the emergence of the Islamic financial system can be considered as a significant development. The real strength of the Islamic alternative however, shall rest on its own inherent characteristics as well as the clarity and ease with which it can be distinguished from the conventional interest-based financial system.

The Islamic financial system has started evolving only during the early seventies. However, Muslim thinking in this regard has a long history. For example, opposition of the *Sharīah* scholars to institutionalized (bank) interest is traced back to 1903. This year, in Egypt, the payment of interest on Post Office Savings Funds was declared unlawful by Shaikh Mohammed Abdu.

In fact, an Islamic critique of interest-based banking had started earlier. A branch of the Barclays Bank was established in Cairo during the last quarter of the nineteenth century. Through this branch, the bank financed construction of the Suez Canal. Ever since the establishment of this first interest-based bank in the Muslim world, Shaikh Abdu had initiated a critique of its operations.
Similarly, the seminal work of Siddiqi (1976) on contemporary Muslim economic thinking tracks the critique of the institution of interest by a Muslim economist to 1946 when an important book was published on Islam and the theory of interest.

Interests in Islamic banking and finance are not only limited to the Muslim countries. Since the early eighties, European as well as American academic circles have taken keen interest in the subject. So far, a large number of Ph.D., thesis have been written on the subject in many Western universities. Prominent Western scholars and institutions are actively contributing books and articles in the area. Western financial institutions are increasingly offering Islamic investment opportunities to their clients.

1.2 THE ISSUE

Research studies to find an Islamic alternative to interest-based banking were initiated by the late forties and intensified during the fifties, sixties, and early seventies. Muslim economists in particular took the task very thoughtfully. As a result, largely between 1955 and 1974-75, the theory of Islamic banking developed. In 1955 the first formal model of an Islamic bank was presented. During 1974-75, two Islamic banks, namely, the Dubai Islamic Bank, UAE, and the Islamic Development Bank (IDB), Jeddah, respectively, initiated their operations for the first time.

As a matter of consensus among majority of writers on the subject during the 1955-75 period, an Islamic bank must primarily be based on the principle of profit/risk-sharing. Profit sharing is the common basis of the two popular Islamic financial contracts: *mudarabah* and *musharakah* (MM). Therefore, the banking model emerging from the MM contracts is often termed as profit and loss sharing - PLS banking (for convenience, in the present research, until otherwise specifically mentioned, we also use the acronym - PLS, interchangeably, for the MM contracts on one hand and for risk-sharing on the other).

Nevertheless, since the actual emergence of the Islamic financial institutions in the market during the early seventies, the proportion of the PLS in their total operations has remained negligible. Scholars, who had envisioned a significant role for the PLS are naturally discontented with this situation. Through the IDB
operations, the mark-up first appeared in Islamic banking in 1976. Ever since its first appearance, the mark-up is the most predominant form of financing among the emerging Islamic financial institutions. Although permissible in the contemporary Islamic law\textsuperscript{14,15}, in terms of non-risk sharing characteristics, the mark-up principle doesn’t differ much from the conventional interest-based banking system. Instead of interest-based money lending, under the mark-up principle, the creation of finance takes the form of deferred trading.

Hence, compared to the mark-up, in terms of risk-sharing, the PLS presents a striking contrast to the traditional interest-based banking. It may also be noted that most Muslim countries are plagued by chronic public budget deficit and skyrocketing public debts. Credit markets and financial systems are inefficient, domestic and foreign risk capital are shy in most of these countries. In this environment in particular, an overwhelming majority of Islamic economists consider that compared to the mark-up, the PLS can offer an efficient and stable alternative to the existing interest-based financial markets in these countries. Consequently, among the Islamic economists the preference for the PLS is much stronger compared to the mark-up.

The PLS and mark-up are in fact two parent principles of Islamic financing\textsuperscript{16}. Ironically, the theory of Islamic finance entirely relies on the PLS, while the practice is dominated by the mark-up! Thus, a dichotomy between the theory and practice of Islamic financing can be observed. An analysis of the causes and effects of this dichotomy is important for understanding the basis of Islamic financing, the future of Islamic financial institutions and the contribution which these institutions may make to individual Muslim economies as well as to the global economic scene.

The research works and ideological rhetoric related to the theory and practice of Islamic financing can be classified into a number of groups. First, a large amount of the existing literature reflects on the hesitation of Islamic financial institutions to offer PLS funds due to many institutional reasons. Second, a small but influential literature also tries to show that the users of funds are not much interested in the PLS either. The existing literature however, does not compare the characteristics of the mark-up and the PLS, in simultaneously meeting the preferences of users of funds and banks. Third, ideologically, in a closed economy context, the PLS is strongly favored. Paradoxical as it is, in an open economy context, the same sentiments disfavor foreign control of national resources which the PLS will seemingly bring with it. It is
noticeable that most Muslim countries cannot meaningfully Islamize their domestic financial systems without at the same time dealing with the rest of the world using Islamic modes of finance. Compared to the previous two aspects of the theory and practice, this important paradoxical phenomena is least talked about, letting alone any serious research. Finally, but importantly, if the PLS has to establish an edge over the mark-up, in practice, it must reward risk. In the literature, this matter has so far not been investigated empirically.

Related to the dichotomy of the theory and practice of Islamic financing, many specific questions can also be posed. Why didn’t, the Muslim economists incorporate the mark-up in their initial theoretical models of Islamic banking? Why didn’t, the Islamic banks adopt the PLS which is strikingly different from interest-based system and simultaneously, is considered to be more efficient and stable than the interest-based banking? Will the domination of the PLS by the mark-up continue or will the Islamic banks develop and keep balanced proportion between the mark-up and PLS? How can the PLS take care for the preferences of user of funds (firms) for different types of finance? What are the requirements for those firms which opt for Islamic financing to fair well in the globalizing markets as compared to their competitors? What are the prospects of mark-up vis-à-vis PLS in mobilizing external resources so urgently needed by the Muslim countries?

1.3 OBJECTIVES OF THE STUDY

The literature on Islamic financing is vast. The question that why should mark-up and not PLS and vice-versa be adopted, has also been discussed either by the proponents of the PLS or the mark-up. However, to gauge the causes of the dichotomy in theory and practice of Islamic financing, a comparative and objective analysis of the inherent characteristics of the two, vis-à-vis the perspective of user of funds and the banks has never been undertaken. Such an analysis is essential for understanding the causes of the phenomenon, its evaluation and suggesting appropriate strategies for the formulation of policies.

In the present research, we aim to seek answers to most of the questions raised above. Compared to the nature and importance of the issue, neither the list of questions can be considered complete, nor an exhaustive treatment of all the questions
raised is possible. Therefore, to limit the scope of the study, and to make it manageable in the given resource-time frame, specific objectives of the research need to be identified. These are to:

1. Trace the causes of the double edged phenomenon: the missed mark-up in the initial models of Islamic banking and the subdued PLS and overwhelming mark-up in the operations of Islamic financial institutions.

2. Discuss the evolution of the mark-up vis-à-vis the PLS in a short and longer-term perspective and the implication of this for the future shape of Islamic financing.

3. Study the preferences of suppliers (banks) and users (firms) for PLS and mark-up funds with a view to understand the phenomenon of subdued nature of PLS in the operations of Islamic banks.

4. Study the financial market performance of the PLS in a mixed environment where interest-based instruments also exist,

5. Examine the inherent characteristics of the PLS in retrospect focusing on firm level considerations,

6. Examine the mark-up and PLS mechanisms in retrospect focusing on an open economy scenario, in particular, formally present the seemingly paradoxical phenomena related to the prospects of using the PLS in external resource mobilization and

7. Suggest possible reform in the PLS for enhancing risk sharing in Islamic financing.

1.4 RATIONALE

Islamic financing is an important area of contemporary academic and policy interest. Opposing views in the area are analyzed in the light of empirical evidence. The implication of answers to questions cited above and similar others for the future shape of Islamic financing is immense. As these questions directly deal with the issue of preferences of users and suppliers of funds with a view to resolve their conflicts and enhance risk capital, we also expect that the study has a general relevance. The study is of general theoretical importance as well as of particular practical
significance for policy makers who intend to conform their existing financial systems to Islamic rules.

1.5 METHODOLOGY

Two important considerations have determined our approach in this research. One of these is general in nature and is related to the state of the existing theory and practices of Islamic financing. The other consideration is related to the specific aspects of the study.

General Considerations

A number of general considerations effect the environment in which this research has to be conducted. First, recently the expansion of Islamic financing practices has out-paced the theoretical developments in the area. Due to this phenomenon it is natural to confront difficulties in choosing a suitable theoretical framework for evaluating various aspects of the practices.

Second, the existing theoretical works mostly relate to Islamic banking. Compared to financing, banking has a narrower connotation. The extension of the theoretical framework of Islamic banking to cover the broader area of Islamic financing is again subject to certain limitations.

Finally, the present age is the age of international interdependence and globalization of financial markets. Economies and firms can neither be expected to remain competitive nor can Islamize effectively by adopting financial policies in isolation from the rest of the world economy. Firms which opt for Islamic financing cannot remain competitive and acquire value by ignoring the availability of finance to their conventional competitors. This requires understanding the challenges and opportunities for opting for Islamic financing in a market where the competitors have access to a wide range of flexible financial alternatives.

Specific Considerations

The above and related considerations were not pertinent even five years ago. We understand that these need to be integrated in attempts to study the theoretical and practical realities of the Islamic financial system. These broader considerations are therefore, incorporated in the approach of the present study.
As for specific considerations are concerned, four separate but inter-related aspects of the present study are clearly identifiable. The study of each of these aspects requires a suitable methodology.

A. We are trying to understand the dichotomy between the PLS-based theory and mark-up based practices of Islamic financing. A comparative study of the evolution and economics of PLS and mark-up is therefore inevitable. This requires an analytical and critical review of the relevant literature in order to gauge why the mark-up was not incorporated in the PLS theory of Islamic banking. At the same time it is also necessary to critically follow the evolution of the theory of mark-up. In this regard, it is necessary to note that we are dealing with both the PLS and mark-up as two parent mechanisms rather than as modes of financing.

B. We want to know why the mark-up is overwhelming in the operations of Islamic banks. In this regard ours is not the first attempt. However, we approach the subject differently.

In the outset it should be mentioned that compared to the PLS, mark-up is certainly more consistent with the traditions and conventions of conventional commercial banking. The orientation of the bank staff, the language, terminology, technology and culture of banking, the premises of competition, similarity of bank products, services, laws and regulations, all put the mark-up at comparatively advantageous situation compared to the PLS. Unless, these parameters are changed in favor of the PLS, mark-up will dominate the operations of the Islamic banks.

As these conditions are related to the banking environment, efforts are required by the Islamic banks to change the conditions for an extended use of the PLS. Thus, the existing research by the Islamic economists on the subject assigns relatively, a greater responsibility to the Islamic banks. This approach implicitly implies that the banks are in a position to dictate forms of financial (PLS) contracts to their clients. Consequently, the preferences of the users of funds for the PLS and mark-up are not discussed in detail simultaneously.

There is no doubt that as suppliers of funds, the banks must be playing important role in influencing the choice of their clients for particular forms of funds. Nevertheless, it is also true that in a competitive environment the banks cannot always dictate funding conditions against the preferences and desires of their clients.
Therefore, along with the supply side considerations, the perspective of the users of funds must also be studied in order to improve our objective understanding of the observed phenomenon. Given the considerations of the banks and their clients, the task, then is to critically compare the inherent characteristics of the PLS and mark-up contracts, in simultaneously meeting these considerations.

The lack of emphasis on the demand side considerations by the Islamic economists is not without reasons. In the PLS modes of Islamic banking developed by Siddiqi (1967, 1983 and 1983b, subsequently used by other researchers as a synonym for Islamic financing), the Islamic economy was visualized to be a debt free economy. Elimination of interest-based debt was taken to leave the companies (user of funds) with only one option - 100% PLS. Moreover, during the last three decades the famous Miller-Modigliani (MM) proposition (that under perfect competition, considerations for the cost of finance is irrelevant in choosing between debt or equity) almost dominated the field of finance. Given the indifference of the firms between debt and equity as implied by the proposition from the cost side, and their clear preference for equity for Islamic reasons, the non-existence of the PLS in the flow of funds can justifiably be seen as a reflection on the banks' attitude.

Nevertheless, the innovation of mark-up as an Islamic form of debt financing has however, restored the users' choice for debt and equity. In addition, the M-M proposition has been weakened substantially due to its very restrictive assumptions which have been proved unrealistic both theoretically as well as empirically. It implies that users' preferences cannot be ignored while explaining the reasons for the overwhelming use of the mark-up as a form of debt finance.

Moreover, the existing works do not consider the most important source of financing the growth of a firm i.e., its retained profits. The reason for this is also understandable - the PLS particularly, pure mudarabah does not allow retention and re-investment of profits in the enterprise.

In addition to the supply side factors, in the present research, we also discuss the preferences of firms for the mark-up as well as profit retention. These considerations allow a comparison of the inherent characteristics of the PLS and mark-up vis-à-vis the preferences of the banks and users of funds. This approach is expected to help the development of such PLS contracts which can simultaneously be
consistent with the preferences of both users and suppliers of funds. In our understanding, this is a crucial requirement for the promotion of the PLS principle in some form.

C. We intend to study the actual performance of the pure PLS. It may be noted that theoretically, the case for the PLS has been strongly presented. But, there is no empirical evidence of its actual performance. In this regard two scenarios can be presented. In the first scenario we need to show that in practice, the Islamic banking is dominated by the mark-up. This is easily done by extracting information from the Islamic banking practices.

The second scenario is related to the practical performance of the pure PLS in a mixed environment. As the Islamic banks do not do PLS, this cannot be done based on their experience. Fortunately, we have a practical experience of the Modaraba Companies of Pakistan with the pure PLS, in the form of the muḍarabah certificates. The analysis of the practices and performance of these companies provides a useful case study and covers the third aspect of the present study.

No specific Islamic theoretical framework is available to analyze the performance of the Islamic companies. Therefore, we have the flexibility to select a suitable one from the conventional methodologies. After a thoughtful comparison between the competing methodologies we select the capital assets pricing model (CAPM). Some Islamic economic considerations for selecting this model, the simple model used and the nature of data on which the model is applied has been explained in the relevant chapter. It is sufficient to mention here that the central concern of the CAPM is valuation of assets under conditions of risk. For this reason, as compared to its counter-parts, the CAPM is directly relevant for the evaluation of the pure form of the PLS.

D. The fourth distinct aspect of the present research is the fact that we deal with a number of issues which are not discussed in the existing literature on the subject. In Islamic economics, the researcher is required to work within a premises which must be consistent with the Shari‘ah. During the research whenever, there was a need, we referred back to the Shari‘ah sources. Some of the prominent contemporary scholars in the area were also accessible. These scholars were frequently consulted, both in writing as well as verbally. After consultation, we have
synthesized each relevant issue in the light of the Shari'ah opinion as well as our own framework. In case no Shari'ah solution was found, we either dropped the issue or approached it from a different angle. This approach was highly rewarding as we found that most problems of the contemporary financial markets can be meaningfully discussed without violating the general Shari'ah framework. Therefore, this work has the merit to explore the flexibility of discussing a number of issues of contemporary financial markets within the framework of Islamic economic principles.

E. It must also be clarified that this research is not a case study of Pakistan. Rather, it relates to the evolution of the central theme of Islamic financing. The case of Pakistan has been introduced only to derive some lessons from the practice of Islamic financing. The Pakistani case is representative for a number of reasons. First, the nation has made conscious efforts to introduce an Islamic financial system. Second, it is an open and liberalizing economy. Third, for economic reasons, recently it has targeted at reducing the interest cost of debt for the economy. Finally, above all, data is available for meaningful analysis.

1.6 OVERVIEW OF THE RESEARCH

The work has been organized thematically. Chapters two and three, respectively, deal with the theory of PLS and mark-up, both in terms of evolution and economics. Chapters four and five deal with the analysis of the practice of PLS. Chapter four specifically deals with our interpretations of the reasons for the lack of use of the PLS by the Islamic banks. In chapter five we formally evaluate the market performance of the pure PLS. The theme of chapters six and seven is a retrospective look at the PLS as well as its prospects. In chapter six we put forward firm-level (micro-economic) considerations. In chapter seven we discuss the relative significance of mark-up and the PLS in an open economy context. Chapter eight provides an analytical recapitulation of the central idea emerging from the discussion of the previous chapters. Conclusions of different chapters are put together in chapter nine in summary form.
NOTES

1 Abolition of Ribâ is the fundamental issue in the contemporary discussions on Islamic financing. In the contemporary context the term Ribâ includes interest (Ribâ of debts) and trading in the forward currency markets (Ribâ of sales). However, in the common usage, Ribâ is a synonym of interest. Throughout this research therefore, we use the terms Ribâ and interest interchangeably.

2 There are different estimates of the present size of funds managed by the Islamic financial institutions at the present. The most systematic source of information about Islamic banks is the International Association of Islamic Banks (IAIB). IAIB (1994) reports that there are 166 registered members, about 100 of these provide information. The reporting institutions have a combined strength of US dollars 2.5 billion paid-up capital; these institutions are managing US dollars 42 billion in deposits and 54 billion in assets. Another estimate by the FT puts the deposits between US dollars 50-80 billion (FT: 28-11-1995). The WSJ (9-4-1996) estimates the size of funds managed by the Islamic financial institutions at US dollars 30 billion. It can therefore, safely be estimated that at the present the Islamic financial institutions are managing at least US dollars 35-40 billion, which is expected to increase in the future. See, also Ahmad (1996).


4 I came to know about this fact while discussing the historical data reported in ibid with the author and followed it with other Egyptian scholars as well.


7 See Ahmad (1996).

8 See, Siddiqi (ibid).

9 For the review of these efforts, see Siddiqi (1983b) and Kahf and Khan (1992).


11 Two unique experiences are worth mentioning here. First, during the 1963-67 period, an attempt towards establishing an Islamic financial institution was made in Mit-Ghamr, rural area of Egypt. This operationally unsuccessful, but conceptually a precursor Islamic banking experience was an attempt to combine the concepts of German savings banks, rural banking and the Islamic participatory modes of financing (for details see, e.g., Khan 1983). Second, during 1962-69, the Pilgrims’ Management and Fund Board (Tabung Hajji - TH) evolved in Malaysia. The TH is not only a viable Islamic financial institution, but is also a dynamic concept. As a concept, the TH suggests that the performance of Hajj and umrah involves substantial cost (I estimated that, about two hundred thousand people performed Hajj and umrah from one country during 1994. For the year, the cost of one Hajj per an individual was about US dollars 1400, hence the total expenditure on Hajj and umrah incurred by the citizens of the country during 1994 was US dollars 280 million). Every Muslim aspires to perform Hajj and umrah. Performance of these religious duties are therefore an important motive for saving. Since, Hajj and umrah are spiritual acts, people would refrain to keep their savings made for this purpose in interest-based banks. Thus, institutions like the TH are needed in the Muslim countries to mobilize these savings. These savings can then be invested in accordance with Islamic principles. Working on this philosophy, the TH is the only Islamic financial institution which has won the prestigious IDB Prize for Islamic Banking (for more details, see, IRTI 1987).

12 Some writers also consider the Nasser Social Bank Egypt established in 1972 as an Islamic bank. This is a public sector institution which largely functions as a non-profit organization.

13 This discontentment is being shown in various forum. Islamic economists are more pronounced in this regard. Sharî'ah scholars who have legitimized the mark-up are also showing their growing displeasure at the disproportionate reliance of the Islamic financial institutions on the mark-up. During discussions in the 1415H IRTI Ramadhan Fiqh Lectures, some Sharî'ah scholars even suggested that the Islamic banks’ reliance on the mark-up is far more than the reliance of the conventional banks on interest. Islamic economists and Sharî'ah scholars agree that this is unhealthy trend for the future of Islamic banking (see, also, IRTI-OICFA, 1993).

14 It needs to be noted that the Report on the Elimination of Ribâ from the Economy (of Pakistan) had recommended very limited and exceptional use of mark-up; otherwise, it was warned that it will open a back door to interest (see, the report in Ahmad, et. al eds., 1983). The Sharî'ah Court Pakistan Judgment on Ribâ 1991, is an important source of the contemporary Islamic law. Despite, wide scale consensus among Islamic jurists on the permissibility of the mark-up principle, the judgment condemns the mark-up as practiced in Pakistan.
It must be noted that a minority of Islamic scholars also maintains the view that a whole-sale acceptance of the mark-up will open a back door to interest.

Service-fee is in fact a third Islamic mechanism which underlies loan financing. The OIC Fiqh Academy (Resolution No. 1 Session No. 3, held in Amman Jordan during October 11-16, 1986) allows charging service-fee on loans which should be exactly equal to the cost of administering the loan (Service-fee = loan amount X implementation period X annual rate). Annual rate is an average of the past five years actual administrative expense on such loans which should not however exceed 2.5 %. In case, service-fee is estimated and charged and is found more than the actual expense on ex post basis, the excess amount is refunded. In case of default, the principal loan amount or service fee does not change. However, the most prominent contemporary Islamic jurist Shaikh Mustafa al Zarqa has reportedly called for an imposition of a financial penalty by the lender if the borrower is found to be actually solvent but defaults in payment. See, Hussain Kamel Fahmi (forthcoming) “Problems of Compensating Islamic Banks for Delay of Payment of Financial Debts and Solutions”, Jeddah: IRTI.


It need to be noted that the matter of debt financing by issuance of bonds and other debt instruments is not yet settled.