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CONVERGENCE BETWEEN THEORY AND  
PRACTICE OF ISLAMIC BANKING:  
AN EMPIRICAL ANALYSIS



By

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November 2016

To my mentor

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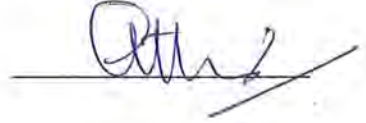
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## **Abstract**

Islamic banking was launched with the hopes that it would provide an alternative banking system. Given that bank interest was deemed impermissible by majority of the Muslim jurists, therefore they sought to replace fixed-return model of banking with that of profit-and-loss sharing banking system. However, even after about half-century of experiment, Islamic banking is not completely based on profit-and-loss sharing.

This study aims at developing a framework that can be used to evaluate convergence between theory and practice of Islamic banking. Objectives of Islamic banking are identified on the basis of its celebrated theory. A set of hypotheses or indicators are derived to reflect the achievement of these objectives in Islamic banking practice. Empirical methodologies and tools are developed to test these observable hypotheses. Finally, the study applies this methodology for investigating the extent to which Islamic banking practice has converged to its theory in Pakistan and Malaysia over time. The results indicate that the Islamic banking industry is largely struggling to approach its stated objectives in both countries.

## Table of Contents

Acknowledgements.....	i
Abstract.....	ii
Table of Contents.....	iii
List of Figures.....	v
List of Tables.....	vi
List of Frequently Used Arabic Terms.....	viii

### CHAPTER 1: INTRODUCTION

---

1.1: BACKGROUND.....	1
1.2: RATIONALE.....	3
1.3: OBJECTIVES.....	6
1.4: SCOPE AND SIGNIFICANCE.....	7
1.5: ORGANIZATION OF WORK.....	8

### CHAPTER 2: LITERATURE REVIEW: IDENTIFYING RESEARCH GAP

---

2.1: DEVELOPMENT OF ISLAMIC BANKING.....	9
2.1.1: Debate on the Meaning of Riba.....	12
2.1.2: Evolution of Islamic Banking Theory.....	14
2.1.3: Evolution of Islamic Banking Institution.....	25
2.2: CRITIQUES OF ISLAMIC BANKING.....	28
2.2.1: Juristic Verdicts (Fiqhi Fatawa).....	28
2.2.2: Structuralist Voices.....	33

### CHAPTER 3: THEORETICAL FRAMEWORK: ISLAMIC BANKING THEORY AND ITS PROFILE IN PAKISTAN AND MALAYSIA

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3.1: GENESIS OF THE FIRST BEST ADVOCACY OF ISLAMIC BANKING.....	40
3.1.1: Outline of First Best Theory.....	42
3.1.2: The Objectives of Islamic Banking.....	46
3.2: DEGENERATION OF THE FIRST BEST.....	53
3.2.1: The Second Best: the First Drift.....	54
3.2.2: The Second Drift: Rise of Pragmatism.....	57
3.2.3: Reasons for the Going Process from Genesis-to-Degeneration.....	66
3.3: CLASSIFYING THE STRUCTURE OF ISLAMIC BANKING THEORY & PRACTICE.....	70
3.4: ISLAMIC BANKING IN PAKISTAN AND MALAYSIA.....	75
3.4.1: Evolution of Islamic Banking in Pakistan.....	75

3.4.2: Evolution of Islamic Banking in Malaysia..... 83

**CHAPTER 4: HYPOTHESES DEVELOPMENT AND EMPIRICAL METHODOLOGY**

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**4.1: HYPOTHESES DEVELOPMENT ..... 87**  
4.1.1: Procedural Hypotheses ..... 88  
4.1.2: Consequential Hypotheses ..... 88  
**4.2: SAMPLE AND VARIABLES ..... 93**  
**4.3: ESTIMATION TECHNIQUES..... 96**  
4.3.1: Procedure for Testing Hypotheses ..... 96  
4.3.2: Analytical Tools..... 103

**CHAPTER 5: EMPIRICAL RESULTS**

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**5.1: EMPIRICAL ANALYSIS FOR PAKISTAN..... 105**  
**5.2: EMPIRICAL ANALYSIS FOR MALAYSIA..... 128**

**CHAPTER 6: CONCLUSION**

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**6.1: FINDINGS..... 136**  
**6.2: ROAD AHEAD..... 140**  
References..... 143  
Appendix A ..... 163  
Appendix B ..... 166  
Appendix C:..... 168  
Appendix D:..... 172  
Appendix E: Publications ..... 174



## List of Figures

<b>Figure 3.1:</b> Schematic Structure of the Modes of Islamic Investment/Financing .....	72
<b>Figure 5.1:</b> Equity-Based Financing Relative to Debt-Based in Pakistan .....	107
<b>Figure 5.2:</b> SME Vs Corporate Financing in both Banking Systems of Pakistan ....	122
<b>Figure 5.3:</b> Equity-Based Financing Relative to Debt-Based in Malaysia .....	129

## List of Tables

<b>Table 3.1:</b> Categorization of Typical Islamic Financial Products .....	74
<b>Table 3.2:</b> Islamic Banking Net-work in Pakistan Overtime .....	81
<b>Table 3.3:</b> Market share of Islamic Banking in Pakistan (in Billion Rs) .....	82
<b>Table 3.4:</b> Market Share of Islamic Banking in Malaysia (in Million RM).....	86
<b>Table 4.1:</b> Summary of Objectives and Corresponding Testable Hypotheses .....	93
<b>Table 4.2:</b> Illustration of advances data by the size of disbursement.....	102
<b>Table 5.1:</b> Cumulative Distribution of Advances by Categories in Pakistani Islamic Banking Industry (% Annual Shares).....	107
<b>Table 5.2:</b> Deposit Modes of Islamic Banking in Pakistan .....	108
<b>Table 5.3:</b> Estimation Results of Time Trend of Equity to Debt Based Modes in Pakistan .	109
<b>Table 5.4:</b> Results and Analysis of Forecasting Methods for Pakistan .....	113
<b>Table 5.5:</b> List of Approved Modes by State Bank of Pakistan.....	117
<b>Table 5.6:</b> Investment Profile of Islamic Banking in Pakistan.....	118
<b>Table 5.7:</b> Corporate and SME Financing Shares of Islamic Banking in Pakistan (%).....	119
<b>Table 5.8:</b> Target Vs Actual Financing Shares to SME by Islamic Banks in Pakistan.....	120
<b>Table 5.9:</b> Corporate and SME Financing Shares in Conventional and Islamic Banking of Pakistan (%) .....	121
<b>Table 5.10:</b> Infection Ratios in Different Sectors of Economy in Pakistan (%) .....	123
<b>Table 5.11:</b> Infection Ratios (IR) and Financing Shares (FS) of Industries in Islamic Banking of Pakistan (%).....	124
<b>Table 5.12:</b> Rank Correlation between Industry Financing Shares of Islamic and Conventional Banking Systems in Pakistan.....	126
<b>Table 5.13:</b> Features of Car Financing Products of Meezan and Habib Banks.....	127
<b>Table 5.14:</b> Cumulative Distribution of Advances in Malaysia (% shares).....	129
<b>Table 5.15:</b> Estimation Results of Time Trend of Equity to Debt Based Modes in Malaysia .....	130
<b>Table 5.16:</b> Forecasting ‘Time of Convergence’ Equation for Malaysia.....	131
<b>Table 5.17:</b> Financing Mix in Bank Islam, Malaysia (% Shares) .....	131
<b>Table 5.18:</b> Use of Controversial Modes by Bank Islam, Malaysia (Amounts in RM 000).	132
<b>Table 5.19:</b> Corporate and SME Financing Shares in Islamic Banking of Malaysia (%).....	133
<b>Table 5.20:</b> Rank Correlation between Industry Financing Shares of Islamic and Conventional Banking Systems .....	134
<b>Table 5.21:</b> Financing to Top Four Sectors by both Banking Systems of Malaysia .....	134
<b>Table 5.22:</b> Classification of Advances by Amount in Malaysia.....	135
<b>Table A.1:</b> Defining Features of the Modes of Islamic Finance .....	163

<b>Table C.1:</b> Bank Advances by Modes of Financing in Pakistan (% shares).....	168
<b>Table C.4:</b> Annual growth rate of share of ideal modes (Shim) in total .....	170
<b>Table C.5:</b> Industry wise financing shares in Islamic and Conventional Bankings (%).....	170
<b>Table C.6:</b> Ranking of industry wise financing rankings in Islamic and Conventional Bankings (in numeric numbers).....	171
<b>Table D.1(a):</b> Industry wise financing shares in Conventional Banking (%) .....	172
<b>Table D.1(b):</b> Industry wise financing shares in Islamic Banking (%).....	173

## List of Frequently Used Arabic Terms

<i>Term</i>	<i>Meaning</i>
<i>Bay</i>	Sale
<i>Bay E'inah</i>	Sale and then repurchase of the same at higher deferred price
<i>Bay-ud-day</i>	Sale of debt (receivables)
<i>Halal</i>	Permissible in Islamic law
<i>Haram</i>	Impermissible in Islamic law
<i>Ijarah</i>	Operating lease / rental agreement
<i>Istisna</i>	Manufacturing sale on advance payment
<i>Mudarabah</i>	Trustee/passive partnership
<i>Murabahah</i>	Mark up sale on deferred payment
<i>Musharakah</i>	Partnership/Joint Venture
<i>Qard Hasan</i>	Benevolent loan
<i>Riba</i>	Interest
<i>Riba ul-Fadl</i>	<i>Riba</i> in barter exchange
<i>Riba ul-Nasiyah</i>	<i>Riba</i> in loan transaction
<i>Salam</i>	Deferred delivery sale on advance payment
<i>Shariah</i>	Islamic law
<i>Sukuk</i>	Shariah compliant securities
<i>Tawarruq</i>	Reverse <i>Murabahah</i>
<i>Zakat</i>	Compulsory defined amount payable on asset annually

## Chapter

# 1

## Introduction

### 1.1: BACKGROUND

---

Islamic banking was launched with the hopes that it would provide an alternative banking system.<sup>1</sup> Since bank interest is impermissible according to the majority of the Muslim jurists, the alternative was proposed in the form of profit and loss sharing (PLS) banking system. Islamic economists sought to replace fixed-return financing model of banking with that of equity financing on the basis of profit-and-loss sharing. Besides this, overwhelming majority of Islamic economists had the view that interest-bearing system promotes income inequalities. They advocated that Islamic banking would promote more equity in resource allocation.

Literature on Islamic finance/banking, before the launch of Islamic banking, asserts that this discipline differs significantly from its counterpart by its transaction forms and values. The pioneers of Islamic banking were of the view that this industry would promote profit-and-loss sharing based business modes and financing instead of interest based ones. As far financing modes like *Murabahah*<sup>2</sup> involving fixed-rate of return were concerned, the pioneers of Islamic banking in general did not consider them in their writings. At the time of launching Islamic banking in Pakistan, Council of Islamic Ideology (1979) that explicitly mentioned them in its report at the time when Islamic banking was in its inaugural phase. The report cautioned “against the danger that these

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<sup>1</sup> Islamic banking refers to Islamic Shariah compliant banking

<sup>2</sup> See Appendix A for brief description of typical business contracts used in Islamic banking

other methods could be misused as a means for opening a backdoor for interest.”<sup>3</sup> This is because these transactions allow banks to charge an interest-like fixed return on the one hand and create debt on the other, hence, leaving no ‘essential’ difference between conventional and Islamic banking.<sup>4</sup> Thus, the Council urged ‘that a basic policy decision should be taken to the effect that with the passage of time the operational field of profit-loss sharing and *Qard Hasan* should gradually be expanded while that of the alternatives reduced’ in order to approach the spirit of Islamic banking [p. xv-xvi].

However, so far the practice of this industry did not seem to follow this ‘consensus’ because fixed-return modes are still widely used by Islamic banks, including Pakistan. Federal Shariat Court (1990 & 1999) of Pakistan reiterated the same position in its decisions that fixed-rate modes prevailing in Pakistani banks were not Islamic. As concerns regarding this theory-practice dichotomy came up, initially practitioners adopted an apologetic attitude but later on started defending it. This apology initially came along the lines that Islamic banking should be treated on lenient standards during its infancy period so that the industry could grow large enough to create its own market. But later on, the apology converted into defense when researchers started questioning the assumption that PLS is the only ideal Islamic business forms. They claimed that financing modes involving fixed-rate-of-return like *Murabahah* approved by Shariah are as good as PLS. This shift of ideology went on even to justify many of the transactions forms, such as *Bay-ul-E’inah* and *Bay-ud-dayn*, that were ruled out by the early advocates of Islamic banking.

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<sup>3</sup>Council of Islamic Ideology in Pakistan is a constitutional body meant for issuing legal advice to the Government of Pakistan and the Parliament regarding harmony of state laws with Quran and Sunnah

<sup>4</sup> It is possible to charge fixed return in a contract that does not involve debt. For example, if the return of financier of capital is made fixed somehow in *Mudarabah* contract, then it would be fixed return without creating debt.

## 1.2: RATIONALE

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These strong assertions and then re-assertions set up a case to be explored whether to what extent Islamic banking has practically followed this re-iterated consensus. Another reason to take up such a study is that though Islamic banking theory and practice has been evaluated on several grounds, but no empirical framework is available to evaluate the practice of Islamic banking in the light of its own objectives. The literature on the critical appraisal of Islamic banking shows that Islamic finance/banking has been evaluated and criticized on four dimensions, given the claim of Islamic economists that it is not only different from but also superior to conventional one.<sup>5</sup>

- i. Many traditional Muslim jurists have been long questioning about the Shariah legitimacy of different financing modes that are used by Islamic financial institutions, especially by Islamic banks [see Jamia Uloom-ul-Islamiya (2008), Wahid (2008), Madrasah In'aamiyah (2008)]. To these critics, Islamic banks are not much different from conventional ones because, in practice, something very similar to interest, i.e. guaranteed *a priori* return though with a different name, is being charged and paid by Islamic banks. They criticize Islamic banking for the incompliance of its transaction forms with Shariah standards.
- ii. Endorsement of fractional reserve banking by Islamic economists is another front that is taken into account by some scholars [see Dewani (1997), Vadillo (2006), Hosein (2007), Kameel (2004) and (2009), Siddique (2010)]. These critics pin point that fractional reserve banking is not consistent with the instructions and objectives of Shariah and by advancing this monetary system Islamic economics / finance is

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<sup>5</sup> In fact this superiority claim of Islamic economists was premised on the basis of orthodox neoclassical welfare economics critique and not on the basis of criteria sanctioned by the orthodox Islamic tradition. It should also be noted that several pioneer Islamic economists reinterpreted welfare objectives to legitimate them within the general strategy of Islamic revisionism [influential references include Usmani (1999b) and Chapra (2008 and 1993)]

helping perpetuate the problems associated with it. These critics call for a comeback to the gold and silver (Dinar and Dirham) currency system

- iii. Some critics of Islamic finance [e.g. Warde (2006)] are concerned about its theoretical inadequacy to cater modern financial needs and about its poor preparation to adapt the modern legal environment. Even more hostile researchers [such as Kuran (1986) and (2005)] are of the opinion that Islamic economics/finance as a discipline is devoid of rigorous substance as it is merely an instrument of identity-creation of Muslims in the modern system.<sup>6</sup> He also maintains that Islamic economics lacks originality of thoughts; most of its fixed basket of ideas is reiterated by different scholars over and over again. Yet others [(Ansari (2004), Siddique (2008), Zaman (2011))], taking a system approach, have criticized Islamic economics/finance for its inherent link with the standard neoclassical economics and for the fact that it actually commits itself to the capitalist ends on the name of Islam. Thus, these critics have questioned the foundations of Islamic economics/finance.
- iv. Finally, professional academic circles have attempted to evaluate the financial performance of Islamic financial systems either in comparison to the conventional system [Iqbal (2001), Hussein (2004), Elfakhani and Kabir (2005), Huzaifa and Zahid (2010)] or in terms of intertemporal performance of Islamic banks [Sarker (1999), Samad and Kabir (1999)]

However, the above kind of criticisms leave, probably, the most important room of evaluating Islamic banking; and that is evaluating the practice of Islamic banking in the light of its own stated objectives. The juristic criticisms on the financing modes and legitimacy of fractional reserve banking (i) and (ii) are procedural in nature bypassing the

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<sup>6</sup> Kuran (2005) writes: "Islamic economics did not emerge from a drive to correct economic imbalances, injustices, or inequalities ... (but to) restore Islamic community's self-respect. Because Islamic economics was developed to serve cultural and political ends, it did not have to meet scientific standards of coherence, precision, or realism"



question of the objectives of Islamic banking altogether. Some of the structural criticisms of type (iii), probably looking at the practice of Islamic banking, raise doubts even on the entire discourse of Islamic economics and to them the very objectives of Islamic banking are misspelled. Finally, comparing Islamic banking with conventional one (type iv) on profitability and other efficiency criteria cannot be the litmus test to measure the success or failure of Islamic banking because Islamic banking was not meant to maximize the profitability.

Khan (2010) made an attempt to check empirically to what extent Islamic banking is Islamic as per its own stated standards. He identified four principles to which Islamic banking should correspond: (1) risk-sharing, i.e. PLS system, (2) materiality, i.e. all financial transactions must have some underlying asset, (3) no exploitation of either of the party involved in transaction and (4) no financing provided for the production and consumption of activities that illegal in Islamic Shariah (*Haram*). He classified all financing modes of Islamic banking into two: (1) main participatory transaction forms which include *Mudarabah* and *Musharakah*, and (2) non-participatory sale-based transaction forms including *Murabahah*, *Ijarah*, *Salam* etc. The latter is classified as 'weak-Islamic forms' while the former as 'strong-Islamic forms' by him. However, his taxonomy of Islamic financing modes does not recognize the 'weak-form' as a 'drift from the first best ideal'. Secondly, he considers all sale-based transactions, including *Murabahah* and *bay-ul-E'inah*, in the second category while we argue in chapter 3 that they should not be classified equally in the light of original or first best theory of Islamic banking. Moreover, his study is limited only to one of the objectives tested in this study.

### 1.3: OBJECTIVES

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This missing work provides the following room of investigation:

- Based on the writing of its pioneers, define an alternative taxonomy and features of Islamic banking vis-à-vis conventional banking
- To develop an empirically verifiable framework that can be used to evaluate the practice of Islamic banking in the light of its objectives set by the pioneers
- To investigate empirically the extent of convergence between Islamic banking theory and practice

The need for such an evaluation of Islamic banking is asserted in the literature. International Association of Islamic Banks (IAIB) notes that ‘profitability is not the sole criterion or the prime element in evaluating the performance of Islamic banks since they have to match both between the material and the social objectives that would serve the interests of the community as a whole’ [IAIB (1990)]. Similarly, Hasan (2004) suggests that the performance of Islamic banking systems should not primarily be evaluated on the basis of, say, standard cost-profit considerations using econometric models or ratio analysis, rather with reference to the goals that they commit to serve in Islamic framework.

Such an evaluation attempt is superior to the above five ones in the sense that it is tantamount to placing Islamic finance in front of its own mirror to reflect upon itself. This is so because if, say, Islamic finance fails to stand with its own commitments, this will raise more deeper issue for Islamic economists to think about the eternity of its rules as compared to the issues raised by its evaluation on criteria not originally committed by the proponents of Islamic finance, such as the criterion of profitability. Thus, examining the convergence of Islamic finance to its own theory is a primary concern. The fact that the

proposed evaluation methodology of this study sets itself the task of conducting internal criticism, as against the external ones of the above five mentioned types, reiterates the primacy of this evaluation methodology.

#### 1.4: SCOPE AND SIGNIFICANCE

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This study would seek to develop a framework that can be used to test convergence between theory and practice of Islamic banking. The study does not deal with the question ‘whether Islamic banking is Islamic or not’ on the basis of changing criterion. Whatever is declared ‘Islamic’ by the early theorists of Islamic banking is accepted for this study because its scope is to evaluate to what extent Islamic banking has converged to its own theory. A set of hypotheses are developed from the objectives of Islamic banking. These hypotheses are examined for Pakistan and Malaysia because they have been one of the pioneering countries, both on academic as well as practical fronts, when it comes to the Islamization of economic order of life within modern epistemological and institutional framework. Other considerations are given in chapter 4.

On completion of this study, expected contributions would be the:

- to development of a valid framework to evaluate the recent practice of Islamic finance/banking on the basis of its own criteria developed since 1970s
- provision of a framework to empirically examine the proposition often stated about Islamic finance/banking: “Islamic banking is the same as conventional banking”
- Identification and measurement of the gap between theory and practice of Islamic banking
  - A guide for the regulators and practitioners of Islamic finance/banking to reflect upon the extent to which their efforts have been futile in the achievement of the desired ideals of Islamic banking/finance, whether their efforts are moving the

industry in the 'right' direction, and in case it is not the case, they might take remedial steps to correct their industry direction

## **1.5: ORGANIZATION OF WORK**

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The study is organized as follows: Chapter 2 summarizes the literatures about the development of Islamic banking theory and institution. The chapter also gives the views of the critiques of Islamic banking. Chapter 3 develops the conceptual framework to categorize the theory of Islamic banking in the light of its stated objectives so that they can be translated into some testable propositions to empirically verify the convergence between theory and practice of Islamic banking. The chapter also gives a brief sketch of the development of Islamic banking industry in Pakistan and Malaysia. Chapter 4 lays down the empirical methodology to test these hypotheses. Chapter 5 applies this methodology to derive empirical results for Pakistan and Malaysia. The chapters analyze these results to define the conclusions regarding the behavior of Islamic finance in Pakistan in terms of its convergence to its ideals. Chapter 6 concludes the study by summarizing major findings and attempts to present some recommendations.

## Chapter

# 2

## Literature Review

Section 1 of this chapter briefly presents the development of Islamic banking theory and institution overtime. It describes the verses and sayings of the Prophet (SAW) that are relevant in understanding the issue of *riba* (interest). The section also discusses the frontiers of debate on the meaning of *riba*. It is important to mention here that this section deals with the development of Islamic banking theory as it took place in relation to the operational requirements of Islamic banks. In the next chapter, this theoretical development is classified in a general framework that is then used to generate testable hypotheses. Section 2 presents the views of critics of Islamic banking as to why they are dis-satisfied with Islamic banking. This would explain the missing gap in the literature.

### 2.1: DEVELOPMENT OF ISLAMIC BANKING

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After losing their political rule to the imperial powers, Muslim societies faced the wide spread dominance of interest based banking system. Although according to the majority of Muslim scholars and jurists bank interest (*riba*) is not allowed yet Muslim societies got engaged in it due to growing spread of interest based banking in modern societies and non-availability of interest-free banking. The political independence in the latter half of the twentieth century provided Muslims with the opportunity to revise and mould their societies according to Islamic Shariah. That is why Muslims scholars sought to propose its alternative soon after Muslims got independence from their foreign masters.

The theoretical stance of the Muslim scholars that 'Islam is a way of life' (*deen*) gave birth to the idea of 'Islamization of modern knowledge' which reflected itself in the area of economics as well. Commitment to follow religious teachings in the public affairs of life and liberty from the colonial oppressors provided the required background for one of such 'revisions' proposed by Muslim scholars which resulted in the discipline of Islamic economics in general and Islamic banking being in particular. Before moving on to its theoretical development, it seems appropriate to study the Quranic verses and Ahadith that deal with the subject of *riba*.

The following Quranic verses regarding *Riba* are considered to be the most relevant ones for deriving principles of Islamic banking.

- 1) "O Believers! Do not devour *riba* doubled and multiplied (i.e. charge not *riba* on top of *riba*) and fear God so that you may prosper" (Al-e-Imran 3: 130)
- 2) "People who indulge in *riba* shall be raised like those who have been driven to madness by the touch of Devil. That is because they say that the *riba*-based transaction is just like trading, while God has permitted trade and prohibited the *riba*" [Al-Baqarah 2: 275]
- 3) O you believers! Fear God and give up *riba* that remains outstanding if you are true believers. Behold! If you do not obey this commandment, then God declares war against you from Himself and from His Prophet. But, if you give up your outstanding *riba*, then you can claim only your principals. Neither should you inflict harm (due to *riba*) to others, nor others should do harm to you (al-Baqarah 2 :278-79)

Historically speaking, the first of these verses was revealed in the second year of Prophet's (SAW) from his native city Makkah to Madinah. This verse explicitly forbids *Riba* for Muslims. The last two of the above were revealed after the conquest of Makkah where after the Prophet (SAW) declared all *riba* due against anyone as null and void

[Usmani (1999a)]. Most Muslim scholars are of the opinion that these Quranic verses deal with what is termed *Riba-ul-Nasiyah* (ربوا النسيه)—i.e. *riba* in loan contracts. It refers to the contractual increase on loaned money against time. Apart from these Quranic verses, following important Sayings of the Prophet (SAW) also deal with this subject matter:

- 1) "The Prophet said: "While exchanging gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, exchange like for like (in equal measure) and exchange at spot. Whosoever paid more than what he received or demanded more than what he gave, verily he dealt in *riba*. Both the payee and the receiver are equal in violating the Law of God" (Muslim: 2971)
- 2) "The Prophet said: "While exchanging gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, exchange like for like (in equal measure). Whosoever gave more or took more, verily he made a *riba* deal. However, you are permitted to exchange gold for silver, wheat for dates, or barley for dates as you wish (in equal or unequal measures) provided that, such an exchange is at spot" (Tirmizee: 1161)
- 3) Abu Saeed Khudri said that once upon a time, companion of the Prophet (SAW) Bilal brought to the Prophet some good quality dates. The Prophet inquired as to where he got those dates. Bilal replied that he had some low quality dates. which he had exchanged in 2:1 ratio for these high quality ones in order to present the latter to the Prophet. Upon hearing this, the Prophet said: "Oh no! Oh no! That is *riba*. That is exactly *riba*. Do not do it again. If you want to do such an exchange, first sell your dates (for money or another commodity) and then buy other ones." (Bakhari 2145)

The mainstream experts of Islamic finance assert that the above Sayings of the Prophet (SAW) deal with the subject of *Riba-ul-Fadl* (ربوا الفضل)—i.e. *riba* in barter exchange or

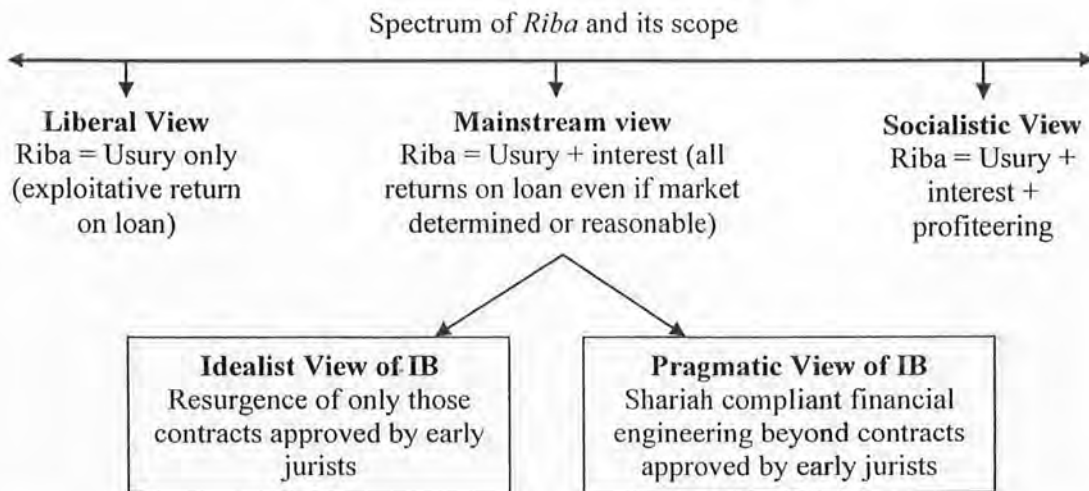
*riba* of excess which arises when same commodity is exchanged in unequal measures at spot or with time lag.

Majority of the Muslim jurists in Islamic jurisprudence consider both types of *riba* equally sinful but some consider the Quranic *riba* or *riba-ul-nasiyah* more sinful than *Riba-ul-fadl*. According to mainstream jurists, bank interest falls in the category of *riba-ul-nasiyah*.

### 2.1.1: Debate on the Meaning of *Riba*

Central to this new discipline of Islamic banking is the concept of *riba* which is unfortunately still controversial among Muslim scholars and jurists. Different perspectives about the meaning of *Riba* can be shown in **figure 2.1**. Since this study is concerned with the insights of mainstream perspective, so the diagram shows further links only beneath this category.

**Figure 2.1: *Riba* and its scope in recent times**



They hold the view that both usury and bank interest are equally impermissible in Islam while business profit is allowed [see Maudodi (2000/1968), Chapra (1984), Shafi (1996), Ayub (1996), Usmani (1999b) and Siddiqui (2004)]. Within this category, there are two



sub-groups. One group that consists of traditional *Ulema* emphasizes the resurgence of only those business contracts which were approved by the early Islamic jurists. They propose profit-and-loss sharing (PLS) as an ideal alternative to *riba*. Though they do not deny the permissibility of other than PLS based financing instruments such as *Murabahah* and *Ijarah*, yet they affirm that equity based financing method is the primary means of achieving desirable economic objectives. Second one is a pragmatic approach. They justify a more liberal and flexible approach in structuring Shariah compatible transaction forms that looks for financial engineering to meet all demands of modern banking customer. Section 1 and 2 of the next chapter explains the development of these two approaches in detail.

On the left of this spectrum fall liberals who are not only skeptical about the operational feasibility of Islamic finance but also dispute whether the Quranic term *riba* includes interest paid and charged by modern banking. To these scholars, interest charged and paid by conventional banking is not prohibited by Quran [Shah (1959), Rehman (1963), Kuran (1986), Pal (1994), Ahmed (1995), Asari (2008)] because in their view the modern interest is the just reward of capital determined by demand and supply forces freely [News and Ibrahim (2008)] while *Riba*, to them, means exploitative return of period before the advent of Prophet Muhammad (SAW), currently referred to as usury.<sup>7</sup> To them, replacing bank interest with anything else is tantamount to obstructing natural operation of economy and creating inefficiencies. According to this perspective, there is no need to have anything distinct like ‘Islamic banking’ to begin with because the existing system is already Islamic. This approach has not gained much popularity among Muslim scholars and masses.

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<sup>7</sup> Period before the advent of the Holy Prophet (SAW) is referred to as *Jahiliyah*, i.e. the period of uncivilized state

Finally, on the other extreme are Muslim socialists who develop their version of Islamic economics based on socialist policy package.<sup>8</sup> For example, Pervaiz (1978) is of the opinion that as far economic policy of socialism is concerned, it is consistent with Islam (p. 358). He is of the view that the Quran neither leaves anyone with surplus wealth nor accepts property rights” (p. 23). To him, the best way of articulating the Quranic teachings is to construct the Chinese economic order on the basis of revelation, because this system can serve Muslim’s religious ends (p. 192). Since socialism considers wage as the only legitimate reward of a factor input, hence these scholars are of the view that not only bank interest but also trade or merchant profit is also banned under the category of *Riba*. They argue that as lender is forbidden the right to charge interest from poor borrower, so should be the rich industrialists and landlords from appropriating lion’s share of value-added on the name of profits. Haque (1993) and Yaqoob (1961) asserts that loaning *riba* covers money lenders and hoarders who charge against time while *riba* of excess is the domain of landlords, merchants and middlemen who exploit poor workers and make unequal exchanges. Seen from their perspective, by promoting the very instruments like *Musharakah*, *Mudarabah* and trade, Islamic banking does not control *riba* of excess and hence violates the principles of Islamic Shariah. This perspective about *Riba* has gained even less popularity among Muslim scholars and masses than that for the liberal one.

### 2.1.2: Evolution of Islamic Banking Theory

The above debate settled slowly in favor of the mainstream view by 1970s when Islamic banking was launched in different parts of the world, including Pakistan and Malaysia where this new banking system was endorsed even at the State level. Following

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<sup>8</sup> It is held that historically the first expression of Islamic socialism appeared in the form of Tatartan movement which opposed Russian monarchy in the late 19<sup>th</sup> and early 20<sup>th</sup> century working along with communist forces. The movement joined Bolsheviks after the latter toppled the Russian monarchy and it supported Lenin’s socialist agenda.

the traces of theoretical development of Islamic banking, one can divide this literature in two distinct periods: (1) prior to the launching and spread of Islamic banking, termed 'idealist stage' or the 'first best theory' of Islamic banking in this study, and (2) after the launching of Islamic banking, termed as 'drifts from the ideal stage' or second best theory. Both are discussed in turn.<sup>9</sup>

### **Prior to the Spread of Islamic Banking**

The pioneers of Islamic banking idealized profit-and-loss sharing (PLS) as *the* alternative to interest based banking system [Maudodi (2000/1968), Uzair (1978/1954), Chapra (1979a), (1979b), Council of Islamic Ideology (1979), Siddiqui (1983 & 1985), Usmani Shafi (1993), Usmani (1999b)]. The idea was to replace the pre-determined fixed-rate of return loans disconnected from actual profitability of investment from those loans. Risk-sharing between providers of funds (saver) and users of funds (investor/entrepreneur) was considered to be one of the most important features of Islamic finance by these authors. The basic rationale for this change was put forward by Maudodi (2000/1968) in these words: 'which logic and principle of justice and economics can justify that those who spend their time, energy and resources and whose effort in reality thrive the business enterprise, are not guaranteed any fixed profit whereas those who only lend out their funds are fully secured against all possibilities of losses and guaranteed a fixed profit?' (p. 124). Economic considerations ranging from equity, efficiency, growth and stability are advanced by the Islamic economists to justify this shift of emphasis from interest-based-debt system to PLS one [discussed in section 3.1.1 in next chapter].

Overwhelming majority of Islamic economists and jurists have the view that interest-bearing system promotes income inequalities and hence unfairness [Maudodi (2000/1968), Siddiqui (2001 & 2004), Chapra (1985, 2000a, 2000b & 2008), Al-Omar

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<sup>9</sup> See Zaman (2009 & 2010) for a survey of literature on Islamic economics

and Abdel-Haq (1996), Usmani (1999b & 2009), Ahmad (2000), Hasan (2005), Mehmet (2007)]. Several reasons are advanced to justify why income inequality is undesirable; such as its detrimental effects on efficiency and growth [Siddiqui (2004)] and unbalancing effects on social and political harmony and cohesiveness of nation states [Chapra (2008)]. Keeping check on income distributional imbalances and promotion of welfare was regarded an essence of Islamic banking [detailed discussion of this point is given in chapter 3).

While charging a fixed return on loaned money was declared unjust and impermissible by most of the Islamic scholars, charging of a fixed return over time on sale based contracts was not spelled out as impermissible by the pioneers [Kahf (1992)]. This discrepancy received full attention in later times. Initially, to make modern banking system operational on the PLS system, Uzair (1954) presented a model of financial intermediation that he termed 'two-fold *Mudarabah*' according to which both mobilization and allocation of resources should be based on *Mudarabah* principle. Siddiqui (83a, 83b and 1985) presented a more formalized and extended version of this model of Uzair. Unlike the classical conception of *Mudarabah* (which was that of a *mudarib* having financing from one or few providers of capital), the modern scholars clarified that funds of numerous financiers can be joined together by an entrepreneur. Moreover, they also allowed mixing up of personal capital of the entrepreneur and his partners with that of financier (*rabb-ul-mal*). Finally, these scholars also allowed the principle of multi-tier *Mudarabah*, i.e. collecting funds from depositors on mutual basis and then advancing them to businessmen or firms on *Mudarabah* contract. Qureshi (1947) and Ahmad (1947) discussed the role of *Musharakah* principle which was then elaborated by Siddiqui (1985). The only notable exception to this model PLS in that period was Sadr (1961) who thought that financial intermediation should be based on

*jualah* principle—fee based contract between clients and bank for specific services such as providing security to deposited money.

As far consumer's cash needs were concerned, Islamic economists asked Islamic banks to rely on *Qard Hasan* (benevolent loan) for this purpose [Ahmed (1947) and Siddiqui (1983)]. However, Irshad (1963) opined that Islamic banks could use sale on credit as an instrument of serving cash needs of their clients. Apart from suggestion of Irshad, the early theorists of Islamic banking equated Islamic banking with debt-free system [Khan (1984), Khan (1985)]. If at all, debt could enter in this model of Islamic banking through benevolent loan. Council of Islamic Ideology (1979) sought to develop the blue-print of interest free banking system in its report in the light of Shariah teachings, views of Islamic economics experts and experience of Islamic banking in the late 1970s. This report classified financing contracts in three schemes: (1) profit-and-loss sharing (*Mudarabah* and *Musharakah*), (2) sale based including *Murabahah*, *bay-muajjal*, hire-purchase etc. and (3) service based and benevolent loans. This policy document of Council of Islamic Ideology of Pakistan (1979) suggested that sale-based financing modes should be used rarely under extreme necessity of real investment needs. In the coming chapter, we will use this CII document as the basis for classifying Islamic banking theory in different phases.

### **After the Spread of Islamic Banking**

Islamic banking was formally launched in late 1970s and became wide spread by 1980s (see next sub-section). Ahmad (1985) showed that 84% of the five Islamic bank's operations relied on the sale-based contract known as *Murabahah*. Haque (1985) raised critical voice against PLS by asserting that it may lead to the advantage of one person in cases of asymmetric information or bargaining power differences. Moreover, managerial issues also make *Mudarabah* difficult. For example, the entrepreneur (*mudarib*) can

venture in more risky business projects or that he may show less profit than he makes). Avoiding these issues requires diligence on the part of Islamic bank.

In the classical fiqh *Murabahah*, which is generally known as mark-up sale, implies that both buyer and seller agree on the cost of commodity exchanged. The basic distinction of *Murabahah* sale was that the seller discloses the purchase price of the commodity and then adds some profit into it. *Murabahah* in this sense was not a financing mode rather a sale agreement [Usmani (2002)]. In Islamic banking, the mark-up mode has different meaning. It is practiced by incorporating the features of both sale of commodity at deferred price (*bay-mu'ajjal*) and *Murabahah* sale. The order of *Murabahah* transaction goes as: (i) the bank and client sign an agreement whereby the client promises to buy while bank promises to sell the commodity at some negotiated profit-margin. This is not sale, rather merely promise of sale. (ii) The bank assigns its customer its agent to buy the commodity it required on bank's behalf. This is agency contract. (iii) After making purchase of commodity on behalf of bank, the client then purchases the commodity from the bank at higher price. This established the relationship of buyer and seller between client and seller. The fact that the commodity is sold at deferred price payable in installments overtime transforms this relationship into that of creditor and debtor. Usmani (2002) lists down the conditions which are necessary for the validity of converting *Murabahah* into a financing scheme. One of the important conditions is that Islamic bank must take possession of the commodity and its associated risk before selling it to the customer.

The justification to increase deferred price from spot price in *Murabahah* transaction is spelled out differently by scholars. Some of the early theorists of Islamic banking theorized the impermissibility of interest based loans as trade where the object of sale is time. For example, Qureshi (1947), citing a classical Islamic jurist Qaffal (D:

417H), asserted that time is neither an object of sale nor anything exchangeable as wealth. This analysis apparently implied that time value of money was not a valid concept in Shariah principles—hence undermining the profit charged by Islamic banks in *Murabahah* because the difference between spot and deferred price in *Murabahah* contract is apparently based on time dimension. However, Abji (1986) and Masri (1986) questioned this negation of time value of money on the grounds that charging higher deferred price as compared to spot price is allowed in Shariah (implying recognition of time value of money). On the other hand, Khan (1986) argues that higher deferred price is allowed for seller not due to time value of money rather due to uncertain nature of this transaction. Saadullah (1986) claimed that time value of money is a legitimate concept in itself but it is permissible in Islamic law only in real sale transactions. However, the justification of earning return in *Murabahah* transactions also requires the ownership of asset, hence its associated risk, by the financier. Thus, *Murabahah* allowed Islamic banks to earn a fixed return on their advances.

Other such sale based contracts were also conceptualized such as *Salam*, *Istisna*. Discussion about rental agreement (*Ijarah*) also remained scant until the appearance of Islamic banks in 1980s [Ahmad (1985)]. Rental agreement, where a price called rent is paid for the usufruct of an asset, is permissible according to almost all Muslim jurists. However, combining rental agreement with other agreements such sale makes it controversial. One of such variants of *Ijarah* contract, called hire-purchase or diminishing *Musharakah*,<sup>10</sup> was used by Islamic banks about which Islamic Fiqh Academy (1989) showed its reservations. This variant of *Ijarah* was also similar to *Murabahah* in its spirit. Thus, debt instruments neglected in the earlier theory of Islamic banking became an integral part of Islamic banking model by the end of 1980s.

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<sup>10</sup> See Appendix A for brief description of diminishing *Musharakah*

It is important to note here that while the early Islamic banking theorists apologized for the use of fixed return modes of financing in Islamic banks, Hamoud (1982) and Ismail (1986) provided theoretical justification for such a wide use of sale-based contracts. Ismail (1986) argued that sale (*bay*), whether spot or deferred, is the alternative of *riba* and is equally permissible according to the Quran. From this he implied that all sale-based financing modes are as good as PLS modes.

*Murabahah* and other deferred-sale financing instruments could not satisfy cash needs, say for working capital, of firms because they could be used for the sale and purchase of real assets and commodities and not for providing liquidity [Usmani (2002)]. Moreover, holding debt contract until its maturity time and the close link between bank's income and actual performance of its client in real economy were burdensome for Islamic banks and not beneficial [Nienhaus (2007)]. Islamic banks' portfolio of financing instrument was enriched to overcome these restrictions by devising Shariah compliant sale contracts, called *bay-ul-E'inah* whereby the client sells an asset to the bank for payment at spot and then buys back the same asset from bank at mark-up for deferred payment [Arbouna (2007)]. *Bay-ul-E'inah* also consists of two contracts: (1) cash sale (*bay ul mutlaq*) whereby the client sells an asset to the bank for cash and (2) deferred sale (*bay bithaman ajil*) in which the client buys back the same from bank at higher deferred price payable in installment.

This sale contract was largely held impermissible in Islamic Shariah because it is a legal device to evade the prohibition of interest.<sup>11</sup> A considerable exception to this position among classical Islamic jurists is Imam Shafi (RA) which is discussed in the next chapter. Rosley and Mahmood (2001) list down the range of banking and other financial

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<sup>11</sup> A sayings of the Holy Prophet Muhammad (saw) on the basis of which Islamic jurists dis-allowed *Bay-ul-E'inah* goes: "Ibne-Umar said: I heard the Prophet of Allah say, 'when you enter into E'inah transaction, hold the tails of oxen, are pleased with agriculture and give up Jihad, Allah will impose disgrace on you (and will not change this state) until you return to your religion" in Sunan Abu-Bawood, quoted in Rosley and Mahmood (2001)



market products that are designed on the basis of *bay-ul-E'inah*. By adding more parties in the above contract than the bank and its client, a more complicated contract with the name *tawarruq* also known as *commodity-Murabahah* is created for which the legal verdict is more lenient than *bay-ul-E'inah*. Here, the client buys an asset from bank for a higher deferred payment, sells the same to another agent for immediate payment, hence the client gets cash today while Islamic banks make profit through trade. These transaction forms are used for liquidity-management by Islamic banks. The structure of *tawarruq* was approved by Security Commission of Malaysia, SC (2007).

The problem of excess-liquidity faced by Islamic banks due to difficulties in finding credit-worthy clients was solved by the introduction of *sukuk*. Three most common *sukuk* structures are (1) *Ijarah sukuk*, (2) *Murabahah sukuk* and (3) *E'inah sukuk*. *Ijarah sukuk* are sort of asset backed Islamic securities created when firms transfer some asset to SPV for generating finances for a fixed time period. SPV then floats certificates, equal to the value of that asset, in capital markets which assign ownership rights to their holders. The firm takes back that asset on lease from SPV and pays rental for its usufruct to SPV which is paid to investors or holders of *Ijarah sukuk*. The earning of *sukuk* holder is thus linked with the underlying asset of *sukuk* [see Obaidullah (2005) for more details on the structure of *sukuk*]. Instead of issuing against specific asset of the firm as listed above, *Ijarah sukuk* are also issued against a pool of *Ijarah* assets of the firm just like mortgage securities.

Another type of *sukuk* is called *Murabahah sukuk* whereby the originator issues *sukuk* for the purpose of obtaining financing for the purchase of some asset. SPV issues *sukuk* against *Murabahah* contract and investors provide proceeds to SPV by investing in them. SPV purchases the asset or commodity at spot price and sells it to the originator at higher deferred price. The difference between spot and deferred price is payable in

installment and hence becomes profit of the investor. Just as in the case of *Ijarah sukuk*, *Murabahah sukuk* are also issued against *Murabahah* receivables of the institution.

*E'inah sukuk* are also important innovations in Islamic finance which are structured by securitizing an asset to be used as *E'inah* asset. This asset is first purchased by the investors (*sukuk* holders) and then sold back to the issuing party at a higher deferred price. The difference between these *Sukuk* and conventional asset backed securities is explained in section 3.2.2 where we explain Shariah issues related to these *sukuk*.

To make *sukuk* structuring process more accommodating for the firms, *bay-ud-dayn* (sale of debt or payable rights)—another controversial contract—was introduced in the portfolio of Islamic finance.<sup>12</sup> Need for *bay-ud-dayn* originates with the trading of *sukuk* (that represent debt receivable) at a discount. *Murabahah* and *E'inah sukuk* represent entitlement of receivables (*debt*), hence their trading, at other than face value, in the secondary market is controversial because it is equivalent to selling debt (*bay-ud-dayn*). While Malaysian scholars allow it, the Middle Eastern and Pakistani scholars equate profits realized on the sale of such instruments with *riba* [Rosley and Mahmood (1999)]. Because the conventional bonds and securities were interest bearing debt instruments, Islamic banks were not allowed to make investment in them. The introduction of *sukuk* helped overcome the issue of excess liquidity of Islamic banks.

Prior to its introduction, Islamic banks could not invest the left-over liquidity, over and above providing financing facilities to the clients, in profitable ventures. *Sukuk* turned out to be a major breakthrough for the growth potential of Islamic finance and banking industry. The issuance of *sukuk* has increased from USD 22 bn in 2006 to USD 120 bn in

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<sup>12</sup> Security commission of Malaysia defines *bay-ud-dayn* as contract involving sale or purchase of debt certificates issued in favor of creditor by debtor as an evidence of indebtedness

2013. The first two quarters of 2014 saw the global new issuance of Sukuk USD 66.2 bn [RSF (2014)].

Finally, the combination of sale contract with promise (*wa'ada*) allowed Islamic finance experts to come up with Shariah compliant derivatives such as options, futures and swaps.<sup>13</sup> Options are legal financial contracts that give its buyer right to buy or sell a stock at preset price at some later time. Futures are similarly used to lock-in future prices. Whereas in future contracts both buyers and sellers have obligations, not merely 'right', to buy or sell the underlying commodity or financial instrument, options only assign right but not obligation on the option buyer to buy, though option seller has the obligation to sell if demanded by the option holder. In futures contracts, buyer does not pay any price to seller to accept the obligation, but a price is paid by option buyer to its seller to undertake obligation [Fabozzi, Modigliani and Jones (2009)]. In swaps, parties exchange securities, or expected cash flows, of one another in order to change either maturity or nature of financial instruments depending upon their objectives (interest rate swaps and currency swaps are common examples).

These contracts are controversial among Muslim jurists due to the reason that they are unfinished contracts and involve buying and selling of promises without taking delivery of the underlying asset which is not permissible in Islamic law.<sup>14</sup> However, the permissibility of currency swap contracts was derived by creating analogy from *bay Salam*. The permissibility of *bay Salam* was largely seen by the classical Islamic jurists as special relaxation of Shariah to facilitate poor peasants who were allowed to sell their

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<sup>13</sup> See Ayub (2009), Ismail (2010) and Ahmed (2011) for description of these financial contracts

<sup>14</sup> Saying reported in *Muatta* of Imam Malik: "Yahya related to me from Malik that he had heard that receipts (*sukukun*) were given to people in the time of Marwan ibn al-Hakam for the produce of the market of al-Jar. People bought and sold the receipts among themselves before they took delivery of the goods. Zayd ibn Thabit, one of the Companions of the Messenger of Allah, may Allah bless him and grant him peace, went to Marwan ibn Hakam and said, 'Marwan! Do you make usury Halal?' He said, 'I seek refuge with Allah! What is that?' He said, 'These receipts which people buy and sell before they take delivery of the goods.' Marwan therefore sent guards to follow them and take them from people's hands and return them to their owners."

crop in advance to buy inputs for harvesting. Whether currencies can become the subject of *bay Salam* is controversial among Islamic jurists. Abu Bakr and Asghar (2015) have argued that this controversy eventually boils down to the Shariah ruling about paper currency.

Future contracts are usually seen as an instrument of hedging price risk. The need to get involve in currency forward contracts arises for Islamic bank, for example, to serve the requirements of its client dealing in export or import. In this transaction, Islamic bank issues a letter of credit on behalf of its client to the exporter that it would make payment of certain amount (say 100) of dollars at specified future date. Because dollar may appreciate in future, the client buys dollars from its bank today for some extra amount against the guarantee that bank would make payment of dollars in future irrespective of its rate. Some researchers argue that a derivative would be allowed if some underlying economic transaction is being hedged [Ayub (2002): p.35 and Warde (2005): ch. 7]. Ayub (2009) explains that such forward currency contracts are allowed only when there is real intention to deliver or receive currency on specified date and then it is actually made as well.

The practice of short-selling is now also considered Shariah compliant by some scholars [Morais (2007)]. Khan (1995) asserts that some of conditions and concepts used in such short trading are similar to those features which are part of forward trading such as *Salam*. Some Sharia compliant hedge funds have created Islamic short-sale with the condition that the person makes down payment to establish his ownership rights on the stock [Morais (2007)]. El Gamal (2006) shows how the Islamic versions of call and put have been developed by Islamic financial institutions, called *urbun*, i.e. down payment sale with buyer having the right to cancel it by withdrawing from down payment.

Thus, in its efforts to serve the business needs of its clients within Shariah ruling, an Islamic banking model envisioned with merely the replacement of interest based loans with profit-and-loss sharing investment grew into a massive tree having Shariah foundations and several off-shoots. Its growth is an ongoing process. After reviewing the evolution of Islamic banking theory, we now move on to the evolution of Islamic banking as an institution.

### **2.1.3: Evolution of Islamic Banking Institution**

Before the formal and official launching of Islamic banking in 1970's, few pilot experiments took place in different parts of the world. In 1950s, rural landlords in Pakistan created a network of interest-free credit provision within themselves [Warde (2006), ch: 4]. The first modern experiment of Islamic banking was rendered by Dr Ahmed Najjar in 1963 in the form of Mit Ghamr Savings Bank, Egypt, which provided free of interest basic banking services (deposits, loans, equity participation, investment) on the principle of rural cooperative banking. Due to political unrest in Egypt and the fears of being labeled 'Islamic fundamentalism', the bank was taken over by the National Bank of Egypt in 1967 [Wilson (1995)].

Similar experiments and outcomes were faced by Islamic financial institutions elsewhere, however, an exception to this was Tabung Hajj established in Malaysia in 1963. It was Muslim Pilgrims Savings Corporation meant for helping those who wanted to save for performing Haj (pilgrim) but later it evolved into a non-bank financial institution providing impetus for the establishment of Bank Islam Berhad, a full-fledged Islamic bank, in 1983 [Sudin and Nursofiza (2009)].

A new era of Islamic banking emerged with the rise of oil prices in 1970s that provided funds to put theoretical ideas into practice. Organization of Islamic Countries (OIC) was created for promoting economic development and social progress of the

Muslim countries within Shariah principles. For this purpose, Islamic Development Bank (IDB) was initiated in 1975 to become the center of Islamic banking. A number of Islamic banks emerged before the end of 70s such as Dubai Islamic Bank, Faisal Islamic Bank etc. [Warde (2006): chap 4]. Most of the banks in this era operated on different type of mark-up schemes involving fixed rate of returns like interest rate. By the late 1970s, Pakistan became the first country to start full-fledged Islamization of its banking industry. Prince Mohammad set up the largest Islamic project Dar Al-Maal Al-Islami (DMI) in 1981 with share holder belonging to sixteen countries and also registered in Geneva. Early 1980s also saw full-Islamization of banking sectors in Iran and Sudan.

From then onwards, Islamic banking progressed not only within Muslim dominating countries but also all over the world. This expansion in Islamic banking required some centralized financial institutions and bodies. As a result, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) (1990) and Islamic Inter-bank Money Market (1994) were established. In this period, attention was given to the regulatory needs of Islamic banking. The industry saw rapid expansion and innovation in the twenty first century when it moved beyond banking due to the introduction of several financial products such as *sukuk*, currency *Salam* (hedging) and derivatives, Islamic mutual funds, risk mitigating practices and Insurance. Sudin and Nursofiza (2009) provide features of decade-wise development of Islamic banking industry:

- 1950s and 60s
  - Pilot experiments of Islamic banking
  - Rise and fall of several Islamic bank type institutions
- 1970s
  - Establishment of Islamic financial institutions
  - Academic research institutions (Islamic Fiqh Academy) were set up

- Government patronage for Islamic banking
- 1980s
  - Rising number of private sector Islamic banks offering variety of products
  - Western economists and scholars getting interest in Islamic banking
  - Conventional banks started offering Islamic services through Islamic window operation
  - Formation of large group companies (e.g. Dar Al-Maal Al-Islami, Al-Baraka group)
  - Impetus of restructuring country wide financial systems (e.g. in Pakistan, Sudan, Iran and Malaysia)
- 1990s
  - Growth in Islamic window operation concept
  - Introduction of asset based financial instruments (*Murabahah, Ijarah* etc)
  - Establishment of Islamic money market and index
  - Attention given to supervision and regulation of Islamic banking
- 2000 onwards
  - Continuous and rapid growth
  - Completion of the architecture of Islamic finance
  - Creation of asset backed securities (*sukuk*)
  - Attention on risk management and corporate controls
  - Establishment of International Islamic Rating Body
  - Products based on reverse financial engineering (e.g. options, swaps etc.)

During this development, Islamic banking went through different experiences across the world ranging from revolutionary approach (Islamization of the entire banking industry of the country at once) to evolutionary one (gradual reform in the prevailing industry) [see

Warde (2006) and Tahir (2004)]. An important feature of this development in Islamic banking has been that instead of taking up PLS in its true spirit, its practitioners tried to innovate Islamic contracts which emulate conventional ones.

## **2.2: CRITIQUES OF ISLAMIC BANKING**

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The preceding section explained the internal development of Islamic banking theory and institution. Islamic banking has undergone several criticisms, one of such being the debate on the meaning of *riba* discussed above whereby the liberals claim that a separate institution like Islamic banking is not required to begin with. On the other hand, Muslim socialists believed that Islamic economics and banking was meant to sustain the then prevailing existing status quo of capitalism [Haque (1993) and Yaqoob (1961)].

Islamic banking was proposed with the expectation that it would replace fixed return banking model with that of PLS. However, Islamic banking struggled to materialize this ideal right from its beginning as fixed-return modes were put into operation. Scholars continued to argue in general and Federal Shariat Court (1992) and Supreme Court (1999) of Pakistan in specific declared that these practices adopted by Islamic banks are not according to Islamic teachings but the practice of Islamic banking went on the same lines. Probably, this persistently deviant pattern of Islamic banking brought forth some other lines of criticism against it that were initially not discussed. In this section, we discuss these other approaches of criticism on Islamic banking. This discussion would highlight the gap which this study attempts to fill in.

### **2.2.1: Juristic Verdicts (Fiqhi Fatawa)**

This approach of criticism attempts to evaluate specific practices used in Islamic banks on the basis of contracts adopted by early Muslim communities. Two of the important lines of argumentation in this approach are as follows:



## Shariah Legitimacy of Contract Forms

Many orthodox Muslim jurists have questioned the Shariah legitimacy of several financing modes used by Islamic financial institutions, especially by Islamic banks. They criticize Islamic banking for the in-compliance of its transaction forms with Shariah. In this regard, one of the influential Shariah verdicts (*fatwa*) was issued by *Jamia Uloom-ul-Islamiya* (2008) which casts Shariah rulings against almost all of the Islamic contracts as they are used by Islamic banks. These critics approve of the vision of Islamic banking that is characterized by (p: 60-61):

- The first feature of Islamic banking is that it should be organized on the basis of Shariah compliant PLS financing and *Qard Hasan*. Apart from these, no other financing mode should be adopted on permanent basis in such a banking system
- Islamic banking, while following Shariah rulings, should promote investment in such a manner that it does not lead to accumulation of wealth and rising inequalities
- Islamic bank should not use such legal devices or tricks (*hiyal*<sup>15</sup>) that allows the frustration of the objectives of Shariah

Thus, any banking system devoid of these features is regarded un-Islamic by these *Ulema*. The Fatwa raised questions over the following aspects of Islamic banking framework and transaction forms:

- First, they disapprove the concept of ‘limited liability’ on the basis of which banks are formed. They are of the opinion that not only that these concepts are alien to Islamic Shariah but also not consistent with Shariah ruling and objectives.

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<sup>15</sup> *Hiyal* are legal devices that are used to attain some given objectives, whether lawful or not, through lawful means

- In *Mudarabah* contract, they criticize Islamic Banks' role of financier with depositors having limited liability because it protects banks in case of big losses but allows them to enjoy share in large profits. They also question various kinds of 'service charges and fee' that Islamic banks charge from their depositors because, given that an Islamic bank assumes the role of manager (*mudarib*) with its depositors, *mudarib* cannot deduct such charges. Similarly, the distribution of profit on the principle of 'weighted daily product' system is also rendered questionable by these critics.
- As far *Murabahah* and *Ijarah* transactions are concerned, they are viewed as legal tricks by these scholars as, in principle, these are forms buying and selling (*bay*) and not modes of financing. Further, they also criticize these financing modes on the ground that they are composite-transaction forms that are created by combining more than single transaction in one. These transactions are not allowed by Shariah according to them. Moreover, determination of the 'mark-up' and 'rental-rate' on the basis of LIBOR/KIBOR is another issue with which these Islamic scholars are dissatisfied. Finally, the practice of charging excess amount as 'forced-charity' in case the client fails to make installment on time is also viewed un-Islamic in this verdict.

The fatwa raises several other issues with the functioning of Islamic banking alongside the above one. Because this fatwa was signed by dozens of Islamic jurists (*muftis*) all around Pakistan, hence it raised serious concerns about the legitimacy of Islamic banking. To rescue Islamic banking from this turmoil, Usmani (2009) responded to this united fatwa of Ulema. Several other institutions [e.g. *Madrasah In'aamiyah* (2008)] and individuals [e.g. Wahid (2008)] have also raised concerns against the practice of Islamic banking on similar lines.

## Shariah Legitimacy of Credit Creation Process

Debate on the legitimacy of fractional reserve banking system and on its associated fiat currency form is not settled completely. The critics of Islamic banking assert that the process of credit creation under fractional reserve banking is not consistent with Islamic principles and objectives. Therefore, by advancing this monetary system Islamic finance is helping conventional system to perpetuate along with its associated problems.

Kameel (2004) also disapproves the use of fiat money on two grounds: (1) it is *riba*, (2) it frustrates the achievement of objectives of Shariah. Just like Vadillo, he also equates fiat-money with *riba* but from a different perspective. He asserts that a feature of *riba* based loan transaction is that it creates extra purchasing power for the money lender without assuming any risk. On the basis of this resemblance he argues that the creation of fiat money allows its issuer the power to create exactly the same kind of purchasing power, hence *riba*. Further, he notes that money created either in the form of paper or through commercial banking is credit on someone in the system which has to be repaid with interest, i.e. money is created when banks advance loan to someone at interest. Using a mathematical model he shows that the total debt (money plus interest) is not payable in aggregate as total money available in the system is  $m$ , not  $m + mr$  (total debt). Hence, default of some borrowers is by default present in the system as there is not enough money in the system as there is debt. For dynamic stability of the system, one of the three needs to take place: (a) additional money should be created continually to reschedule loans, (b) additional paper money should be created in the system or (c) bank confiscates collateral of the defaulters. The first two options would only defer the problem to be materialized at later stage with even bigger default amount. The third option will transfer real assets to the banking sector, hence, more redistribution in favor of banks.

To Kameel, the ownership of paper money, i.e. who is the first owner of thus created money, also has strong implications for distribution of income in the economy. The US dollar currently enjoying world wide acceptance for settling transactions creates the same problem at international level where uncompetitive developing countries lose their wealth against dollar seigniorage because dollar has purchasing power outside US. He maintains that ‘in this era of globalization and neo-liberalization, interest-based fiat money systems no longer work to the advantage of developing nations’ (p. 22). Based on this analysis of how fiat money system works in favor of few bankers domestically and in favor of US internationally, one of the key objectives of Shariah, i.e. protection of wealth (*mal*) cannot be maintained. As wealth accumulates in the hands of money creators and its first users, sovereignty of weaker Muslim countries is eroded which also has implications on other objectives as sovereignty is a key requirement to defend them within this global order. Apart from this, the author criticizes exiting monetary system for the fact that it is hidden inflationary tax. Newly created money is borrowed by rich while poor, having low savings, are most affected by inflation. Thus, the fiat money system works in favor of rich against poor leading to income inequality. The conclusion is straight forward: fiat money is *riba*, it hurts the interest of Muslims and also leads to accumulation of wealth in favor of rich; hence its use should be suspended in favor of real money (dirham and dinar) which is more consistent with the objectives of Shariah.<sup>16</sup>

Others researchers like Dewani (1997), Vadillo (2006) and Hosein (2007) have raised concerns against fiat money. They call forth a revival of the gold and silver (Dinar and Dirham) currency system. Diwani (2002) has given a stepwise framework to implement such a system in the Muslim world. In this regard, Vadillo has even made attempts to introduce Islamic Dirham and Dinar in Malaysia.

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<sup>16</sup> For his detailed argument on this, see Kameel (2009)

In contrast to these critics, Hasan (2008) is of the view that the process of credit is not itself un-Islamic, the issue is how it is generated and used. Like mainstream economists, he argues that this process is necessary for the frictionless functioning of the modern economies. However, his analysis does not address the specific issue of dynamic instability of fiat money raised by Kameel (2004). Similarly, most proponent of Islamic banking seem to have accepted the wide use of paper and bank money without probing issues associated with it by much.

### **2.2.2: Structuralist Voices**

Unlike the above critics, these critics do not evaluate the specific practices in which Islamic finance/banking is involved, rather they take a more general (system) approach to examine the *effects* of those practices. Three of such approaches of argumentation are pointed below under this category.

#### **Micro-Macro Mismatch**

Apart from the above legalistic or juristic issues with the structuring of Islamic business contracts, critics have been uncomfortable with the on-going Islamic banking on the grounds that it is not much different from conventional one because, in practice, something very similar to interest, though with a different name, is being charged and paid by Islamic banks. This brings forth the important debate over ‘substance Vs form’ in Islamic banking—i.e. Islamic banking experts seem to be wrestling merely with form of business contracts and not their substance, i.e. economic effects. Islamic finance/banking is claimed to be superior to its counterpart not on the basis of its ‘processes’, rather due to the ‘outcomes’ which are expected from those processes. If the process is generating the same outcomes, this raises the question on the legitimacy of Islamic banking. Mehmet (2009) emphasizes that the distinguishing feature of Islamic banking lies neither in the

nature of contracts they make nor merely in being interest-free, rather in its underlying ideology and objectives that go beyond mechanistic nature of Shariah compliance with which Islamic banks seem to be more concerned currently. It is the establishment of an 'Islamic moral economy' that has to be produced by these Shariah compliant processes but Islamic banking practice seems to have failed to attain this objective.

In order to explain this theory-practice mis-match, researchers question the 'micro-foundations' of Islamic finance/banking. These critics point out the mismatch between the goals of Islamic banking and the banking structure they are using to achieve those goals. Hasan (2010) asserts that the reason for this emerging and rising gap was *structure-objectives mismatch*—i.e. Islamic banks used the conventional banking structure in pursuit of materializing their long run objectives while the structure was designed to serve the short run objectives. He asserts that Islamic economists missed 'the point that structures erected to meet *short term* ends could rarely be efficient for achieving *long run* goals'. This mis-match frustrates the goals of Islamic banking through two channels according to him: (i) in modern economies, most of the output is produced by large scale corporations which need funds for running an ongoing manufacturing or service activity, (ii) financiers provide a fraction of total financing needed for business activity and they behave as outside financiers providing funds for short term period. This, on the one hand, denies the supervisory role of these financiers and also involves them on short term basis [Hasan (2005)]. Apart from these considerations, moral hazard, adverse selection and cost considerations are also advanced as reasons for this theory-practice mismatch (see Warde (2006) and Hasan (2002)]. However, whatever being the underlying reasons, Islamic banking was stuck at a 'cross-roads' [Hasan (2005)] where the growing practice was not reflecting the principles of theory.

Warde (2006) raises concerns even about the theoretical adequacy of Islamic finance to cater modern financial needs and about its poor preparation to accommodate the modern legal environment. More hostile critics such as Kuran (2005) question the micro foundations Islamic economics/finance by asserting that Islamic economics as discipline is devoid of rigorous substance because it is merely an instrument of identity-creation and protection of Muslims in the modern system. He maintains that 'Islamic economics did not emerge from a drive to correct economic imbalances, injustices, or inequalities ... (but to) restore Islamic community's self-respect. Because Islamic economics was developed to serve cultural and political ends, it did not have to meet scientific standards of coherence, precision, or realism.' Kuran negates the generally maintained claim of Muslim scholars that Islam is a complete code of life in the sense that Islamic tradition provides solution to the evils of modern life. To him, the discourse of Islamic economics and banking was constructed on the basis of self-created conception of Islamic tradition to strengthen communal bonds of Muslims in the twentieth century, especially in the sub-continent. Because this discourse creates an anti-modern and anti-western attitude among Muslims, hence it paves the path for Islamic militancy. He also states that Islamic economics lacks originality of thoughts; most of its fixed basket of ideas is reiterated by scholars over and again and too apriorily without proving the validity of their ideas empirically. To Kuran, bank interest is not *riba* and claims that even Islamic banks are involved in charging interest with different name. He even goes on to question the workability of Islamic economics' claims that *Zakat* is the basis of social security network in Islamic economy [Kuran (1986)].

### **Paradigm Mismatch**

Probably one of the most telling criticisms against the entire discourse of Islamic economics and broadly on 'Islamization of Sciences' is leveled by Ansari (2004) in his

book *Rejecting Freedom and Progress: The Islamic Case against Capitalism*. He maintains that economics is an off-shoot of epistemology that originated from Enlightenment movement. This epistemology seeks to justify capitalist life world—life world based on the premise of maximization of freedom/capital as capital has historically been the only material manifestation of freedom. To him, the discipline of economics provides the policy framework to make possible and regulate this capitalist social and political order. Islamic economics is a fundamentally flawed project as it justifies capitalist values and transaction forms by accepting almost all premises of neoclassical economics; premises such as utility and profit maximizing agents. As he puts:

“Islamic consumer/producer/public policy maker is a welfare maximizer (like his neoclassical compatriot) and the definition of his utility function is a task usually left to the *faqihs* (the neoclassical economists also depend upon the philosophers of utilitarianism to define individual and community welfare functions). Although the constraints within which utility maximization is sought by the Islamic economists are claimed to be uniquely Islamic, this is of very little significance. For, the Islamic economists claim also that in the long run the elimination of interest, the introductions of Zakat etc. are necessary for the maximization of efficient production. The Islamic constraints thus appear in the guise of procedures which constrain short term utility maximization so that long term utility may be maximized. The Islamic economists are rule utilitarian and short term constraints turn out to be no constraints at all in the long run. This methodological similarity necessitates that the ethics of capitalism—acquisitiveness, competition, primacy of material well being, freedom, equality—are all endorsed by Islamic economics.” (p. 77)

Because Islamic economics does not question the objectives of capitalism, instead treats them natural human tendencies, it legitimates all institutions that emerged out of it including money and capital markets, and corporate property form. Thus, Islamic



economics is an attempt to legitimize the ethics and institutions of capitalism. In this approach, Islam is seen as an instrument to reform the injustices of capitalism—capitalism is criticized not for its ends but for failing to maintain balance in those conflicting ends while Islam can provide mechanisms to achieve that balance. Ansari sees this entire discourse of Islamic economics as dangerous one in the sense that it paves way to subsume Muslim societies into the global capitalist order, especially by legitimizing capitalist property form called corporation. The growth of Islamic banking, according to this approach, is due to this specific role that Islamic banking seeks to serve within this global order. As he puts it: ‘the introduction of Zakat and the introduction of Shariah compliant financial contracts replicating interest based transactions within capitalist financial markets represent no more than marginal policy changes...this is a small price to pay for co-opting potentially troublesome Islamic parties and for diverting revolutionary energy into reformist politics’ (p. 77).

To him, Islamic economics is a conceptual hurdle in the attempt to define ideals beyond capitalism and the social processes through which these ideal types can be approached overtime. To kind of ideal types he values are highlighted by him as: “Islamic conception of justice can assign intrinsic value only to the religious norms Iman, Islam, Taqwa and Ihsan. Islamic theorists thus face the task of conceptualizing a social and economic order in which the practice of the religious virtues, not utility, is enhanced. Economic institutions have to be examined and their potential for inducing individuals to accord priority to the attainment of spiritual progress must be identified. The factory, the system of land tenure, the family as consuming unit, the distributive and marketing channels, the *bazaar* (market), the policy making and executing offices, saving and investment institutions all must be redesigned to facilitate the growth of virtue. This is essential to develop an economic system the purpose of which is the promotion of the

religious virtues. Islamic economics cannot of course raise such questions. It is a branch of neo classical economics and assumes the value neutrality of capitalist institutions” (p. 79).

On the same theme, Siddique (2008) elaborates how the project of Islamic economics advances capitalist world order. He also attempts to evaluate the nature of metaphysical and structural issues embedded with Islamic economics. In this approach, banking is seen as not merely some value neutral economic organization of linking savers with investors, rather as a necessary ingredient of capitalism; the one that perpetuates the possibility of ‘endless accumulation of capital’. Hence, Islamizing banking institution necessarily justifies this accumulation of capital and its associated ethics of acquisitiveness and rivalry for worldly riches on the name of Islam. Zaman (2011) on the same line of argument has also questioned the foundations of Islamic economics. He is of the view that by accepting too many ideas of modern secular economics uncritically, Islamic economics has, in fact, compromised its essentials. He believes that a crisis in Islamic economics has resulted due to the failure of combining two contradictory systems of knowledge.

The preceding critical dimensions do not evaluate Islamic banking from ‘within’. Islamic banking was launched to meet certain objectives (as explained below in detail), therefore the more relevant line of assessment would be to evaluate it within a framework that can indicate whether or not Islamic banking is approaching its stated objectives overtime. Khan (2010) made an attempt to check empirically to what extent Islamic banking is Islamic as per its own stated standards. He identified four principles to which Islamic banking should correspond: (1) risk-sharing (i.e. PLS system), (2) materiality (i.e. all financial transactions must have some underlying asset implying that derivatives are not allowed), (3) no exploitation of either of the party involved in transaction and (4) no

financing provided for the production and consumption of sinful (*Haram*) activities. He classified all financing modes of Islamic banking into two: (1) main participatory transaction forms which include *Mudarabah* and *Musharakah*, and (2) non-participatory sale-based transaction forms including *Murabahah*, *Ijarah*, *Salam* etc. The latter is classified as ‘weak-Islamic forms’ while the former as ‘strong-Islamic forms’ by him.

However, his taxonomy of Islamic financing modes does not recognize the ‘weak-form’ as a ‘drift from first best ideal’ that we discuss in the next chapter. Secondly, he considers all sale-based transactions including *Murabahah* and *bay-ul-E'inah* in the second category while we argue in the next chapter that they should not be classified equally in the light of original or first best theory of Islamic banking. Moreover, his study is limited only to one of the objectives tested in this study. The present study has developed more indicators than used by Khan (2010) for examining theory-practice convergence in Islamic banking. Finally, detailed dynamic analysis of two specific countries is rendered in this study while his study refers to overall trends in Islamic banking.

## Chapter

# 3

## Theoretical Framework: Islamic Banking Theory and its Profile in Pakistan and Malaysia

This chapter contextualizes the theoretical development of Islamic banking in a general framework. Section 1 outlines the theory and objectives of Islamic banking proposed by its pioneers. Section 2 discusses the later developments in Islamic banking theory that went in the opposite directions of what was theorized by the pioneers. The section also analyzes some of the weaknesses in the theory of Islamic banking due to which this deviation took place in Islamic banking. In the light of discussion of sections 1 and 2, the financing and investment modes used by Islamic banks are categorized in section 3. This categorization is then used for the development of hypotheses in chapter 4. Finally the history of development and progress of Islamic banking in Pakistan and Malaysia is traced in section 4.

### 3.1: GENESIS OF THE FIRST BEST ADVOCACY OF ISLAMIC BANKING

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The prominent precursors defended the idea that Islam has a unique economic system of its own which is meant to serve some key objectives.<sup>17</sup> The last chapter showed

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<sup>17</sup> There is some dispute about who wrote the founding treatise of this modern sub-discipline, Maududi's *Sood (Interest)* (2000/1968), Qutb's *Social Justice in Islam* (1970/48), Al-Sadr's *Iqtisaduna (Our Economy)* (1961) and Iqbal's *Reconstruction of Religious Thoughts in Islam* (1999/1929) are credited with this status. However, the first systematic work on Islamic economics was authored by Maulana Hifzur Rahman Seoharawi (1939), the first book in English on Islam and theory of Interest was written by Dr. Anwar Iqbal Qureshi (1947) [in Urdu in 1945], and the first clear exposition of Islamic banking on the basis of *mudarabah* was done by Uzair Ahmad (1954). The first comprehensive official document on the subject was by Council of Islamic Ideology (1979). The summary of important issues discussed in the official document given by Khan (1994). For a survey of influential literature on the subject, see Council of Islamic Ideology (1991) Siddiqui (2010), (2001) and (1983), Chapra (1993) and (1979a), Usmani (1999b), Mohsin (1986), Mannan (1970), Ahmad (1979)

how Islamic banking theory and practice evolved in the second half of the twentieth century. We now spell out different phases of theoretical development that Islamic banking went through overtime. This will provide the theoretical framework to derive the objectives of Islamic banking. Islamic economists conceived of banks as finance companies which would raise and use/invest funds on PLS basis. They hoped that this would bring about a fundamental change in the very *nature* of the conventional banking model—a change without which, to them, banking cannot be attributed as ideally Islamic [See Usmani (1999b)] who proposes the desired change in these words:

“In the conventional banking system, bank operates merely as an institution that seeks to *exchange money*...According to Islamic teachings, the bank cannot continue to exist merely for the exchange of money. Rather, it has to be transformed into a *business* unit that collects savings from the masses and *directly* invests them into different business ventures, whereby the saving agents must participate in these businesses and their profit-or-loss should be linked to the profitability of their savings in these business ventures...(without bringing this fundamental change in banking from financial intermediary to business unit) the requirement of seeking an alternative (Islamic) system cannot be satisfied” [p. 134, (parentheses have been added)]

In this conceptualization, bank is seen as an ‘investing unit’, not merely a financial intermediary. The underlying principle on the basis of which Islamic banking derived its legitimacy was that neither the principal nor the profit can be guaranteed both on customer’s deposits and on bank’s advances. The two business arrangements that best suit this principle are *Musharakah* and *Mudarabah* both of which are meant to transform the identity of relationship among business partners from lenders-borrowers to business partners who share *realized* profits and losses, none having any contractual guarantees of *ex-ante* return. Islamic economists seek to replace ‘*debt financing*’ model of banking with that of ‘*Equity financing*’ on the basis

of PLS'. Here, the depositors are more like share-holders who get share in profit if Islamic bank happens to make profit and share in loss if otherwise.

### 3.1.1: Outline of First Best Theory

1970s and 1980s saw the emergence of banking system based on Islamic teachings in different parts of world, including Pakistan and Malaysia, where this new banking system was endorsed even at the State level. With the appearance of such a system, the discipline of Islamic banking made inroads both on theoretical as well as practical fronts as explained in the previous chapter.

#### *Preference for PLS*

The model of Islamic banking proposed by its first generation advocates, who constitute 'Idealists or Jeddah School of Islamic Economics' [Hasan (2005)], theorized three primary sources of funds that should constitute the liability side of Islamic banks, namely (i) bank's own capital, (ii) *Mudarabah/Musharakah* deposits and (iii) current deposits. On the other hand, the three primary uses of these funds on the asset side were said to be (i) *Mudarabah* financing, (ii) *Musharakah* financing and (iii) *Qard Hasan* (and fourth one the purchase of ordinary shares of business enterprises). As discussed in the previous chapter, Islamic scholars theorized *Musharakah* and *Mudarabah* as the desired modes of Islamic banking. As far sale-based contracts including sale with deferred payment (*bay mu'ajjal*) were concerned, they were in general not discussed. Their status in the light of pioneers' writings is best given in the policy document of the Council of Islamic Ideology (1979) in these words:

"the ideal alternatives to interest in an Islamic economic system are profit-loss sharing and *Qard Hasan*. However, in view of the difficulties in the practical application of the system of profit-loss sharing...certain other methods like leasing, hire-purchase, *Bai'*

*Mu'jjal*, investment auctioning and financing on the basis of normal rate of return...may also be used in interest free banking operations. Cautioning against the danger that these other methods could be misused as a means for opening a backdoor for interest...it is, therefore, imperative that the use of these methods should be kept to the minimum extent that may be unavoidably necessary under the given conditions and that their use as general technique of financing *must never* be allowed” [p. xv-xvi and 5]

The permissibility of these fixed return modes was conceptualized for the purchase of machinery and equipments (i.e. for real investment needs). The document further says:

“these alternative methods...are no more than a second best solution from the view point of an ideal Islamic economic system. Moreover, there is also a danger that they could even eventually be misused as means for opening a back-door for interest along with its attendant evils. It is, therefore, imperative that the use of these methods should be kept to the minimum extent that may be unavoidably necessary under the given conditions and that their use as general technique of financing *must never* be allowed” [p. 5]

For several reasons, this quote of CII carries much relevance for classifying different stages of later developments in Islamic banking theory. This CII document is a representative of pioneer’s wisdom about Islamic banking and it was documented at the time of the launching of Islamic banking.

On the same note, Islamic Fiqh Academy (2000) has also expressed similar concerns. For example, regarding hire-purchase or diminishing *Musharakah* contract it states: ‘It is preferable to refrain from the use of hire-purchase deals and adopt other alternatives’ (p. 99). Other influential authors such as Shafi (1993), Usmani (1999b), Siddiqui (1983, 1985 & 1999), and others [such as Ahmad (1984 & 2000), Siddiqui S. (2001), Haron (1995 & 2000), Rosly and Bakar (2003), Haron and Hisham (2003), Naqvi (2003) and Khan (2010)] have also reaffirmed this priority ordering of Islamic-financing modes and have consistently emphasized that the practice of Islamic banking should be

primarily based on equity based modes if it has to be consistent with the spirit of *Shariah* and its objectives.<sup>18</sup> To these writers, desirable objectives such as economic justice, growth, efficiency and stability cannot be achieved without adopting equity-based modes of financing. Thus, business modes regarded ‘permissible but undesirable’ were the ones that involved fixed rate of return and were also debt-like in their nature and were meant for financing real investment needs of the client. It is important to note that the permissibility of fixed return modes was not granted for providing cash to the customers at fixed rate of return.

### *Apology for Drift*

While the pioneers of Islamic banking theorized the superiority of PLS based banking system over the interest based banking system, the empirical studies revealed that Islamic banks were primarily not structuring their financing around *Musharakah* and *Mudarabah* [Agarwal and Yousuf (2000)]. Instead, they provide most of the financing through debt-like instruments (such as *Murabahah* etc.). Metwally (1992) also found that the maturities offered by Islamic banks over time in Egypt and Iran in 1980’s were mostly short (1 year) to medium term (2.5 years). In other words, what was allowed merely for ‘transitory phase’ of Islamic banking by the early advocates was turning out to be the standard in practice.

In the early phase of Islamic banking, scholars provided apologies for the use of debt like fixed-rate modes in Islamic banking. One such apology is rehearsed in Ahmed (1993) who argued that the apparent similarities in conventional and Islamic banking would wither away as Islamic banking comes out of its transitional period. He also claimed that the significance of *Murabahah* was on the decline in the total financing of

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<sup>18</sup> For example, Usmani (1999b) writes: “the true Islamic modes of financing are *Musharkah* and *Mudarba*” (p. 139)



Islamic banks. But these hopes did not materialize; Islamic banking continued to flourish in 1990's on the path that it had set for itself since its beginning.

To give a theoretical account for the failure of Islamic banking to promote PLS based modes of financing, rationales were advanced by researchers based on the logic of information asymmetries giving birth to the problems of adverse selection and moral hazard that hinder the use of PLS. Given the nature of these PLS modes, Islamic banks are more likely to attract riskier projects (adverse selection) and its business partner has incentive to show low profits (moral hazard). Warde (2006) points out a list of what he calls 'Islamic moral hazard' problems ranging from depositors (e.g. asking for higher return with guaranteed principal) to borrowers (e.g. who challenge the permissibility of late payment charges in the form of forced charity etc). Referring to such moral hazard and adverse selection problems, Usmani (1999b) apologizes that operating bank on the principle of profit and loss sharing becomes difficult when people in general have lower personal ethical standards. In other words, the low use of PLS is linked with the low ethical standards prevailing in societies by him.

Apart from information asymmetries, higher cost of vigilance and tax advantage of debt financing over equity financing [Iqbal et. al (1998)] were also advanced as reason for this phenomenon. El-Gamal (2006) is of the opinion that the functional similarity between conventional and Islamic banking is more due to legal requirements that Islamic banks face from the regulators in the sense that their products have to fit within the given legal forms available with the regulator.

These apologies were in principle demanding some academic leniency for the use of sale-based financing modes in the starting phase of Islamic banking so that the industry could gain market share and, hence stability; else the industry may wither away in favor of the existing interest based system.

### *Promotion of Equity*

Besides emphasis on profit and loss sharing, overwhelming majority of Islamic economists have the view that interest-bearing system promotes income inequalities and hence unfairness. Islamic economists advocated that Islamic financial system commits social welfare over and above profit-maximization.<sup>19</sup> Consideration for reducing income inequality and social welfare, discussed below, is one of the most important themes that many Islamic economists believe distinguishes Islamic finance from conventional one.<sup>20</sup>

In the light of above discussion, the defining features of the 'first best' theory of Islamic banking were:

- Emphasis on profit-and-loss sharing business dealings, instead of maintaining business relationships on interest bearing loans
- Permissibility of the debt-like modes of financing that involved fixed rate of return but these were seen undesirable
- Apologetic attitude for the use of fixed rate modes of financing
- Promotion of distributional equity or social welfare seen an integral part of Islamic banking

### **3.1.2: The Objectives of Islamic Banking**

The above theorization of Islamic banking leads to the following two objectives of Islamic banking as perceived by its pioneers. It is important to note here that the first objective relates with the *procedural* change in the banking system while the second one talks about the *consequences* of that procedural change.

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<sup>19</sup> Siddiqui (2004) and Mehmet (2007) spell out that promoting social welfare is key for the development of welfare-oriented economic paradigm.

<sup>20</sup> See Chapra (1985, 1992, 2000a, 2000b and 2001), Ahmad (2000), Siddiqui (2001) and Usmani (1999a, 1999b)

## **Objective 1: Promotion of Equity based Financing**

Early advocates of Islamic economists are of the view that the prime objective of Islamic finance is to replace interest based system of banking with profit-and-loss sharing (PLS) system [see Chapra (1979a), (1979b), (1985), (1993) and (2008); Siddiqui (1978), (1983), (2001), and (2004); Ahmed (1979), (1999b) and Usmani (2002)].<sup>21</sup> This risk-sharing between providers of funds (saver) and users of funds (investor/entrepreneur) is one of the most important features of Islamic finance. Standard economic considerations ranging from equity, efficiency, growth and stability are advanced by the Islamic economists to justify this shift of emphasis from interest-based-debt system to PLS one as discussed briefly below.

### *Fairness Considerations*

To begin with, there is a fairness claim associated with PLS as compared to conventional interest based system. Given that the very nature of this world is uncertain, the outcome of any investment project cannot be known with certainty *ex ante* and there is always some risk involved. This uncertainty, says Siddiqui (1994), is not merely the result of the quality of entrepreneurship, but also of the nature of the world where this entrepreneurship is being carried out by someone. The conventional system puts all this risk on the shoulders of entrepreneurs—the owner of capital is entitled to a predetermined return no matter what happens to the investment. Fairness, according to Islamic economists demands that business risk should be borne by both the parties. It is also rigorously argued by Islamic economists that an interest based system has tendencies to breed income inequalities beyond toleratable limits needed to maintain high economic efficiency and growth (this argument is substantiated under the statements of objectives 2 below).

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<sup>21</sup> We have deliberately focused on the writings of pioneering figures [such as Dr. Umar Chapra, Dr. Nijatullah Siddiqui, Maulana Taqi Usmani and Professor Khursheed Ahmed]. See the listed references for the statement of these objectives (the chapter 2 of our thesis would elaborate on them)

### *Efficiency Considerations*

Islamic economists assert that conventional financial system gives more importance to credit-worthiness of borrower, i.e. his ability to repay the loans plus interest, other than the expected income from the underlying project. Since under PLS system the bank's return is linked with the financial viability of the proposed investment project, the Islamic bank will pay more attention to the real variables while making investment decision; i.e. financial soundness of the project and the managerial capabilities of the entrepreneur. This shift from credit worthiness to productive viability of underlying project not only has its implications for the distribution of funds but also for its allocative efficiency. Here, the financier will look for the projects with higher return rather than going for creditworthy borrowers with low-return business ventures hence improving allocative efficiency. On the contrary, the refusal of the supplier of capital under interest-based system to share risk of loss involved with innovative business ventures will curtail the potential gains in productivity growth through innovation. The risk sharing feature of Islamic financial system makes many projects viable. Thus, both these features (increasing possibility of more productive projects being undertaken and more risks being shared) are expected to increase the economic efficiency of the system. Another reason, according to Al-Jarhi (2002b), why Islamic economists believe PLS system to be more efficiency enhancing is that it is nearer in spirit to self-financing as far as work incentive is concerned.

Vigilant involvement of Islamic banks is another reason to Islamic economists that helps improve allocative resource efficiency. Because now the bank's interest is directly linked with the business venture, it will evaluate and monitor the project more vigilantly rather than merely focusing on collaterals. Moreover, banks would now like to

participate in the project management and, with its specialized expertise in fund and risk management; it can improve its profitability.

### *Growth Considerations*

Islamic banking, according to Islamic economists, will boost economic growth because it will finance innovation—the engine of economic growth—coming even from the small and medium enterprises of the economy. Conventional financing system, because of its collateral based nature, usually funds new ideas arising from large corporations. Because risk is shared between both investors as well as entrepreneurs in Islamic banking, new entrepreneurs can make better advantage of this opportunity which is not available in conventional system because all the risk is here borne by the entrepreneur. Al-Jarhi (2002a) has argued that the transaction cost of PLS based financial system will be lower than its counterpart interest based system because of higher integration of financial and real sectors under PLS system. This lower cost will release valuable resources that can be used elsewhere in the system, hence leading to more economic growth.

Siddiqui (1994) argued that interest rate is a factor that adds to the cost of production, resulting in higher market price and hence lower scale of operation by the firm at higher price as market demand becomes lower. This in turn also implies lower than otherwise zero-interest rate state of the world output level in the economy and thus a less output expansion.

### *Stability Considerations*

Siddiqui (2004) has presented a detailed argument that Islamic banking system dominated by PLS system will be relatively stable because of synchronization between its payment obligations and earning receipts. Changes in its earning profile would have no impact on its financial liability to pay to the depositors and hence it would face no

liquidity shortage or solvency threat. Moreover, the system to them also has greater ability to absorb real economic shocks because increased profitability, say due to productivity shock, would increase demand for finances which will push the cost of capital in the same direction and vice versa. Mirakhor (1995) has also argued that the PLS based interest-free system minimizes the possibility of financial speculation and also protects economies from foreign financial inflows or outflows. Because of such considerations, Siddiqui (2004) concludes that:

“an arrangement based on profit-sharing, with some room for debt creating transactions (like *Murabahah*), is more efficient than the one based entirely on debt finance in which all the risk and uncertainty is shifted to the entrepreneur. The reason is debt-finance does not have any obvious advantage over the profit-sharing alternative insofar as mobilizing surpluses is concerned. It is in fact disadvantaged by the limited scope for maneuverability, and has a definite disadvantage insofar as the investor is held back from taking greater risks and launching more productive projects due to own-resource constraints. As we have argued above, the investor in the sharing environment tends to take greater risks and expand projects more in view of the consequences being shared by the financiers and, through them, by savers.” (p. 109)

Ahmed (1987), by developing a macro model, shows that a profit-and-loss based investment function can generate a more stable equilibrium between savings and investments in the economy as compared to the interest bases function.

## **Objective 2: Promotion of Equitable Resource Distribution and Welfare**

Islamic economists believed that interest-bearing system promotes income inequalities, both functional and size. They present a number of arguments to justify why income inequality is undesirable; such as its detrimental effects on efficiency and growth [Siddiqui (2004)], unbalancing effects on social and political harmony and cohesiveness

of nation states [Chapra (2008)]. Brief description of their arguments in this regard goes as below.

Abo-zaid (2008) and Rahman (2007) argued that profit-and-loss sharing system is expected to promote SME as well as micro financing. The underlying reason, in line with Rosly (2005), is that financing rule based on 5C's (credibility, character, capital, collateral, and capacity) favors corporate clients. Soumik (2008) argues that the trust required to make transaction possible in the modern system is a function of net-worth of the firms that the emerging small businesses lack, hence, they fail to borrow. Profit-and-loss sharing, as opposed to debt-based system, will open the possibility of advancing financing to small but viable projects as the criterion of getting financing is not net-worth rather profitability of the project under question. This will divert resources to the segment lower on national income ladder.

Underlying the advocacy of reducing income inequality by Islamic economists is their expectation from Islamic financial system to commit social welfare over and above profit-maximization. Siddiqui (2004) and Mehmet (2007) spell out that promoting social welfare is key for the development of welfare-oriented economic paradigm. Wajdi and Irwani (2006) see Islamic banking beyond technical conditions satisfying *Shariah* compliant products, as a system that aims at fulfilling socio-economic objectives at large. This commitment to serve social-objectives will help promote the desired homo-islamicus individuality according to Mehmet (2007). Achieving such a welfare oriented society, Islamic economists argue, requires equity financing.

The consideration for equity is one of the most important themes that many Islamic economists believe distinguishes Islamic finance from conventional one. Chapra (1985, 2000a and 2000b), Ahmad (2000), Siddiqui (2001) and Usmani (1999b) see Islamic banking as a sub-set of the broader Islamic economic order that tries to establish a

just society. As Chapra (2001) states, “Islamic economics is based on paradigm which has socio-economic justice as its primary objective” [p. 25]. According to these authors, most ‘economic prohibitions’ (like interest, gambling, excessive speculation) and ‘obligations’ (like zakat, inheritance, PLS) are means of achieving growth with equitable opportunities to all parties in society and preserving social harmony [Chapra (1992) and (2000b), Siddiqui (2001) and Naqvi 2003]. In fact, they see Islamically sanctioned constraints on individual behavior as welfare-enhancing devices because they restrict his self-interest such as to maximize social welfare. In the words of Chapra (2001), they make possible ‘perusing one’s self-interest within the constraint of social interest by passing all claims on scarce resources through the filter of moral values” (p. 26).

Moreover, since Islamic banking is based on moral foundations of Shariah to these authors, thus Islamic banking must be morally and socially committed institution [Mirakhor (2000), Warde (2000), Ahmad (2000), Al-Omar and Abdel-Haq (1996)]. International Association of Islamic Banks (IAIB) says:

“Islamic banks take into prime consideration the social implications that may be brought about by any decision or action taken by the bank. Profitability—despite its importance and priority—is not therefore the sole criterion or the prime element in evaluating the performance of Islamic banks. They have to match both between the material and the social objectives that would serve the interests of the community as a whole and help achieve their role in the sphere of social mutual guarantee. Social goals are understood to form an inseparable element of the Islamic banking system that cannot be dispensed with or neglected.”<sup>22</sup>

Islamic economists also attribute the power imbalance in the modern capitalist world order to the institution of interest [See Siddiqui (1994)]. They are of the view that interest allows wealth to concentrate in the hands of banks and large corporations because

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<sup>22</sup> Quoted from m Al-Omar and Abdel-Haq (1996), p. 27



banks advance loans mostly to credit worthy borrowers—corporations being the most attractive option in this case. With wealth goes the concentration of social and political power, hence, making society increasingly unequal by allowing fewer and fewer economic agents to determine the destiny of masses. Monopolies and oligopolies tend to emerge, argues Usmani (1999b), as result of interest based system. To curtail this economic and social power of these few economic agents, transformation of interest based system into Islamic one is required to the proponents of Islamic economists.

Thus, it may be concluded from the above that Islamic banking is much more than a *technically defined* institution, i.e. one avoiding interest and providing Shariah compliant alternatives. It is a system that is expected to serve socio-economic objectives by bringing about balance between the poor and the rich. Usmani (2009) writes: ‘when we talk about Islamic banking or organizing banking on the basis of Islamic rulings, we do not talk of using some legal tricks (*hiyal*) to organize banking under the umbrella of Islam in such a way that the existing system continues the way it is. Rather, we intend to alter the entire structure of investment and financing in the light of *Shariah* such that they have positive impact in income distribution...by continuing with mark-up type financing schemes, we cannot produce even a tiny impact on the existing problems of income distribution’ (p. 260).

### **3.2: DEGENERATION OF THE FIRST BEST**

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In the early phase of Islamic banking, scholars were asked for some academic leniency for the use of sale-based financing modes so that the industry could sustain. These contracts had the benefit that they minimized the higher business risk associated with *Mudarabah* and *Musharakah* and allowed Islamic banks to earn a-priori guaranteed return. But the cost of this risk minimizing strategy was drifting towards the kind of

contracts which Council of Islamic Ideology had referred to 'means for opening a backdoor for interest.' The latter generation scholars of Islamic banking theorized these apologies into full-fledged justification for these fixed-return sale-based contracts.

### 3.2.1: The Second Best: the First Drift

This approach emphasizes that conservative mainstream model of Islamic banking faces problems when it comes to practicality. It emphasizes that financial contracts that involve trade or sale (*bay*) of one good with another, whether spot or deferred, are equally Islamic as PLS contracts. Thus, while the first generation scholars provided apologies for the heavy use of fixed-rate modes in Islamic banking, the later generation of researchers moved forward from being apologetic to defending them on theoretical front. They simply ranked all modes of financing equally Islamic and desirable without any preference ordering among them. Further, they cast doubts against the efficiency claim of PLS system.

Ismail (1986 & 2001) provided theoretical justification for the sale-based contracts such as *Murabahah* and *ijara* discussed in the previous chapter. He argued that sale (*bay*) is the alternative of interest (*riba*) according to the Quran. From this he implied that all sale-based financing modes are as good as PLS modes. El-Gamal (2000) further argues that there is no Quranic verse for preferring one financing mode over other, this may only be a matter of choice of the observer or researcher.

Hamoud (1982) argued that profit and loss sharing based banking system is constrained by several limitations: (1) it cannot serve the credit needs of customers, (2) profits are distributed in *Mudarabah* contract after the completion of transaction when the principal is recovered while in modern financial system profit is determined by the principle of present value of investment pool. Haque (1985) also raised critical voice against profit and loss sharing by asserting that it may lead to the advantage of one person

in cases of asymmetric information. Moreover, managerial and regulatory issues also make *Mudarabah* difficult. For example, Manager of funds in *Mudarabah* (*mudarib*) can venture in more risky business projects or that he may show less profit than he makes. Avoiding these issues requires diligence on the part of Islamic bank, hence leading to the operating and monetary cost increase. Warde (2006) also highlights moral hazard and adverse selection issues due to which *Mudarabah* and *Musharakah* contracts could not be used.

The criticism leveled against such sale-based contracts is also defended in this approach. For example, two major objections are raised against *Murabahah* and *Ijarah* (hire-purchase) contracts by critics. First, they were converted into financing modes by combining more than single contract into one. For example, a typical *Murabahah* contract rendered by Islamic banks involves two sales transactions: first, the client buys good from the manufacturer as bank's agent and then he buys the same from bank at marked up price. This practice of combining more than one contract into one is denounced in traditional Islamic jurisprudence because of the existence of fallacy of composition—contracts acceptable and legal in isolation may assume an illegal form when joined together [Saeedi (1998)].<sup>23</sup>

However, the proponents of *Murabahah* assert that this impermissibility applies to the cases where several contracts are joined together such that the validity or obligation of one contract is conditional upon the other [Usmani (2009)]. For example, Mr A sells a commodity to Mr B with the condition that B will employ A's brother in his office. This sale would be void because the condition is part of the sale and hence this sale is conditional. However, if all contracts are in principle held and executed separately, this impermissibility does not apply. Because different transactions in a *Murabahah* contract

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<sup>23</sup> Marriage (*nikah*) and divorce are legitimate contracts in Shariah. However, combining them together in a single contract (e.g. a man marries a woman for a fixed time, say one month) creates an unacceptable form on marriage

take place separately (unconditionally) according to Islamic banking proponents, hence *Murabahah* contract of Islamic banks is permissible. According to Arbouna (2007), the impermissibly relates to the former situation, called tying arrangements among contracts (*ishtirat-ul-aqad fi aqad*) which is different from combining of contracts (*ijtima-ul-uqud*) wherein parties enter into a deal involving several contracts of different features to make a viable investment product. To him, no Quranic verse explicitly forbids combination of contracts. He believes that this approach should be adopted sooner than later to provide Islamic banks with more investment outlet. Usmani (1999b) warns that special care must be given to the order of transaction in *Murabahah* to ensure that the product is owned by the bank before it is sold to the agent to justify its claim on profit.

Second objection on these sale-based contracts is that they create debt just like conventional banks liabilities and are disguised instruments of earning fixed bank interest [Warde (2006), Kuran (2005), Madrassa Ina'amiyah (2008)]. This point is further substantiated by the fact that Islamic banks usually determine their mark up on *Murabahah* and rental rates in *Ijarah* contracts on the basis of interest rate bench mark. But the practitioners assert that *Murabahah* ties the financial activities of Islamic banks with the real economy, unlike interest based loans. To them, though such modes do not equal the ideal of PLS system, yet they serve the needs of real economy without involving the volatility of conventional interest based system because they are based on the sale of real asset [Nienhaus (2007)].

To sum up, the 'second best' theory had these features:

- Justification for the use of financing modes involving fixed-return as desirable as PLS modes
- Rationalization of combining several contracts in a single contract
- Attitude of defending sale-based contracts against all kinds of criticism

### 3.2.2: The Second Drift: Rise of Pragmatism

The insistence to defend the widespread use of fixed-return instruments and to structure Islamic banking on conventional banking foot-prints, instead of what the pioneers conceived of, led this approach not only to look beyond the desirable business contracts but also to engage in the kind of financial engineering that was either not envisaged or even disapproved by the early theorists of Islamic banking. Three of such deviations are worth considering here.

#### *Fixed Return on Cash: Bay-ul-E'inah and Tawarruq*

Sale and rent based products involving fixed rate of return like *Murabahah* and *Ijarah* could be used to finance real investment or asset purchase needs of the client but not cash needs. Usmani (2002) writes:

“Murabahah cannot be used as a mode of financing except where the client needs funds to actually purchase some commodities. But where the funds are required for some other purposes, like paying the price of commodities already purchased by him, or the bills of electricity or other utilities or for paying the salaries of his staff, *Murabahah* cannot be effected, because *Murabahah* requires a real sale of some commodities, and not merely advancing a loan.” (p. 73)

Previous chapter explained how *bay-ul-E'inah* allows Islamic banks to supply cash loans at fixed rate of return by involving two sales, one spot and another deferred, with the same person at different prices. This sale-contract was not allowed by most of the classical Muslim jurists [Saeedi (1998)].

One notable exception to this general opinion was Imam Al-Shaf'i<sup>24</sup> [see Usmani (2009) for detailed description of his position]. According to him, a contract is valid in Shariah law as long as all elements of it are rendered without violating any Shariah law

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<sup>24</sup> Imam Al-Shaf'i (767-820 AD) was the founder of Shaf'i school of thought in Islamic jurisprudence

[Qadri (1981)]. The intention of the parties cannot invalidate the contract unless they are explicitly expressed in the contract. To illustrate his point, Al-Shafi' gives the example that if a person has the intention to keep his wife for a limited time period, his intention cannot make his marriage contract invalid, though it may be undesirable [Rosley and Mahmud (2001)]. On the other hand, Malki and Hanbali schools of thought hold that this is an invalid contract because the intention of the contracting parties plays an important role in determining the legal verdict of a contract.<sup>25</sup> To them, *bay-ul-E'inah* is a legal device to obtain interest bearing loans without having an intention to sale or exchange any asset. Similarly, Hanafi school of thought also considers this contract invalid, except Abu-Yousuf [Saeedi (1998)]. These jurists point out several examples of contracts that are unlawful because of the unlawful intentions of contracting parties. To quote one of such examples from Ibne-Qudama, an influential Hanbali scholar, if a grapes vender knows, either indirectly or directly, that the buyer of grapes has the intention to use it to make wine, then this contract would be invalid. Rosley and Mahmud (2001) and Saeedi (1998) take a detailed critical account of Al-Shafi's position. However, Islamic bank's Shariah advisors rely on the opinion of Al-Shafi for justifying *bay-ul-E'inah*.

As explained in the previous chapter, *tawarruq*, alongside *bay-ul-E'inah*, is also used by Malaysian Islamic banks to cater the cash needs of its customers but it is also one of those contracts that do not appear in the writings of pioneers of Islamic banking. Moreover, this contract is also similar to *bay-ul-E'inah* in spirit except that three, instead of two, parties are involved in it (see last chapter for description of *tawarruq* or **Appendix A**). While Shariah Advisory Council of Malaysia [SC (2007)]<sup>26</sup> allows the use of *tawarruq* as well as *bay-ul-E'inah*, Siddiqui (2007) traces the undesirable

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<sup>25</sup> Malik and Hanbali are the two, among four, famous schools of thought in Islamic jurisprudence along with Hanfi and Shafi

<sup>26</sup> See *Resolutions of The Securities Commission Shariah Advisory Council*, for resolutions that declare the legitimacy of these transaction forms

macroeconomic consequences of such debt-creating instruments. He concludes his analysis, by re-iterating preference for PLS modes, with these words:

“Islamic economic movement was launched to usher in a financial system that would help remove the *zulm* (injustice) and *fasad* (corruption), inequity and inefficiency, perpetrated by the currently dominant system based on debt. It is our duty not to endorse a process that could someday take us back to the same system....An innovative recourse to sharing based modes and asset based financing may get a boost from closing the door to *tawarruq*” [p.7]

#### *Trading of Debt: Sukuk and Bay-ul-Dayn*

Another significant financial innovation was *Sukuk* that has created a vast new market for Islamic finance and banking as explained in previous chapter. Bonds and securities created in the conventional financial systems represent debt obligations of the issuer promising a specified return as percentage of par value [Fabozzi, Modigliani and Jones (2009)]. Some of these securities are backed by specific assets, such as physical property or mortgage receivables, as pledge to secure the payment to their holder in case the issuer becomes insolvent. They are called asset backed securities. These securities are also traded in the secondary market leading to capital gains or losses to their holders. Given this structure of conventional bonds and securities, there were two Shariah issues with them: (a) being debt obligation, return on them comes under the preview of interest (*riba*) which is not allowed by Islam and (b) their trading in the secondary market implies trading of debt (*bay-ud-dayn*) which is not allowed according to most jurists because physical or constructive possession of asset is required before selling it.<sup>27</sup> *Sukuk* were designed to set aside these Shariah issues with securities.

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<sup>27</sup> Hadith [saying of the Prophet Muhammad (saw)] is quoted in *Tirmidi* (one of the six authentic books of Hadith): ‘Do not sell what you do not possess’.

Unlike bond, *sukuk* represent ownership rights in some underlying assets and the *sukuk* holder is entitled to share in revenues generated by the *sukuk* assets [see section 2.1.2 in previous chapter for details]. As per the idealist Islamic finance theory, *sukuk* should be based on participatory modes paying variable rate of return (and not fixed return like interest payment on conventional bonds). Probably, only ideally structured *Mudarabah sukuk* can fulfill this condition. In *Mudarabah sukuk*, investors are providers of funds (*rabb-ul-mal*) while the originator or issuing company is entrepreneur (*mudarib*) and the realized profits from the project or asset is shared between the two as per agreed ratio while financial losses are borne by the investors. Such *Mudarabah* certificates were issued in Pakistan in 1980's but enjoyed limited success due to depressing profit margins [Wilson (2008)]. These types of *sukuk* can usually be applicable when a firm needs finances for direct structuring, i.e. investment for a new venture.

Apart from *Mudarabah sukuk*, Shariah scholars have proposed several Shariah compliant contracts on the basis of which such *sukuk* can be issued. *Ijarah*, *Murabahah* and *E'inah sukuk* are common ones (their structure is discussed in the previous chapter). All of them pay fixed return just like conventional bonds but represent ownership rights in favor of their holders. Due to this fixed rate of return feature, such *sukuk* structures are classified second best in this study.

From the point of view of second best theory, these *sukuk* should be issued against some underlying asset and should represent ownership rights and not debt obligations of the issuer because otherwise the return on them, say in the form of rental payment, would not be different from interest payments on conventional securities [Usmani (2008)]. If *Ijarah sukuk* are not issued against physical asset which is first sold to SPV and then taken back on rent by the firm, then earnings of *sukuk* holders cannot be ascribed to the earnings originating from the underlying asset. Because *Ijarah sukuk* represent ownership



rights, their trading in the secondary market does not entail trading of debt and hence is considered permissible. On the other hand, *Murabahah* and *E'inah sukuk* signify debt receivables and trading them at other than par value means trading of debt. Therefore, trading of *Murabahah* and *E'inah sukuk* falls under the category of *second drift* of the second best theory. In other words, *sukuk* structuring must, at least, fulfill two conditions from second best point of view: (i) it should avoid payment and receipt of interest, i.e. should be based on some underlying asset<sup>28</sup> and (ii) should not involve trading of debt receivables (*bay-ud-dayn*). However, several theoretical and practical considerations have led Islamic finance practitioners to deviate from these ideals. These deviances are worth consideration here.

*First*, as discussed above, transfer of ownership is a necessary condition in case of *ijjarah sukuk*. However, legal issues, especially in case of government assets, impede the real transfer of underlying assets after sale to thousands of owners which implies that the tangible asset remains in the ownership of SPV while the *sukuk* holder is given only the guarantees of repayments by the originator. Keeping this in view, Dususki and Mukhtar (2010) differentiate between *asset based* and *asset backed sukuk*. To them, a *sukuk* where its holder has only safety interest, i.e. collateral over assets, in the underlying asset but not ownership interest, then it is as an *asset based sukuk* which functions more like a conventional bond or asset backed security. In asset based *sukuk*, only the beneficial interest in the asset is transferred by the originator to SPV without any true sale. As a result, *sukuk* holders have no interest in the ownership and control rights over the asset. Thus, such *sukuk* are issued against creditworthiness of the originator and not risk and return of the underlying asset. Lahsasna and Lin (2012) identify that one reason for this practice to prevail is the legal restriction on foreigners' ownership of certain domestic

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<sup>28</sup> Khan (2010) terms this *materiality* criterion for Islamic banking to be Islamic

assets, especially in case of state owned assets. It is, however, clear that if asset based *sukuk* do not represent true ownership claims, earnings proceed to *sukuk* holders become more like interest earnings because these *sukuk* are then more like conventional debt instruments. Moreover, their trading in secondary market also becomes questionable due to trading of debt.

Since *E'inah sukuk* are in principle issued by selling some underlying asset at spot price and buying it back at higher deferred price, these *sukuk* represent debt or liability receivable (*dayn*) hence their trading involves *bay-ud-dayn*. There are two controversial issues regarding the current practice of *bay-ud-dayn*, first relates to its legitimacy and scope while second relates to selling debt at other than its face value. To understand the first issue, it should be noted that *bay-ud-dayn* can take place in two ways: (i) sale of debt at cash and (ii) sale of debt at deferred payment. As far *bay-ud-dayn* at deferred payment is concerned, it was considered illegitimate by most classical Islamic jurists on the basis of Hadith whereby the Prophet (saw) forbade sale of debt with a debt.<sup>29</sup> There were some disagreements regarding Shariah ruling of *bay-ud-dayn* at cash. Most jurists allowed *bay-ud-dayn* at cash between creditor and debtor, and not between creditor and the third party.<sup>30</sup> These scholars found their argument on Hadith: 'do not sell what you do not possess' [Rosley and Mahmud (1999)]. However, some Shafi and Malki jurists allowed *bay-ud-dayn* at cash to third party because to them debt is a kind of right in the possession of creditor and he can sell it to anyone [see Zuhayli (2003) for detailed description].

Contemporary Islamic jurists, who allow *bay-ud-dayn* derive their argument from these scholars. Shariah advisory Council (SAC) (2002) of Malaysia accepted the principle of *bay-ud-dayn*. As far the second issue is concerned, most classical jurists did not allow the principle of discounting the debt while selling it because reducing the amount of

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<sup>29</sup> Quoted in At-Tabrani

<sup>30</sup> Because in the former case, the liability of debtor is paid to him which removes the very reason why this is not allowed between creditor and third party, i.e. the risk of inability of third party to pay it to the debtor.

liability when made prior to the time of maturity is similar to increasing the amount on debt when delayed, called interest. However, the proponents of its permissibility derive their argument from the view associated with Ibne-Abbas, a companion of the Prophet (saw). Ibn-e-Qayyam (a renowned Islamic scholar) says that while increasing payment on late payment is *riba*, decreasing it on early payment is incentive [SAC (2002)]. Islamic Fiqh Academy (1992) has also accepted this principle of discounting debt.

The *second* drift took place due to the recognition of fact that *ijara sukuk* restrict the issuance of *sukuk* to the value of underlying asset and not beyond it. Islamic Fiqh Academy (1988) had issued the resolution that a bond or a written note can represent any collection of assets and this bond can be sold and bought at any market price subject to the condition that majority of the assets underlying that bond are physical. Using this decision along with the permissibility to sell debt at any value, , hybrid *sukuk* have been invented whereby originator is allowed to sell a mixed portfolio of its physical assets and receivables from *Murabahah* and *istisna* to issue *sukuk*. The minimum physical asset requirement in these *sukuk* is set at 51% by Scholars while some have allowed them even against 30% tangible assets. Thus, while asset based *Ijarah sukuk* violated the ownership feature of *sukuk*, hybrid *sukuk* relaxed the requirement of tangible assets behind *sukuk* [Saeed and Salah (2012)]. Debt once becoming tradable, it was just one step forward to certify the securitization of Islamic Private Debt Securities (IPDS)—corporate accounts receivable—by some of the Malaysian jurists [Khan (2010)]. The trading of debt has allowed Islamic banks to deal in discounting the bill of exchange.

*Thirdly*, similar kind of innovations were embedded in even equity based *sukuk* such as *Mudarabah* where the *sukuk* holders were provided the repayment guarantee of principal amount by the originator which in principle cannot be provided to the financier, in *Mudarabah* contract. Further, their return was also fixed which again should not be the

case in *Mudarabah*. When losses accrue on the underlying *Mudarabah* assets, they were borne by the originator instead of passing on to the investor to keep their financial interest alive, while excess profits were held by the originator as incentive fee of floating *sukuk*. Thus, returns were made fixed one way or the other even on *Mudarabah sukuk*. It is evident from the above that *sukuk* issuing practices did not hold up to even the standards of second best theory. Usmani (2008), a proponent of first and second best advocacy of Islamic banking, raised criticism against these *sukuk* structuring practices. He maintained that offering a fixed rate of return on *Mudarabah sukuk* is against the principles of Islamic justice. He also objected on *sukuk* where ownership rights are not transferred to *sukuk* holders.

#### *Derivatives*

Lastly, with the passage of time, derivatives are also coming within the horizon of Islamic finance. As explained by Khan (2010), trading in derivatives involves uncertainty resulting due to the sale of assets that are non-existing or not possessed.<sup>31</sup> Moreover, they also involve trading of financial instruments not-backed by assets. Ayub (2002) and Mills and Presley (1999) assert that application of the principle of avoiding excessive speculation (*gharar*) rule out options and futures from Islamic finance. Usmani (1999c) discarded futures and options because these are unconcluded contracts and partially funded transactions do not establish ownership claims. Thus, derivatives are generally regarded unacceptable by Shariah scholars.

Contrary to this opinion, Khan (1995) asserts that some of conditions and concepts used in such short trading are similar to those features which are part of deferred trading, e.g. *bay Salam*. Some researchers argue that a derivative would be allowed if some underlying economic transaction is being hedged [Ayub (2002): p.35 and Warde

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<sup>31</sup> This uncertainty is called *gharar* in Islamic Shariah terminology.

(2005): ch. 7]. Though short-selling was considered un-Islamic by most scholars, however, extending the argument of Khan (1995), some *Shaf'i* scholars have created some hedge funds wherein short-sale is seen Shariah compatible if a down payment is made by the shorter towards shorted to ascertain the ownership of underlying asset that is being sold [Morais (2007), p. 131]. Jobst and Sole (2012) provide detailed analysis of conditions that are required for transaction in derivatives and also list out a number of implicit and explicit derivatives used in Islamic finance. The decision of Shariah Advisory Council of Malaysian Securities to allow short-selling is criticized by Dusuki and Abozaid (2008) on the grounds that it is against the objectives of *Shariah*. They raise three critical issues against it: (a) selling what is not in possession is not allowed in Shariah, (b) a stock does not qualify to become the object of a loan contract and (c) benefitting from loan contract is not allowed.

#### *From Social Responsibility to Maximization Mania*

Apart from the above three drifts, the pragmatic approach also casts doubts on what is called 'social responsibilities' of Islamic banking beyond profit-maximization. This primarily profit-oriented view of Islamic banking, borrowed from Friedman's (1970) view of corporation, is associated with Ismail (1986). He divides the Islamic economic order into three parts: (i) government (*siyasi*), (ii) commercial sector (*tijari*) and (iii) welfare sector (*ijtimai*) and, on the basis of this classification, maintains that the commercial sector is primarily supposed to meet the stakes of shareholders and depositors, not those of society as a whole (which are to be served by institutions operating under the third sector) [(Hassan and Lewis, 2007: 10) Given the above description, the defining features of this phase of development in Islamic finance can be summarized as:

- Justifications for the use of controversial forms of business contracts

- Reverse financial engineering—development of new composite Shariah compliant contracts to copy conventional banks products—to cater customer needs
- Ignoring welfare-commitments of Islamic banking. Dominance of ‘form’ over ‘content’ in Islamic banking industry

Today, the horizon of Islamic finance, consisting of the first generation idealists and the second generation pragmatists, has become bewildering on theoretical front. While there are pragmatists asking for more financial engineering, there are idealist conservatives rehearsing the echoes in the name of ‘calls and hopes for return’. Concerns are being raised not only by the pioneers but also by some later generation Islamic economists against industry foot prints. For example, critical voice against this practice has come from pioneers of Islamic finance like Siddiqui (2010). Hasan (2005) has gone even more vocal to argue that the use of sale based deferred contracts should be restricted under the Shariah principle of *Sadd-ul-zarae*<sup>32</sup> (سد الذرائع) because these contracts open up the back-door for charging interest.

### 3.2.3: Reasons for the Going Process from Genesis-to-Degeneration

The degeneration process of Islamic banking theory from idealist to pragmatic approach can largely be analyzed in terms of the theoretical inadequacies and compromises that were built within the first best theory of Islamic banking. We highlight them in this section.

The first of these loop-holes is found in the vague position assumed by the pioneering individuals and institutions regarding the use of debt-like fixed return modes when they proposed that the use of such second best modes should be ‘minimum’ and allowed under ‘unavoidably necessity’. The terms like *minimum* and *necessity* were not

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<sup>32</sup> In Islamic Usool-e-fiqh, *Sad-ul-zarae* refers to the principle of blocking the permissible means that lead to impermissible outcomes

spelled out to signify clearly what they exactly referred to and a great deal of room for subjective interpretation was left to be filled by practitioners of Islamic banking. These rather vague words were used to defend the drifting practice of Islamic banking from criticisms just as infant industry argument is used to defend domestic industries from foreign competition without specifying what *exactly infancy is and for how long*.

Second, the early advocates of Islamic banking generally accepted the assumption ‘what is good for an individual or unit is also allowed for institution (bank)’ [IIIE (1997)], hence ruling out any possibility of fallacy of composition—it is in general not true that whole equals the sum of parts, rather the whole may be different from the sum of parts. This assumption provides the foundation for disregarding any possibility of micro-macro mismatch by ignoring the concept of ‘emergent properties’—properties that are observable in the aggregate and not in individual parts of that whole.<sup>33</sup> However, it was a questionable assumption as Siddiqui (2007 & 2010) tries to make Islamic bankers realize by illustrating the point that many Shariah compliant actions rendered permissible at micro level may generate undesirable outcomes at macro level when performed by large institution for example bank.

This vague position about debt-like fixed returns modes and the naïve assumption of no fallacy of composition paved way for the practitioners to rely continuously on these modes of financing. Putting these modes into operation required some more sufficient conditions beyond these two. In order to design such modes, at least three other conditions were needed. (i) future or credit price of the product should always be greater than its spot price in *Murabahah* contract for banks to make profit, (ii) the difference between spot and future price<sup>34</sup> should be around interest rate for Islamic banks to remain

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<sup>33</sup> A simple example of argument ignoring emergent property is: ‘because hydrogen and oxygen are not wet, therefore water is not wet’.

<sup>34</sup> Rental rate in case of *Ijarah*

competitive with their counter parts and (iii) combining individually permissible contracts together in single contract should be permissible.

The justification of increasing credit price in *Murabahah* contract was validated by the permissibility of raising price in case of installment sale. Determination of profit and rent margins on the basis of interest rate was allowed on the grounds that Shariah gives liberty to set profit and rentals at any margins and that it does not forbid to fix it around interest rate.<sup>35</sup> Finally, it was argued that if some hypothetically structured procedure is ensured in designing composite contracts where contracts are enacted in specific order, then Shariah ruling has no objection on combining several contracts into one. Thus, while the first two factors explain the tendency of Islamic banks to indulge in these modes, the remaining three explain how that tendency was put into operation.

Building on these theoretical developments, the pragmatic approach to Islamic finance stretched it to its logical extreme. This approach can convert Islamic banking industry very much similar to the conventional banking. The researchers have started to warn it against facing the same kind of financial crises as hit the conventional banking. That is why, Y-sing and Richter (2010) expressed their concerns in this regards with these words: 'the industry is in danger of dying in its cradle because it has taken poison in its food from conventional capital markets'. Brown (2009) argues that if Islamic banking continues on its selected path of developing reverse engineered Islamic instruments, it will become as vulnerable to cycles and shocks as conventional system. Ghoul (2011) gives a detailed description of how different *sukuk* went into crises and how the global crises impacted Islamic finance. He suggests some regulations that need to be followed to

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<sup>35</sup> Usmani (2002) explains his argument through an analogy: Mr. A and Mr. B are two traders. Mr. A sells liquor, which is prohibited, and earns a profit of say x. Mr. B being a Muslim sells only permissible (*halaal*) drinks say soft drinks and dislikes Mr. A's dealing in liquor. Mr. B wants his business to earn as much profit as Mr. A's, he decides to sell permissible drinks at the same profit margin as charged by Mr. A on liquor. One may argue that Mr. B's benchmark for profit rate is not desirable, but no one can say that it is not permissible (*haram*). Usmani adds that even though this measure is permissible but not desirable and Islamic banks as well as other financial institutions should leave this process as soon as possible.



avoid the same destiny for Islamic banking as of conventional one. Similarly, Hasan and Jemma Dridi (2010) show that, though differently; the recent financial crises did hit the Islamic banking industry.

Instead of paying heed to this alarming drift that was an outcome of continuing with the above *undesirable permissibilities*, an ingenious argument was constructed by later jurists of Islamic banking to defend themselves against critics: *Shariah permissibility rests upon procedures, not outcomes*. This *procedural compliance* largely explains why Islamic banking is stuck in *form* ignoring *substance*. When warned against the outcomes of this position, the so called Islamic banking Shariah experts express a different opinion: since Islamic banking has to compete with conventional one in a mixed system, therefore it is necessary for Islamic banks to have efficient and attractive products, else Islamic banks would fail as most of the bank customers look for procedural equivalence. In this scenario, it makes sense first to develop Shariah compliant products that are similar to those in conventional banking to attract customers and then look for products with new form and substance [Nienhaus (2011)]. Such scholars of Islamic banking hold that the industry should be allowed to flourish and become sufficiently larger enough despite its less than ideal outlook. Once grown up, Islamic banks can then create market of their own. Hence, this argument justifies persisting with the use of such drifting financing modes by Islamic banks. As put in logic, ‘two wrongs cannot make one right’, so it applies to the logic of Islamic banking proponents: ‘cumulative effect of several undesirable cannot turn it into desirable’.

The above analysis demonstrates that the ongoing drifts in Islamic banking theory and practice are more due to some of its theoretical vagueness, compromises and approach to defend those compromises. Zaman (2011) explained this ‘crises’ in Islamic finance by an alternative hypothesis: “that most Muslim economists have accepted too

many of the ideas of Western economists uncritically” (p. 147). This acceptance of modern economic ideas, which are at odd with the Islam, by Muslim economists has resulted in a contradictory body of knowledge on the name of ‘Islamization of knowledge’ project. This hypothesis can partly explain the theoretical compromises that the experts of Islamic finance have been making over the last few decade. If Islamic economics and finance is a sub-discipline of neoclassical economics as explained by Zaman (2011) and Ansari (2004), then institutions emerging out of this economic theorization is the natural abode of Islamic finance to reside in.

### 3.3: CLASSIFYING THE STRUCTURE OF ISLAMIC BANKING THEORY & PRACTICE

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The objectives of Islamic banking as perceived by its pioneers were spelled out in section one of this chapter. In the light of development of Islamic banking theory explained above, the schematic structure of Islamic banking business contracts is shown in **figure 3.1**. Business modes used by of Islamic banks are divided into two categories:

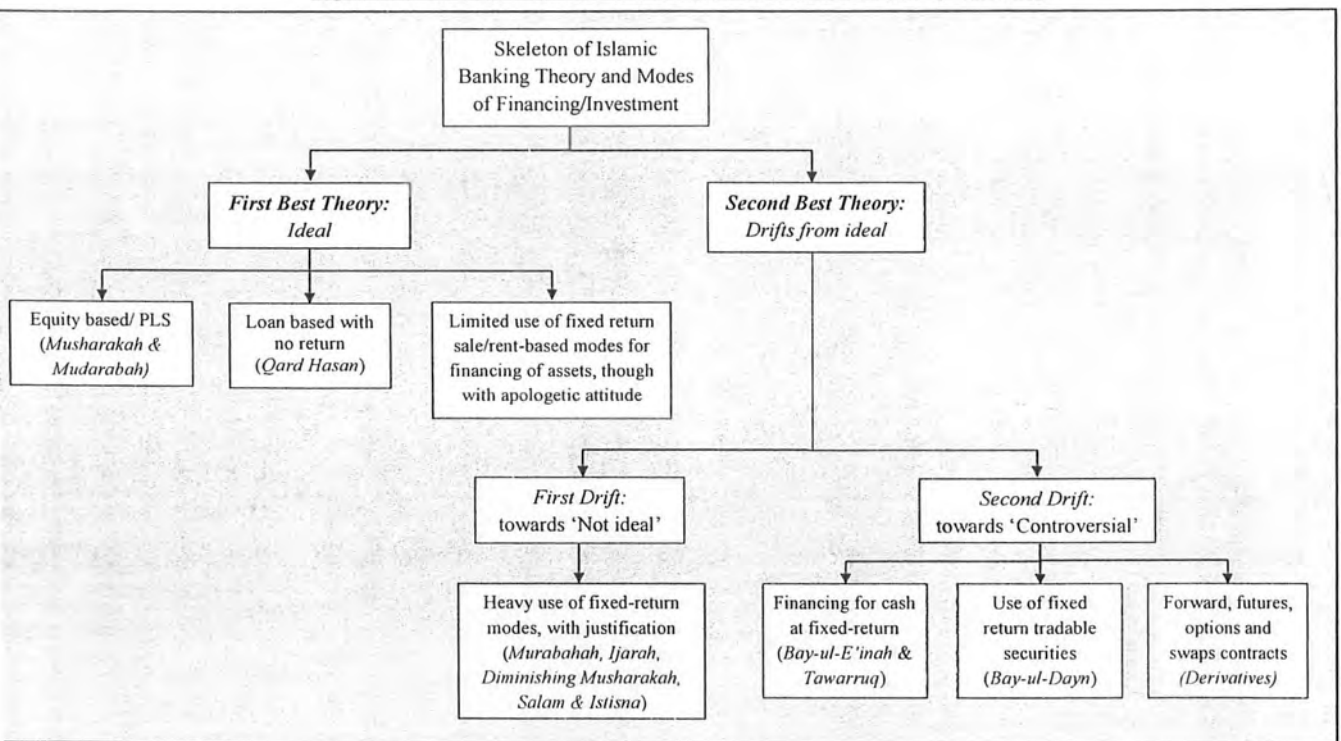
- *First Best*: Equity financing, including *Musharakah* and *Mudarabah*<sup>36</sup> and *Qard Hasan*, were considered to be the desired financing modes. *Qard Hasan* is placed under this category despite that it does not involve equity. It reflects the welfare-commitments of Islamic banking perceived by the pioneers. As far as sale or rent based fixed-return modes are concerned, their limited use for financing real investment needs was held permissible by the CII report
- Second Best*: Islamic banking theory has undergone two drifts from its ideal; therefore we have two divided second best theory into two sub-categories, first and second drifts. ‘First drift’ includes modes that were allowed by the pioneers under necessary

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<sup>36</sup> For schematic description of how these modes of Islamic finance are used to serve these banking needs, see Obaidullah (2005)

circumstances with apologetic attitude. These modes were the second best. However, the later jurists provided theoretical justification for their heavy use in Islamic banks and also defended them against criticism. The 'second drift' consists of modes that are controversial in permissibility. They are an outcome of financial engineering of Islamic banking practitioners.

**Figure 3.1: Schematic Structure of the Modes of Islamic Investment/Financing**



Thus, we classify Islamic modes of finance in three categories, namely:

a) *Permissible as well as desirable*: These financing modes are:

- deemed permissible by consensus
- categorized as ideal by the pioneers, and
- regarded equally good by the later jurists (or pragmatists).

These modes are labeled as *ideal* in **table 3.1**.

b) *Permissible but not desirable*: These include the financing modes that are:

- considered permissible by all
- however, pioneers categorized them ‘not ideal’, but
- regarded equally good by the later pragmatists

These modes are labeled as *not ideal but permissible by majority* in **table 3.1**.

c) *Disputed in permissibility*: These transaction forms are:

- either disapproved or not discussed by pioneers
- treated permissible as well as equally good by later jurists

These modes are labeled as *not ideal and disputed in permissibility* in **table 3.1**.

The ‘*ideal* (desirable) and *not-ideal*’ (not desirable) [categories (a) and (b) in this table] distinction is based upon whether or not the specific transaction/financing mode involves debt and fixed return. If it involves debt and fixed return, it is considered less than ideal in this classification. It should be noted that *Ijarah* in this table refers to composite or conditional *Ijarah* which is the usual practice in Islamic banks. The simple or unconditional *Ijarah* may fall under first best category. The same holds for *Salam* and *Istisna*. The ‘*not ideal and disputed in permissibility*’, category (c), includes those transaction forms which have striking similarity with conventional financial products even in its form. Apart from having fixed return, they also involve the feature of trading

in debt instruments and derivative. They are so classified because these transaction forms were either disapproved or were not mentioned by the early advocates of Islamic banking.

**Table 3.1:** Categorization of Typical Islamic Financial Products

	Status in the light of Pioneer’s Writings		
	<i>Equity based / PLS</i>	Debt based / Fixed return	
	<i>First Best</i>	<i>Second Best</i>	
		<i>First Drift</i>	<i>Second Drift</i>
<b>Financing/ Investment Modes</b>	<i>(a) Ideal— Approved With consensus</i>	<i>(b) Not ideal, but permissible by majority</i>	<i>(c) Not ideal and disputed in permissibility</i>
	<i>Musharakah (Operating partnership)</i>	Diminishing <i>Musharakah (Hire-Purchase agreement)</i>	<i>Bay-ul-e 'inah (Repurchase)</i>
	<i>Mudarabah (Trustee / passive partnership)</i>	<i>Ijarah (Operating lease)</i>	<i>Tawarruq (Reverse Murabahah + Liquidation)</i>
	Shares	<i>Murabahah (Mark-up sale on deferred payment)</i>	<i>Sukuk (Securities)</i>
	<i>Qard Hassan</i>	<i>Salam (Deferred delivery sale on advance payment)</i>	<i>Bai-ul-Dayn (Purchase of debt)</i>
		<i>Istisna (Manufacture sale on advance payment)</i>	Derivatives
			<i>Sukuk (Securities)</i>

Source: Developed by Author

It is important to note here that Khan (2010) divides all of these investment/financing modes under the two classes of ‘main participatory forms’ and ‘main non-participatory or trade-based forms’ instead of using the terms ‘equity and debt based’ for his purposes. However, the proposed classification is not only more relevant for examining the convergence hypothesis of this study but is also more meaningful in the

sense that they reveal the actual essence of trade contract that takes place under Islamic banking—these create outstanding debt unlike a typical trade contract.

### **3.4: ISLAMIC BANKING IN PAKISTAN AND MALAYSIA**

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This section gives a brief sketch of the development of Islamic banking industry in Pakistan and Malaysia because the study examines theory-practice convergence of Islamic banking in these two countries.

#### **3.4.1: Evolution of Islamic Banking in Pakistan**

According to the history, Pakistan came into existence on August 1947 for the purpose of modeling Muslims' lives as per the principles of Islam incorporating it within the modern life world. Regarding the financial matters, Mr. Muhammad Ali Jinnah, the founder of Pakistan, said in his address at the inauguration of the State Bank of Pakistan (SBP):

“I shall watch with keenness the work of your Organization in evolving banking practices compatible with Islamic ideas of social and economic life. We must work our destiny in our own way and present to the world an economic system based on true Islamic concept of equality of manhood and social justice”.<sup>37</sup>

The Objective Resolution 1949 asserts that the State of Pakistan is bound to follow and implement the Will of Allah in this country. A legal body, namely, the Council of Islamic Ideology (CII) was established as Advisory Council of Islamic Ideology on August 1962 under the Constitution of the Islamic Republic of Pakistan 1962 to give legal recommendations and suggestions to the government in order to structure the public life of the citizens of Pakistan according to the Islamic Shariah. Islam being the state identity of Pakistan, the constitution of Pakistan (1973) commits the elimination of Riba as: “The

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<sup>37</sup> Quaid-i-Azam: *Speech at the foundation laying stone of the State Bank of Pakistan*, 1st July 1948.

State shall ...eliminate *riba* as early as possible.” [article 38(f)]. The constitution also binds state to create an environment wherein Muslims can live their lives in accordance with the principles of Islam: “[w]herein the Muslims shall be enabled to order their lives in the individual and collective spheres in accordance with the teachings and requirements of Islam as set out in the Holy Quran and Sunnah”. The emergence of Islamic banking in Pakistan, viewed in this light, can be considered a response to this constitutional commitment.

### **Emergence of Islamic Banking in 1970s & 1980s**

After the Iranian revolution, there was resurgence for the call towards Islamic order of life, led under the movement *Tehreek-e-Nizame Mustafa*, in the latter half of 1975 in Pakistan. The then Army chief, Mr. Zia-ul-Haq, took charge of the country and went to bring legal and practical reforms in order to facilitate the Islamization of the public order of life, including the financial matters. Creating an alternative to interest based banking system henceforth has been a continuous process which could be traced in the light of reports of the Council of Islamic Ideology (CII) of Pakistan first published in 1980. Some of the key steps proposed/implemented in this regard were:<sup>38</sup>

- Amendment in Banking and some other relevant laws (e.g. State Bank Act, BCO (banking companies ordinance, Companies Ordinance, negotiable instruments act etc.)for the facilitation of interest free banking system.
- Preparation of new regulations prescribing the modes of financing, profit distribution system for depositors, financing facilities by SBP, etc. for providing ground work in the direction of Islamization of banking system
- Elimination of interest from the operations of specialized financial institutions in 1979 and from commercial banks during 1981 to 1985

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<sup>38</sup> See State Bank of Pakistan (2008c)



- Amendment in the legal framework of country's corporate system on June 1980 that permitted issuance of riba free Participation Term Certificate (PTC) for corporate financing
- Legal permission for the establishment of *Mudarabah* companies and floatation of Modarba certificates
- To mobilize deposits on the basis of PLS system, separate riba free counters started operations in all nationalized commercial banks in January 1981. As far investment of these funds, banks were asked to provide financing facility to government commodity purchases on deferred payment basis at mark-up price.
- Provision of financing for working capital of trade and industry on the basis of *Musharakah* was allowed in July 1982
- From July 1985, no commercial bank was allowed to accept interest bearing deposits
- *Zakat* and *Ushr* ordinance (applicable to Muslims) was passed in 1980 which divided assets into two categories: (a) those liable to the *Zakat* rate of 2.5% on the date of valuation, (b) those liable to rates such as 5% of land produce in case of irrigated land and 10% for rain-fed land etc.

### **The Deadlock of 1990's**

But the efforts of 1980s saw a turn around when Federal Shariat Court (1990) declared the procedures adopted by the banks un-Islamic on the grounds that most of the financing was based on 'mark-up' technique. The FSC declared that the earlier laws will cease to be effective from July 1992 and order the government of Pakistan to Islamize the financial system on valid Islamic grounds. However, some 67 appeals were filed against this judgment, by the government and some Banks, in the Shariah Appellate Bench (SAB) of the Supreme Court of Pakistan which eventually rejected them in December

1999. The SAB decision was to ban interest in all of its forms and names.<sup>39</sup> The decision declared that laws that allow interest bearing transactions would finally cease to be effective by June 30, 2001. The judgment ordered the government of Pakistan to make a Commission for transformation of the financial system and two task forces for implementation of that system in conformity with Shariah. Though, later on, the decision about the whole transformation of system was put aside in a review petition by the Supreme Court of Pakistan, but it had laid foundation for the groundwork of this emerging sector in the country. The State Bank of Pakistan, hence forward, proceeded ahead for the promotion of Islamic banking in Pakistan. This dead-lock in 1990s can be seen as an echo of the bewildering state of Islamic economic theory that was discussed in section two of this chapter.

### **The Re-birth in 21<sup>st</sup> century**

As a consequence of Supreme Court's judgment, January 2000 saw the Commission for Transformation of Financial System (CTFS) at State Bank and a task force at Ministry of Finance to devise the road map of eliminating interest from the financial transactions. Another Task Force at the Ministry of Law was handed the task of identifying the required legal amendments to accommodate this road map. In September 2001, it was decided that State Bank would allow three kind of institutional set ups to promote Islamic Banking:

- 1) Setting up of subsidiaries by the commercial banks to conduct Shariah compliant transactions
- 2) Exclusive branches of the commercial banks dealing in only Islamic banking
- 3) Commercial banks to carry out banking on Shariah basis exclusively

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<sup>39</sup> The full decision of SAB comprises of around 1,100 pages.

To execute the above, an Islamic Banking Division was launched at State Bank in 2001 to gradually develop a parallel Islamic banking system to the conventional one. Later in 2003, a separate Islamic Banking Department (IBD) was established at State Bank with the vision “to make Islamic Banking, the Banking of First Choice for the providers and users of financial services” and with the mission “to promote and develop Islamic Banking industry with the best International Practices ensuring Shariah compliance and transparency” (State Bank of Pakistan). Then after, Islamic banking took a fast flowing flight in Pakistan as shown below.

### **The Salient Features**

Islamic banking industry took-off under the guidance of Islamic Banking Department in Pakistan within the framework of ‘first drift’ in that fixed return modes were allowed right from its starting time 2003 as indicated by the data on financing modes in **table C1**. Since then, it has continued on the same lines adding more such contracts into its business profile such as investment in government issued *Ijarah sukuk* floated in the market in 2009. The industry has made progress in developing Shariah compliant products to meet client needs. One of such examples is the introduction of *master Muarabahah* which is an equivalent of conventional bank’s over-draft facility. Banks and client enter into a contract by which client agrees to purchase goods from Bank as per his needs over a specified time period. Under this contract, several *Murabahah* dealings can be executed overtime. The total amount of transactions cannot exceed the limit mentioned in the agreement that has to be signed once at the time when the facility is sanctioned by the Islamic bank. Instead of making any significant inroads to achieve the ‘first best’, the key policy features of Islamic banking industry, according to Akhtar (2007), remained as below:

- It was decided by the policy makers that the industry will adopt an evolutionary process rather than revolution, i.e. both systems would operate side by side for some time
- Flexible and accommodationist approach was used to tackle the needs of market
- Building customers' confidence and disseminating awareness about *Shariah* compliant procedures was given importance for the spread of this industry
- It was recognized that all the stakeholders including regulators and practitioners had to equip themselves for the eventual implementation of the new system

It was only recently in 2014 that State Bank of Pakistan has shown an urge to take industry to its desired objectives of promoting 'risk and reward sharing and equitable distribution of economic gains' [SBP (2014): p. ii]. In this regard, an action plan is devised that identifies the required policy measures in four areas: (1) Enabling Policy Environment, (2) *Shariah* Governance & Compliance, (3) Awareness and Capacity Building and (4) Market Development. The last one is meant for undertaking 'product diversification and financial inclusion'. Though the document spells out the importance of using *Musharakah-Mudarabah* contracts, however it does not set any specified target for the industry to achieve during the policy period 2014-2018. Appendix B gives the proposed initiatives of the document. Overall, main emphasis of this policy document is still on increasing market shares (growth) of Islamic banking.

### **Industry Progress**

Al-Meezan Investment Bank Limited was the first one to apply for conversion into a full-fledged Islamic commercial bank in December 2001, and was given license under the name Meezan Bank Limited to start its operation in March 2002. Section 23 of BCO 1962 was amended in September 2003 to facilitate the establishment of Islamic

banking subsidiaries which allowed the conventional commercial banks to join and hence speed up the process of development of the new industry as indicated in **table 3.2**.

**Table 3.2: Islamic Banking Net-work in Pakistan Overtime**

Year	No of full-fledged Islamic Banks	No. of Conventional Banks with Islamic Banking Divisions	No of Islamic bank branches	Branch network growth (%)
2003	1	3	17	
2004	2	9	48	182.4
2005	2	9	70	45.8
2006	4	12	150	114.3
2007	6	12	289	92.7
2008	8	12	515	78.2
2009	6	13	651	26.4
2010	5	13	751	15.4
2011	5	12	886	18.0
2012	5	13	1097	23.8
2013	5	14	1304	18.9
				Avg.=61.6

Source: Islamic Banking Bulletins, SBP

The branch net-work of Islamic banking in Pakistan has an impressive average growth rate of 61.6% in the last one decade, though with considerable yearly fluctuations ranging from 182% in 2004 to 15% in 2010. In addition to phenomenal growth in branch network, Islamic banking has also shown significant growth in total assets and deposits as shown in **table 3.3**.

**Table 3.3: Market share of Islamic Banking in Pakistan (in Billion Rs)**

Description of Item	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total assets	13	44	71	119	206	276	366	477	641	837	1014
% of banking industry	0.5	1.5	2.0	2.8	4.0	4.9	5.6	6.7	7.8	8.6	9.6
Deposits	8	30	50	84	147	202	283	390	521	706	868
% of banking industry	0.4	1.3	1.8	2.6	3.8	4.8	5.9	7.2	8.4	9.7	10.4
Financing & Investment	10	30.0	48.0	73.0	138.0	187.0	226.0	338.0	475.0	626.0	709.0
% of banking industry	0.5	1.3	1.7	2.3	3.5	4.4	4.5	6.2	7.4	8.1	8.5

Source: Islamic Banking Bulletins of various years, SBP

Total assets have grown from mere Rs 13 billion in 2003 to Rs 1014 billion in 2013 showing annual compound growth of 7700%, deposits from Rs 8 billion to Rs 868 billion while investment and financing from Rs 10 billion to billion 709 billion. The financing refers to the amount of advances given to different customers of the bank under different financing modes while the investment relates to banks purchase of different investment options such as government securities, bonds etc. The industry has not only been expanding on its terms but also relative to conventional banking system as indicated by the rising market shares of Islamic banking assets, deposits and financing. These growth numbers indicate that Islamic banking has been flourishing at a rapid pace in Pakistan overtime and it is now time to evaluate its achievements on its own criterion, i.e. convergence to its objectives.

### 3.4.2: Evolution of Islamic Banking in Malaysia

Malaysia has been another country that has remained at the fore front of Islamic finance and banking since early 80s.<sup>40</sup> The origins of Islamic banking in Malaysia can be traced back to a saving management institution, namely, Tabung Haji or Pilgrims Management and Fund Board, that was established in 1963. The institution was a meant to invest savings of those who intended to perform pilgrimage on interest free options. The fund was allowed to use *Mudarabah*, *Musharakah* and *Ijarah* as its basic modes of operations. However, in search of diversification, Tabung Haji started making investments in bonds, corporate notes and government securities overtime. The first legal call for separate Islamic banking was raised in 1980 when participants of seminar held in National University of Malaysia passed the resolution for setting up such a banking system. A National Steering Committee was set by government in 1981 which prepared the blue print of Islamic banking system. The government then passed Islamic banking Act 1983 which allowed Bank Negara Malaysia (BNM) to assume the role of giving license to Islamic banks and regulating them. Bank Islami Malaysia Berhad (BIMB) was established in July 1983 as the first full fledged Islamic bank to promote Islamic banking in the country.

The success of BIMB prompted government to expand the industry and after ten years of its inception, the Islamic Banking Scheme 1993 allowed conventional banks to offer Islamic banking services alongside their conventional interest based products. This move provided a great boost to the progress of Islamic banking in country. In the mid 1990's, steps were taken to develop Islamic Inter-Bank Money Market and Islamic capital markets (ICIM) in the country wherein Shariah compliant securities were supposed to be traded. Security Commission (SC) of Malaysia was established to deal with Shariah

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<sup>40</sup> Most of the details given in this section are based on "Development of Islamic banking in Malaysia", Presentation made at Bank Negara by its staff on Oct 31, 2001

considerations of capital market practices on the one hand and undertake research on product development. Shariah Advisory Council (SAC) consisting Islamic scholars and Islamic finance experts was also established in 1996 which was supposed to advise SC about Shriah rulings of ICM products and practices. The monopoly of BIMB was broken with the establishment of Bank Muamlaat Malaysia Berhad (BMMB) as second Islamic bank of the country. Islamic banking industry of Malaysia consists of full-fledge Malaysian Islamic Banks (BIMB and BMMB), full-fledge foreign Islamic banks (Kuwait Finance House, Al-Rajhi Banking and Investment Corporation), Islamic subsidiaries (Commerce TIJARI Bank Berhad, Hong Leong Islamic Bank Berhad, RHB Islamic Bank Berhad) and Islamic window operation by several conventional commercial banks.

There are two views about why the government of Malaysia embraced Islamic banking enthusiastically. One view is that it was response to the needs to Muslims in the country [Bank Negara Malaysia (1983): p 16]. But Torii (2003) is of the opinion that Islamic banking was a strategic move of Dr Mahatir, the former prime minister, to involve Muslims in the national economic development through promoting Islamization. The plan, according to him, was to motivate Muslims to increase their saving rates and channelize these savings in the banking system. Hence, Islamic banking was a means for government to stimulate national saving rates to materialize its development agenda.

Debt-like fixed return modes have remained in practice in Islamic banking of Malaysia. The introduction of Islamic money and capital markets slowly drifted Islamic banks towards the use of securities (*Sukuk*). Islamic banks of Malaysia now deal in all types of Islamic contracts including *Bay-ul-E'inah* and *Tawarruq* (see in chapter 5). No significant effort seems to have been made to guide the industry to its original theory. Government of Malaysia prepared ten years master plan for financial sector development of the country with focus on *building institutional capacity* and *development of the*



*supporting financial infrastructure* of Islamic banking industry of the country [Laldin (2008)]. The plan had three phases: from 2001-2004 for improving operational infrastructure, from 2005-2007 for intensifying industry competition, and from 2008-2010 for progressive liberalization. The document lists ten key areas of interference none of them even emphasizing the need to structure the industry on the first best theory.

### **Industry Progress**

Establishment of International Islamic Money Market and Islamic Financial Services, meant to streamline international standards for Islamic banking, are two other significant initiatives of Malaysia. Other achievement that Malaysian Islamic financial industry achieved included the first issuance of *sukuk* by a foreign-owned company in 1990. Introduction of the first global sovereign *sukuk* in 2002 and the first real estate trust fund (I-REIT) in 2006 were other pioneering innovations that took place in Malaysian Islamic financial system.

Islamic banking has made significant inroads in Malaysia shown in **table 3.4**. Total assets have grown from 73,801 million RM to 394,605 million RM experiencing cumulative growth of 440%, similarly advances and deposits have shown cumulative growth of 578%. Market share of Islamic banking industry has become 20% in terms of assets, advances and deposits. The number of Islamic banks increased from 1 to 16 since 2013 in three decades [Bank Negara Malaysia (2013)]. Just like the experience of Pakistan, Islamic banking in Malaysia has also followed evolutionary process but it has remained more progressive, dynamic and pragmatic as compared to that of Pakistan.

**Table 3.4: Market Share of Islamic Banking in Malaysia (in Million RM)**

Description of Item	2006	2007	2008	2009	2010	2011	2012	2013
Assets	73,801	94,892	185,912	224,938	258,725	326,841	373,275	394,605
% of Banking industry	6.8	7.8	13.9	15.8	16.7	18.3	19.5	19.8
Advances	36,542	46,137	104,027	132,812	158,692	196,539	232,398	247,838
% of Banking industry	6.2	7.2	14.4	17.0	18.0	19.6	21.0	21.6
Deposits	58,470	75,169	149,931	181,877	211,837	261,542	301,537	316,235
% of Banking industry	7.2	8.7	15.4	17.1	18.6	20.1	18.6	21.6

Source: BNM

## Chapter

# 4

# Hypotheses Development and Empirical Methodology

Given the theoretical evolution and objectives of Islamic banking in previous chapter, this chapter will use that framework (a) to map the practice of Islamic banking into its objectives set by its pioneers and (b) develop an appropriate empirical methodology to test whether the practice of Islamic banking matches with its objectives. In other words, this chapter develops the framework using which the practice of Islamic banking can be compared against its theory.

## 4.1: HYPOTHESES DEVELOPMENT

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Having reviewed the theoretical development and objectives of Islamic banking discipline in the last chapter, we spell out empirical hypotheses to verify convergence between theory and practice of Islamic banking. The objective of this study is to investigate whether Islamic banking has been progressing towards its ideals as visualized by its pioneers or it has been drifting away from those ideals. Given this objective and the fact that the basic motive behind launching Islamic banking was faith, it would not be advisable to run a proto-type multi-regression equation to identify any other significant factor for sizable expansion of Islamic banking over years. To achieve the objective of this study, two types of hypotheses have been developed corresponding to its objectives: (1) *procedural* which provide the criteria to measure the extent to which Islamic banking has approached its desired procedural change and (2) *consequential* which identify the

extent to which Islamic banking has helped bring about its desired outcome. Both types of hypotheses are discussed in turn. The first type of hypotheses is directly deducible from the first objective of Islamic banking while the second ones are indirect inference from the second objective that the pioneers of Islamic banking conceptualized.

#### **4.1.1: Procedural Hypotheses**

As stated above (and in the last chapter), the point of departure of Islamic banking from its conventional counterpart is characterized by the move from a debt-and-fixed-return based financial system to a risk-sharing based financial arrangement formulated in *mudarabah* and *musharakah* contracts. Alternatively stated, an ideal Islamic banking system must be reflected through the balance sheet structure of Islamic banks heavily dominated by profit-loss-sharing (PLS) on both asset and liability sides. Under such a system of banking, any adverse outcome on the asset side of the bank is passed on to risk sharing depositors of the bank on the liabilities side. If Islamic banking is committed to its declared objectives, then the following self-explanatory hypotheses should hold regarding the practice of Islamic banking:

*Hyp. 1: the share of 'ideal' modes is greater at any point in time and rising overtime relative to 'permissible but not ideal' modes both in financing as well as deposits of Islamic banking*

*Hyp. 2: No share is allocated to 'Disputed or disapproved earlier' modes in principle; but if some is allocated, it is eliminating overtime*

#### **4.1.2: Consequential Hypotheses**

A direct approach of testing objective 2 is to reflect upon the fact that according to Islamic economists [Chapra (1993), Haron (1996), Rahman A. (2007) Abo Zaid

(2008)], one of the interesting implications, resulting from the replacement of interest based financing by PLS, is that it promotes SME and micro-financing. Rising SME sector thus is expected to increase the share of labor class in national income and reduction in wage inequalities. Nugent (1989) examined the dispersion of wages across workers in Korea and found that its dispersion is lower for SMEs.

These enterprises play key role in promoting inclusive growth by providing employment to low or even unskilled segment of the economy. Islamic banking is expected to be more inclined to SME because of two reasons: (1) commitment to promote equity and (2) unlike conventional banks with their collateral-and-creditworthiness based lending favoring large established corporations, PLS instruments are quite compatible with the requirements of small entrepreneurs having viable projects which are usually ignored by the conventional banks. Since the proponents of Islamic banking put this system as a superior alternative to the conventional system, the above equity concern of Islamic banking should be evaluated against the conventional one on the same parameter. The following behavioral regularity is expected to hold:

***Hyp. 3:** financing offered by Islamic banks to SME sector of the economy is rising overtime relative to that offered to the corporate sector. Moreover, the share of financing to the SME sector of the economy in Islamic banking system is greater than that in conventional banking*

Another line of observing whether equity claim is being pursued by Islamic banks is to examine their financing pattern to different industries or sub-industries of the economy.<sup>41</sup> This differential in financing preference across different industries can be theorized on the principle of *ethical investment* [Nienhaus (2011)]. This concept includes

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<sup>41</sup> Subject to the availability of data

a 'negative list' which points out the business activities that fall in the category of prohibited (such as drugs and alcohol or pork in case of Islamic banking). However, beyond this negative list, there is a second tier-filter of 'positive lists' which determines preferential areas of financing and investment through which certain activities are promoted in the economy to improve welfare. The objective of Islamic banking is not to focus on investment areas that are already considered desirable by the interest based banking, rather to prevent the 'concentration of investment'. Moreover, this positive list also implies avoiding those industries that are already heavily 'polluted by interest' element. This gives the observable behavioral pattern that 'industry financing profile' of Islamic banking should be much different from that of the conventional banking system. This also holds given the proposition made in support of Islamic banking that this system will promote efficiency and equity due to its orientation towards profitability of projects and not credit-worthiness of borrower; hence projects from small entrepreneurs will be more readily acceptable in this system as compared to conventional banking system. We have the hypothesis:

***Hyp 4:** Difference between Islamic and conventional banking's financing for different industries is observed; with Islamic banking entertaining the neglected industries of the economy more than the conventional one*

Chapter 3 spelled out the views held by the pioneering Islamic economists that Islamic financial system should not only be concerned with the maximization of profit, rather it should seek to promote equity as well in order to be in line with the spirit of *Shariah*. To them, Islamic banks should behave systematically different from conventional ones in setting its priorities for the promotion of fairer distribution of income and protecting the needs of society. Al-Zuhayli (2003), like other Islamic

economists, endorses this socio-economic framework for Islamic financial institutions: ‘the primary goal of Islamic financial institutions is not profit-making, but the endorsement of [the] social goals of socio-economic development and the alleviation of poverty’ (Al-Zuhayli (2003), p. 350). He is of the view that while making profit from their business ventures is allowed for Islamic banks; the accumulation of profit without taking care of distributing it for the welfare of society is undesirable. This means that Islamic banking is perceived as much more than merely prohibition of interest rate, it is an instrument to the creation of just social order that facilitates fulfillment of socio-economic objectives [Siddiqui (2001), Mehmet (2007)]. With this bigger goal in view, Islamic banks are supposed to be more sensitive to the needs of society, promote more welfare programs, and make more contributions towards the needy and the poor segments in society. In this regard, an important indicator of welfare orientation of Islamic banks is the share of *Qard Hasan* as pointed out above. This implies that the share of *Qard Hasan* should be significant enough and be rising overtime. However, to convert it into empirically verifiable form, some bench mark level of the share of *Qard Hasan* is required. For this purpose, we use 2.5% share of Zakat as minimum bench mark for *Qard Hasan*. Hence, the following hypothesis should hold for convergence between theory and practice of Islamic finance to hold true:

***Hyp 5: the share of Qard Hasanis at least 2.5% in total financing***

One of the criticisms, we noted in the last chapter/essay, leveled by Islamic economists on the interest bearing system was its contribution in concentration of wealth and hence promotion of power inequality in society. Islamic economists believe that substitution of interest bearing system with Islamic one will help minimize this power. The large source of this power is based on interest based bank lending offered on credit

worthiness principle that makes large business units a suitable candidate for bank lending. Islamic financial system, according to Islamic economists, will reduce this concentration of wealth by denying this very principle as profitability and not credit worthiness is the guiding principle behind Islamic transaction forms.

Results of hypotheses 3 and 4 would reflect the contribution of Islamic banks for improving resource allocation in favor of low-income and small-sized producing units of economy. By using argument from analogy, the same contribution for *consumer sector* can be captured by an examination of the earning profile of Islamic banking borrowers in the category of personal financing. In this regard, the share of financing opportunities offered to relatively low income groups should be greater for Islamic banks as compared to conventional banks. Islamic economists, as explained previously, claim that a moral filtering out process ensures discouragement of some forms of consumption patterns for different reasons such as social cohesion, avoidance of waste and excessive spending, simplicity. For this consolidation purpose, the following two supplementary hypotheses are proposed:

***Hyp 6:*** *The clients'/borrowers' income profile is different in Islamic banking in personal loan category as compared to the conventional one, i.e. more financing is offered by Islamic banks to relatively lower income earners/asset holders*

For strict theory-practice convergence to take place in Islamic banking, all of the above hypotheses are supposed to hold. However, majority must hold for this convergence in a mild some. **Table 4.1** gives a schematic summary of objectives and the corresponding hypotheses to test them.



**Table 4.1:** Summary of Objectives and Corresponding Testable Hypotheses

	Objective	Hypotheses to Test
1	Promotion of equity-based financing	<i>H1:</i> Larger and rising share of ‘ideal’ modes relative to ‘permissible but not ideal’
		<i>H2:</i> No or eliminating share of ‘disapproved’ modes
2	Promotion of welfare	<i>H3:</i> Increasing financing for SME sector. Larger financing for SME by IB as compared to that by conventional banking
		<i>H4:</i> Systematic difference b/w Islamic and conventional bankings’ financing for different industries; with Islamic banking entertaining the neglected industries more than the conventional
		<i>H5:</i> Minimum 2.5% share of <i>Qard Hasan</i>
		<i>H6:</i> Larger share of personal financing for relatively low income holders in Islamic banking as compared to conventional one

## 4.2: SAMPLE AND VARIABLES

Islamic finance made its appearance in 1970’s and by now has gone beyond fad at the level of both theory and practice. This is indicated by the fast growing literature on this field and also by its assets of around 1,460 billion dollars [GIFR (2012) and IFSL (2013)]. Its global average annual growth rate has been 24 percent over the last seven years [IFSL (2013)]. Today, Islamic financial institutions are operating in more than 70 countries. Global market indexes, e.g. Dow Jones Islamic Market Index, have also been

developed which attempt to track 600 companies whose products meet Shariah standards. Some 700 Shariah compliant institutions are registered in financial assets [(IFSL 2013)]. The industry has large growth potential as implied by the facts noted by Rung, Travis and Rico Brandenburg (2011) and UKIFS (2013):

- Muslim population is about 25 percent of the world population
- less than 20 percent Muslims around the world use Islamic financial products
- the Shariah compliant assets consist of only 1 percent of total global assets

These points imply that its share can go up to 5 percent of total global assets from its current position of 1 percent if average asset holding of an Islamic finance client equals that of a conventional finance client.

Analyzing the convergence behavior of such a wide spread industry is difficult due to the unavailability of consistent time series data. Due to this reason, we have restricted empirical analysis to Pakistan and Malaysia. Several considerations justify the choice of these countries for this study purpose:

- *Firstly:* Pakistan and Malaysia are the pioneering countries, both on academic as well as practical fronts, of Islamic banking
- *Second:* Official and consistent time series data on variables that are relevant for this study is available for both these countries over a considerable period of time during twenty first century
- *Third:* the growth of Islamic banking in Pakistan and Malaysia has been quite healthy as it has captured almost 10 percent of the market share in one decade in Pakistan while its share has reached 20 percent in Malaysia. On the other hand, for example, starting in 2000, Islamic banking in Turkey could achieve the market share of 5.6% by 2012 while in Indonesia it captured 4.6% market share by 2012 [EY (2013)]. This

relatively fast growth performance of Islamic banking in the two countries provides a motivation to examine this fast growing segment of Islamic banking

The behavior of entire Islamic banking industry is examined for both the countries during twenty first century because the earlier practices of Islamic banking, especially in Pakistan, were brought into question by the judgment of Supreme Court of Pakistan in 1999. Exclusive Islamic banking started in Pakistan in the twenty first century. Therefore, the industry in Pakistan is studied for its entire duration of 2003 to 2013. To conduct the comparative analysis as required for several hypotheses, we use data of conventional banking industry in Pakistan. Because detailed time series data on Islamic banking for Malaysia is available only from 2006 onwards, we analyze it over the period of 2006 to 2013.

Data on the following variables is used in the coming chapter to empirically verify the above hypotheses and to derive the results.

- Financing of Islamic banking by different modes of financing
- Sector wise financing of Islamic and conventional banking
- Industry wise financing offered by Islamic and conventional banking
- Amount of advances or loans of Islamic and conventional banking

Most of the relevant banking data is collected from the several publications, such as Islamic Banking Bulletins, Quarterly Compendiums, of State Bank of Pakistan regarding financial and banking sector in the country and some is obtained from the Annual Reports of Islamic banks. Similarly, banking data of Malaysia is obtained from its central bank Bank Negara Malaysia and annual reports of Bank Islam Malaysia.

One data limitation faced in this study is about data *frequency* and *length*. Not all the relevant and required data is available with the same frequency in the country; for

some variables it is provided on quarterly basis while for others only yearly data is available. Similarly, in some cases, data is available back till 2003 while for others it is not the case. To summarize, working balanced-panel type data is not possible to test all hypotheses due to data limitations. However, these limitations have very little bearing on the results that are derived from the analysis.

### 4.3: ESTIMATION TECHNIQUES

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#### 4.3.1: Procedure for Testing Hypotheses

This section elaborates the estimation techniques that are used to test the above listed six hypotheses.

##### **For Hypothesis 1**

This hypothesis has two elements: (1) that the share of *ideal* modes is larger than *not ideal* ones, and (2) that this share is rising overtime. The hypothesis is tested for the two elements one by one as follows:

##### ***1) Comparison of share across financing modes***

The shares of *ideal* and *not ideal* modes are compared with each other in financing and deposits sides of Islamic banking. The share of each mode is given by the ratio of amount allocated for financing using specific mode to total Islamic banking financing.

##### ***2) Trend of shares over time***

To evaluate hypothesis 1 in this form, statistical significance of the trend of equity based (EB) financing to debt based (DB) financing is examined. For this purpose, the ratio of equity-based to equity plus debt-based modes is regressed against time to examine how equity-based modes behave in their sum over time:

$$\left(\frac{EB}{EB+DB}\right)_t = a + bTime + e_t \quad (4.1)$$

A significant positive time-coefficient ( $b$ ) of this regression would imply that the share of asset based financing has increased significantly in the composite financing over time. This in turn will lead to the confirmation of hypothesis 2 and hence would suggest convergence between theory and practice. On the other hand, an insignificant or negative significant coefficient would imply divergence. This gives us the null and alternate hypotheses for  $b$ :

$H_0: b = 0$	Accepted: Neither convergence nor divergence Rejected: <ul style="list-style-type: none"> <li>• <math>b</math> Significantly positive <math>\rightarrow</math> convergence</li> <li>• <math>b</math> Significantly negative <math>\rightarrow</math> divergence</li> </ul>
$H_a: b \neq 0$	

#### *'Time to Convergence' Method*

While evaluating the convergence possibility of Islamic banking to its ideal, an important question to examine is: can it achieve this ideal, and if yes 'how long will it take to reach it? If  $b > 0$  in the above test, it implies that the industry is moving towards its ideal. But in order to say that industry has converged, we need to define the condition under which Islamic banking can possibly be said to have converged to its desired objective (i.e. promotion of 'ideal modes'). In other words, a bench-mark needs to be defined which, if attained, would indicate the convergence and otherwise not. Given the fact that Islamic economists idealize the 'ideal modes of financing', the bench mark may be set by the fact that its share should be greater in its overall financing basket. Taking this 'larger share' of ideal modes in the minimal sense implies 51% share at least (or any bench mark number above it, say 2/3 or 3/4, but we take it in the strict minimum sense of majority here). Thus, convergence would be observed when the share of ideals modes has

exceeded 51% in the total business profile of Islamic banking. The ‘condition of convergence’ to this bench mark level can now be defined as follows:

*If the growth rate of ‘ideal modes’ is greater than the overall growth rate of Islamic banking financing, convergence can possibly take place to the bench mark level*

Defining the average annual growth rate of ideal modes as  $g_{im}$  and that of Islamic banking industry as  $g^{IB}$ , the above can be put as:

$$\text{if } g_{im} > g^{IB} \rightarrow \text{Converge possible} \quad (4.2a)$$

$$\text{if } g_{im} < g^{IB} \rightarrow \text{Not possible} \quad (4.2b)$$

Because we are interested in the time that it will take the share of ideal modes ( $sh_{im}$ ) in total financing to reach its minimum target level 51%, we calculate  $Sh_{im}$  by taking the ratio of financing under ideal modes to total financing:

$$Sh_{im} = \frac{\text{Financing under ideal modes}}{\text{Total financing}} \times 100 \quad (4.3)$$

The question is important for itself because, even if some convergence may be seen in the past data set, the next logical issue of interest is ‘in how long’? *The longer is the time period required to reach the target level (assuming that the ‘current trend’ would hold keeping other things constant), the less likely is the convergence, given the recent past performance and trend.*

For the purpose of finding time needed to approach the target value (51%), different forecasting methods are used. These methods include: AR-model, time trend model and AR + Time trend models. Since the data used to test this condition is quarterly, the above forecasting methods are applied on actual as well seasonally adjusted series of share of ideal modes ( $Sh_{im}$ ), after checking for seasonal variation, to come up with better forecast. Dividing each  $Sh_{im}$  data value of the specific quarter of every year by the

corresponding seasonal factor of that quarter gives seasonally adjusted series. The seasonal factor of each quarter is given by dividing the average of each quarter by the overall average of the series; i.e.

$$\text{Seasonal factor of Quarter } i = \frac{\text{Average of Quarter } i}{\text{Overall average}} \quad (4.4)$$

Where average of  $i^{\text{th}}$  quarter is given by:

$$\text{Average of Quarter } i = \frac{\text{Value of } i^{\text{th}} \text{ Q for every year}}{\text{Number of observations}} \quad (4.5)$$

The choice of the best fitted model is made on the basis of mean absolute deviations (MAD) and mean squared errors (MSE) criteria. The forecasting rule that has lower values of MAD and MSE are better than the one that has larger values.

### **For Hypothesis 2**

In order to test this hypothesis, financing data of disapproved modes (e.g. *Tawarruq* and *Bayul-E'inah*) is examined in case of Malaysia only because data about the use of these modes is not available in case of Pakistan. Investment profile of Pakistani Islamic banks is investigated to verify the presence of investment instruments that fall under the category of disapproved modes. Moreover, an indirect approach is adopted to verify this hypothesis for Pakistan by checking the list of State Bank of Pakistan's approved modes of financing. If this approved list includes some or all of these earlier disapproved modes as one of the approved modes of finance for Islamic banks in Pakistan, this implies that Islamic banks are in principle not barred from the use of these modes.

### For Hypothesis 3

To examine this hypothesis, share of financing provided to SME sector relative to the corporate sector in Islamic banking is compared. If SME share is increasing overtime relative to that of corporate, then further investigation is applied, else the hypothesis is disproved.

To verify this hypothesis alternatively in case of Pakistan, the actual share of SME financing with the target shares set by the State Bank's (2008) policy document on *Handbook on Islamic SME Financing*. While this document spells out the importance of SME financing and lays out its procedure, it also sets specific targets in this regard for Islamic banking industry of Pakistan. Only if the actual shares of SME exceed or equal its target shares that the hypothesis would hold and so would convergence.

Since hypothesis 3 also relates to the comparison of SME and corporate financing of Islamic banking with that of conventional banking, we compare Islamic banking shares of financing to corporate and SME sectors with those of conventional banking. As per the hypothesis, the relative share of SME financing in Islamic banking should be larger than that of in conventional banking system. To compare these relative shares in both banking systems, we define the relative share of SME in the sum of SME and corporate shares for both banking systems as:

$$\text{Relative share of SME financing} = \frac{\text{Share of SME financing}}{\text{SME Share} + \text{Corporate Share}} \quad (4.6)$$

Only if the relative SME financing share is significantly larger in Islamic banking then the hypothesis would hold.



#### **For Hypothesis 4**

For testing this hypothesis, industry financing shares in both conventional and Islamic banking systems are compared. To see how different these financing shares in Islamic banking are from its counterpart, we calculate rank-correlation for each corresponding year between the financing shares of the two systems. For above hypothesis to hold, the value of rank correlation should be close to zero or preferably negative to indicate significant difference in industry financing preferences of Islamic banking as compared to conventional one.

#### **For Hypothesis 5**

Another important hypothesis for testing convergence towards objective 2 is to examine the share of *Qard Hasan* in the total financing of Islamic banking. Its share should be at least 2.5% for convergence to hold.

#### **For Hypothesis 6**

As explained, the welfare commitment of Islamic banking implies larger personal financing for relatively low income segment of society as compared to that in conventional banking. Direct testing of this hypothesis requires an examination of the earning profile of individuals getting personal financing from Islamic banks. However, banks don't provide this type of data due to customers' privacy concerns. An indirect approach is, hence, required in this matter. We propose two such methods here.

#### *Method of Concentration of Personal Financing*

The idea is to examine how the 'number of advances (loans)' and the 'total amount of those advances' vary across different 'size of advances'. For example, how many advances were given to individuals in the range from 1-to-10,000, similarly how

many advances in the range of 10,000-to-50,000 and so on. This data set, when arranged, would look like as shown in **table 4.2**.

**Table 4.2:** Illustration of advances data by the size of disbursement

Size of Advances	Number of advances offered	Amount of advances offered (Rs)
Less than 10,000	98	81,679
10,000 to 50,000	124	5,670,243
50,000 to 100,000	106	8,643,105
100,000 to 150,000	153	...
....	...	...

Hypothetical data for illustration

This data set provides the foundation for the following relationship that we term ‘advances inequality indicator’ (*AII*):

- if the amount of advances remain the same in all advance-sizes arranged in ascending order, this would imply perfect equality—something similar to the line of perfect equality of Lorenz curve
- However, if the amount of advances increases as the size of advances moves into the larger brackets, this would reflect inequality. Thus, the larger is the difference between the line of equality and the actual spread of advances in different advances’ sizes, the larger is the inequality created by the banking system.

The plausible underlying assumption behind this method is that the size of disbursement offered by the banking system reflects the earning or asset profile of the borrower, i.e. more ability to pledge collaterals with the bank, more capacity to repay due to higher income. Therefore, if the amount of advances increases at higher ‘size of advances’, it means more and more amount is being offered by the banking system to those who are relatively rich. As the size of this inequality rises, this reflects that the banking advances are concentrated more among the higher income people in the economy. In this

connection, if more advances are concentrated in low advances ranges, this would indirectly reflect that low income or asset people are benefitting more from the banking system and, hence, equity and welfare.

The converse will hold otherwise. For convergence to hold in hypothesis 6, the share of personal advances concentrated in the lower 'range of advances' should be greater for Islamic banks than conventional ones. Inequality in the above explained sense would imply divergence in this regard. This type of disbursement data could not be made available for Pakistan. Future researcher having access to this type of data set for Pakistan can examine this hypothesis through this method.

#### *Method of Consumer Based Product Feature Analysis*

An alternative method is to examine and compare the 'features of products' offered by Islamic bank and conventional bank to its customers. Here, *features* refer to its financing terms and conditions (e.g. eligibility criterion, relationship between the amount of financing limit and earning profile of the customer etc.). If:

- the financing limit increase as the earning profile of the customer increases and/or
- the minimum criterion to become eligible for Islamic bank financing is higher, and/or
- the list of items financed by the Islamic banks relate more to higher income earners than lower ones

the less financing will flow to the low income earners as compared to people in the higher income brackets and hence more inequity and less welfare effects. This method is used for Pakistan while the previous one is used for Malaysia.

#### **4.3.2: Analytical Tools**

Following statistical and mathematical tools and technique are thus applied to test the relevant hypotheses:

- *Trend analysis:* This method is applied to trace the pattern of a particular time series over time so as to compare this observed trend with the hypothesized one. Apart from deriving results from simple graphical trends, time regression is also used
- *Forecasting methods:* These are used to analyze the question ‘how long it may take for convergence to be attained with respect to a specific objective’. In this regard, two methods are used: (1) time-trend based forecasting, (2) auto-regressive (AR) process based forecasting. Relevant statistical statistics, such as mean absolute deviation, are used to make the choice of the best fitted forecasting method among these
- *Rank correlation:* This is brought into use in connection with comparing the ranking of particular industries in Islamic and conventional banking when it comes to their financing preferences to these industries.

## Chapter

# 5

## Empirical Results

Chapter 4 outlined the hypotheses against which the objectives of Islamic banking can be tested using the methodology described in chapter 4. This chapter shows the empirical analyses of those hypotheses and results. These results would indicate the behavior of Islamic banking in Pakistan and Malaysia in terms of its convergence to its ideals.

### 5.1: EMPIRICAL ANALYSIS FOR PAKISTAN

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The descriptive statistics of the key variables involved in analysis over the study period is listed in table 5.1 for Pakistan. The average share of debt based financing was 94.2 percent while that of equity based was 2.1 percent. Average financing to corporate sector remained 67 percent as compared to 8 percent average financing share to SME sector. The numbers indicate that the practice of Islamic banking industry in Pakistan showed little variation as the standard deviations and the difference between minimum and maximum values remained low.

**Table 5.1: Descriptive Statistics of Financing under Different Modes and for Sectors for Pakistani Islamic Banking**

	<b>Equity Based</b>	<b>Debt Based</b>	<b>SME Financing</b>	<b>Corporate Financing</b>
Minimum Share (%)	0.7	89.2	4	58
Maximum Share (%)	4.6	98.9	16	74
Average Share (%)	2.1	94.2	8	67
Standard Deviation	1.28	2.7	0.04	0.06

Source: Islamic Banking Bulletins of SBP

### **Hypothesis 1: Comparison of Shares across Financing Modes**

The proposed hypothesis is tested using data of Islamic Banking industry of Pakistan in this section. The relevant hypothesis to be tested is:

*Larger and rising share of ideal modes in deposit, financing and investment components relative to permissible but not ideal modes*

This hypothesis has two components of analysis: the share of ideal modes is greater at any point in time and that this share is rising overtime. We test it in its both forms for the three components one by one as follows.

#### *For Financing Component*

**Table C.1** appendix C shows the share of each mode of financing in the total financing provided by the Islamic banking industry in Pakistan from 2003 to 2013. The annual cumulative shares of equity based (columns 1+2) and debt based (columns 4 to 8) modes are given in **table 5.2**. It is clear from this table that the share of equity based modes has remained quite thin while that of debt based overwhelmingly dominates the business profile of Islamic banks in Pakistan. The average share of PLS based ideal modes has been 2.1 percent (with very little standard deviation of 1.28) while that of debt based has remained 94.22 percent (with just 2.68 standard deviation showing a fairly stable behavior of this series).

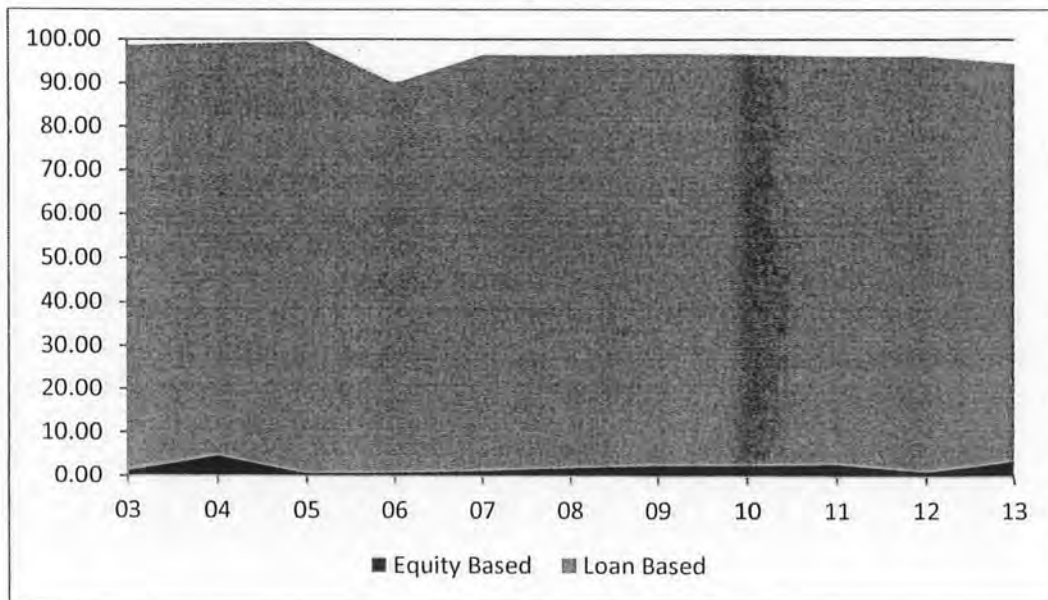
**Table 5.2: Cumulative Distribution of Advances by Categories in Pakistani Islamic Banking Industry (% Annual Shares)**

Years	Equity Based	Debt Based
2003	1.28	97.36
2004	4.60	94.46
2005	0.53	98.91
2006	0.74	89.15
2007	1.26	95.12
2008	1.99	94.34
2009	2.61	94.11
2010	2.58	94.00
2011	2.88	93.19
2012	1.08	94.98
2013	3.60	90.82
<b>Avg.</b>	<b>2.10</b>	<b>94.22</b>
<b>SD</b>	<b>1.28</b>	<b>2.68</b>

Source: Islamic Banking Bulletins of SBP

The relationship between shares of ideal (asset or PLS based) modes and of debt modes is more visibly indicated in **figure 5.1** with almost non-existent layer of asset based financing (represented by black-shaded area at the bottom) as compared to debt based (represented by gray-area).

**Figure 5.1: Equity-Based Financing Relative to Debt-Based in Pakistan**



This figure brings us to the rejection of hypothesis 1 (i.e. the share of ‘*ideal*’ modes of financing should be greater relative to ‘*permissible but not ideal*’ modes). Thus, we conclude that hypothesis 1 does not hold in case of Pakistan and convergence is not achieved between theory and practice of Islamic banking on this front.

#### *For Deposit Component*

The deposit side of Islamic banking shows a different picture as compared to the above as reflected in **table 5.3** which lists the nature of deposits and its underlying Islamic contract. This list indicates that other than current accounts, almost all deposits / accounts are based on *Mudarabah* mode (i.e. one of the ideal modes). Thus, it is fair to say that Islamic banks are maintaining their link to their depositors on the basis of ideal financing modes.

**Table 5.3: Deposit Modes of Islamic Banking in Pakistan**

<b>S.no.</b>	<b>Nature of Deposits / Accounts</b>	<b>Underlying Islamic mode</b>
1	Current	Qard
2	FCY Current Account	Qard
3	Saving	Mudarabah
4	Karobari Munafa	Mudarabah
5	FCY Savings	Mudarabah
6	Dollars Mudaraba Certificate	Mudarabah
7	Certificate of Islamic Investment	Mudarabah
8	Meezan Amdan Certificate	Mudarabah
9	Meezan Providence Certificate	Mudarabah
10	Monthly Mudarabah Certificate	Mudarabah



S.no.	Nature of Deposits / Accounts	Underlying Islamic mode
11	Meezan Business Plus	Mudarabah
12	AlBaraka Incentive Account	Mudarabah
13	AMI Joint Pool Account	Mudarabah
14	Islami Bachat Account	Mudarabah
15	Islamic Amadani Certificate	Mudarabah
16	Term Deposit Mudaraba	Mudarabah
18	Special Musharaka Certificate	Musharakah

Source: Handbook of Islamic Banking Products & Services, SBP

### Hypothesis 1: Trend of Shares Over time

#### *Time Trend Method*

To evaluate the trend of *ideal* modes' share relative to *permissible but not ideal* modes overtime, equation (4.1) is estimated to examine the statistical significance of the trend of equity based financing to debt based financing. Share of ideal modes relative to debt based is calculated using data in **table C.1**. The results of this time regression are shown in **table 5.4** (robust standard errors are obtained due to the presence of Heteroskedasticity in the model suggested by White Heteroskedasticity diagnostic test).

**Table 5.:** Estimation Results of Time Trend of Equity to Debt Based Modes in Pakistan

*Dependent Variable:* Equity Based financing as ratio of Equity plus Debt Based financing [EB/(EB + DB)]

White Heteroskedasticity-Consistent Standard Errors & Covariance				
<i>Variable</i>	<i>Coefficient</i>	<i>Std. Error</i>	<i>t-Statistic</i>	<i>Prob.</i>
C	0.0141	0.00526	2.6625	0.0122
TIME	0.00051	0.00033	1.5391	0.1339
R-squared	0.1255			

The null hypothesis for  $b$  is that it is zero and it is accepted at 95% (even at 90%) confidence interval. This means that, apart from being very small (0.0005), the coefficient is insignificant which implies that the equity based financing as ratio of debt based financing has not increased significantly in the last decade in Pakistan. The hypothesis 2, thus, also suggests non-convergence between theory and practice of Islamic banking.

#### *'Time of Convergence' Method*

We now check how long Islamic banking may take to approach to its minimum bench mark level in Pakistan. The data used for the estimation / calculation of the required time of convergence is given in **table C.2** (Appendix C). Using data on financing mix of Islamic banks, **table C.2** gives the calculated share of ideal modes of financing in total financing ( $Sh_{im}$ ) in column 2 & 5. This is generated using formula (4.3). To capture seasonal variations,  $Sh_{im}$  series is seasonally adjusted using (4.4) and (4.5). Seasonal factors that are used to construct series in column 3 and 6 of **table C.2** are given in **table C.3**. Using seasonally adjusted series usually gives more reliable estimate of time trend for the forecasting purpose. Following methods are applied to check for 'time convergence condition'.

#### *a) The AR Model*

Applying auto-regressive moving average;  $ARMA(p,q)$  where  $p$  and  $q$  represent the order of autoregressive and moving average processes of the underlying series, type models are typically used for univariate forecasting purposes. Only  $ARMA(1,0)$  is found to be significant for the given data set (all MA and higher order AR terms were insignificant). Thus, the equation to be estimated is  $AR(1)$  process. Its resulting coefficients are:

$$Sh_{im(t)} = a_0 + b_0 Sh_{im(t-1)} \quad (5.1)$$

$$Sh_{im(t)} = 2.968 + 0.775 Sh_{im(t-1)}$$

This is a first-order differential equation and we need to check how long it will take to converge to 51% level of  $Sh_{im}$ . Its solution is given by:

$$Sh_{im(t)} = (Sh_{im(o)} - 12.1143) (0.775)^t + 12.1143 \quad (5.2)$$

Solving (5.7) for  $t$  gives:

$$t = \frac{1}{\log(0.775)} \times \log \left( \frac{Sh_{im(t)} - 12.1143}{Sh_{im(o)} - 12.1143} \right) \quad (5.3)$$

The target value of  $Sh_{im(t)}$  is 51 (so numerator is ok) but in the given data series, the value of  $Sh_{im(o)}$  is 1.283 which means negative value in denominator having no real log value and, hence, no real solution exists for this equation. In other words, there is no  $t$  in (5.3) for which  $Sh_{im(t)} = 51$ . Applying the same AR(1) process of seasonally adjusted series gives the equation:

$$SaSh_{im(t)} = 2.273 + 0.462 Sh_{im(t-1)}$$

which solves into:

$$Sh_{im(t)} = (Sh_{im(o)} - 4.225) (0.462)^t + 4.225$$

$$t = \frac{1}{\log(0.462)} \times \log \left( \frac{Sh_{im(t)} - 4.225}{Sh_{im(o)} - 4.225} \right) \quad (5.4)$$

Again, the solution does not exist. Thus, the AR(1) process fails to give a value of  $t$  for which  $Sh_{im}$  approaches 51% target level.

#### b) *The Time Trend Method*

In this method, time trend of share of ideal modes ( $Sh_{im}$ ) in total Islamic banking financing is estimated and then the time required to approach the target share value is estimated by projecting this time trend on to the future time period. The following function is estimated on seasonally adjusted series of  $Sh_{im}$  to obtain the time trend:

$$SaSh_{im} = \alpha_o + \beta_o(\text{time}) \quad (5.5)$$

Only if  $\beta_o$  is a large positive number that the convergence time will be shorter. The results of this method are shown in column 2 of **table 5.5**. The time coefficient is positive but not large enough (0.048); i.e. every quarter, the share of ideal modes rises by 0.048 points. Projecting this time trend on to the future gives seasonally adjusted forecasts and then multiplying each of the value in this estimated seasonally adjusted quarterly series of shares by the corresponding seasonal factor gives actual forecast based on the estimated time trend of equation (5.6). This series approaches 51% minimum target level in 658 quarters amounting to 165 years, shown in the last row column 2 of **table 5.5** (whether or not it is a good estimated model is discussed below on the basis of other estimates given in **table 5.5**).<sup>42</sup> Performing the same time trend analysis on actual (not seasonally adjusted) series gives different estimates as shown in column 1 of **table 5.5**. Future projection on the basis of these estimates gives 783 quarters (roughly 196 years)!

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<sup>42</sup> The estimated seasonally adjusted shares of ideal modes hit 51% target value in 1034.3 quarters (roughly 258 years). This can be calculated directly from the given estimates as:

$$SaSh_{im} = 1.354 - 0.048T = 51\%$$

$$T = \frac{51 - 1.354}{0.048} = 1034.3 \text{ quarters}$$

**Table 5.5: Results and Analysis of Forecasting Methods for Pakistan**

	Forecast Rule Estimates	1	2	3	4	5
		Simple Trend		Time trend + AR (1)		Annual Average
		Actual ( $Sh_{im}$ ) based	Seasonally adjusted ( $SaSh_{im}$ ) based	$Sh_{im}$ based	$SaSh_{im}$ based	
1	<b>Intercept</b>	1.196	1.354	0.727	1.466	
2	<i>T-Stats</i>			0.46		
3	<i>P-value</i>			0.649		
4	<b>Time Trend</b>	0.063	0.048	0.108	0.046	-
5	<i>T-Stats</i>			1.24	1.210	
6	<i>P-value</i>			0.223	0.230	
7	<b>AR (1) term</b>	-	-	0.679	0.399	-
8	<b>R<sup>2</sup></b>	0.187	0.136	0.392	0.236	-
9	<b>Adj-R<sup>2</sup></b>	0.158	0.105	0.345	0.177	-
10	<b>DW</b>	0.816	1.171	1.736	1.927	-
11	<b>MAD</b>	0.956	0.953	1.604	1.279	1.249
12	<b>MAPE</b>	-	-	1.064	0.850	
13	<b>MSE</b>	1.390	1.361	3.897	2.531	3.563
14	<b>MSPE</b>			2.316	1.452	
15	<b>Convergence Time (Quart.)</b>	783	658	147	394	
16	<b>Convergence Time (Years)</b>	196	164	37	98	78
	<b>Decision</b>	Rejected due to low DW	Rejected due to low DW	Rejected in favor of 4 due to high MAD & MSE	Selected	

*c) The Auto-Regressive + Time Trend Modeling*

More sophisticated forecasting methods such as auto-regressive modeling can also be used to approach the problem in question. The method is to first find the appropriate lag length that explains the current values of  $Sh_{im}$  and then obtain forecast from them.

Auto regressive of order 1 along with time trend was found to be significant for the given data set, so following equations are estimated:

$$Sh_{im(t)} = \alpha_1 + \beta_1 t + \gamma_1 Sh_{im(t-1)} \quad (5.6a)$$

$$SaSh_{im(t)} = \alpha_2 + \beta_2 t + \gamma_2 SaSh_{im(t-1)} \quad (5.6b)$$

The results are shown in columns 3 and 4 of **table 5.5** ( $t$  and  $p$  values are listed below the coefficients in case they are insignificant at 5%). The forecasted period for  $Sh_{im}$  to approach 51% level through these two rules is 37 and 99 years respectively (the choice of better suited model is discussed below).

#### *The Choice of Model*

Model 1 and 2 (time trend based) are rejected due to the presence of auto-correlation as shown by low values of DW (0.81 and 1.17). These low values suggest the inclusion of some auto-regressive term (as done in expressions 4.7a and 4.7b). Models 3 and 4 both have healthy values of DW (the  $R^2$  values are not comparable for these models as dependent variables are different in these equations). The explanatory powers of the forecasting rules are compared on the basis of their *mean absolute deviations* (MAD)—mean forecasting error (average absolute difference between actual values and forecasted values)—and *mean squared errors* (MSE)—mean of the squared of forecasting errors. Also their associated concepts such as mean absolute percentage error (MSPE) and mean squared percentage errors (MSPE) are used for this purpose. The forecasting rule that has lower values of MAD (and MAPE) and MSE (and MSPE) are better than the one that has larger values. On this account, model 4 is better suited among 3 and 4. Moreover, both intercept as well as time trend are insignificant in model 3 (intercept is highly insignificant) while intercept term is significant in model 4. Thus, not only model 4 is

superior to model 3 on the basis of MAD and MSE values but also on the basis of providing more number of significant parameters.

Finally, model 4 is the only model that makes intuitive sense when it comes to the estimate of ‘convergence time’. It says that the series will converge to 51% level in 98 years roughly (or 394 quarters). This is consistent with the annual growth series of  $Sh_{im}$  given in C.4 which grows at an average growth rate of 0.661 annually. The series (in column 2) has grown from 1.28 to 6.81 in 11 years (means roughly 5 fold or times in 11 years). If the series continues to grow at its average growth rate of 0.661, then to reach from 6.81 to 51% level, the series has to grow by roughly 7 folds, which means  $11 \times 7 = 77$  years. A better estimate of the forecasted values through this annual average rule can be obtained by:

$$\text{Forecasted } Sh_{im(t)} = Sh_{im(t-1)} + \text{Avg growth rate of } Sh_{im} \quad (5.7)$$

The estimated time from this method is 78 years—the closest to 98 years of model 4—in column 5 of **table 5.5**. Thus, model 4 is the best suited model for Islamic banking data set of Pakistan. Of course, this 98 years (or even 78 years of annual average method) is quite a long period to think of and hence conceiving of this minimum 51% criterion convergence possibility seems untenable in case of Pakistan. Making convergence possible in some conceivably sensible time requires speeding up the process from the policy makers of Islamic banking.<sup>43</sup>

<sup>43</sup> A related interesting question that follows from the previous discussion is to find out the ‘required rate of growth’ in the share of ideal modes that would ensure convergence to 51% level in some conceivable time frame of time (say, 10 years). For the data set given in **table 5.4**, the relevant question is: given that  $Sh_{im}$  has reached to 6.8% level in almost 11 years, at what percentage point rate of growth ( $g_p$ ) it must grow, on an average, in every time period to reach 51% level in 10 years (or may be 20 years). The subscript  $p$  with  $g$  is to emphasize that it is percentage *point* growth rate, and not simple growth rate, that is to be calculated here (i.e. by what percent point the series must grow to achieve the target value). Using the equation:

$$\text{Current value of } Sh_{im} + g_p \times \text{Target time of convergence} = \text{Target } Sh_{im} \text{ to be approached}$$

$$6.81 + g_p (10 \text{ years}) = 51$$

$$g_p = 4.419/\text{year}$$

## Results for Hypothesis 2

### *No financing for dis-approved modes*

In order to test hypothesis three, financing data of unapproved modes (*Tawarruq* and *Bay-ul-E'inah*) is required. However, neither the state bank of Pakistan nor individual Islamic Banks in Pakistan publish and provide this data. An indirect approach is hence required to verify this hypothesis. For this, State Bank of Pakistan's list of approved financing modes is examined which says that the Islamic banks can offer the modes shown in **table 5.6**:<sup>44</sup> The list includes *Tawarruq* finance as one of the approved modes of finance for Islamic banks in Pakistan. This shows that Islamic banks are in principle not barred from the use of this mode as against *Bai-ul-Enah* which is not included in this list. From this list it can be indirectly concluded that this mode of financing could or may be used by the Islamic banks, if required.

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Thus, convergence in ten years requires a rise of 4.419 percent point in the share of ideal modes for ten years.

<sup>44</sup> Some others modes include *Wakalah* (agency contract) and *Kafalah* (third party guarantee contract)



**Table 5.5:** List of Approved Modes by State Bank of Pakistan

S.no.	Modes	Comments
1	Mudabah	Refer to table A.1
2	Musharkah	Refer to table A.1
3	Diminishing Musharkag	Refer to table A.1
4	Equity Participation in the form of shares in a corporate entity	Refer to table A.1
5	Ijarah(or Ijarahwa-Iqtina)	Refer to table A.1
6	Murabahah	Refer to table A.1
7	Musawamah	<i>Musawamah</i> is a general kind of sale in which price of the commodity to be traded is stipulated between seller and the buyer without any reference to the price paid or cost incurred by the former. Thus it is different from Murabahah in respect of pricing formula. Unlike Murabahah, seller in Musawamah is not obliged to reveal his cost
8	Salam	Refer to table A.1
9	Istisna	Refer to table A.1
10	Tawarruq	Refer to table A.1
11	Qard	Refer to table A.1

Source: Instructions for Shariah Compliance in Islamic Banking Institutions, SBP

Apart from financing for *tawarruq* and *bay-ul-E'inah*, *sukuk* also fall under the category of business modes whose permissibility is controversial. **Table 5.7** divides the total investment (columns 2) of Islamic banking industry of Pakistan into two categories:

- a) investment in government issued *Ijara* securities (or *Sukuk*) and in bonds and Debentures (column 3)—these both reflect less than ideal investment component
- b) investment in ordinary shares and participation term certificates (column 5)—both have PLS nature.

Clearly, the share of category (a) (column 4) is far greater than that of category (b) (in column 6) in total investment of Islamic banking. This shows that Islamic banks are relying more on sovereign guaranteed fixed return *sukuk* for their investment purpose

showing a tendency of divergence from the first best theory. It is important to note here that State Bank of Pakistan (2008b) allows investment in ordinary shares for Islamic banks without placing any ceiling on it.

**Table 5.7: Investment Profile of Islamic Banking in Pakistan**

1	2	3**	4 = 3/2	5**	6 = 5/2
Time	Total Investment (Million Rs)	Inv. in Government <i>Ijara</i> Securities + Bonds & Debentures (Million Rs)	Ratio of Inv in Government Securities in Total Investment	Inv. In ordinary Shares + PTC (Mil Rs)	Ratio of Inv in ordinary shares in Total Investment
Dec-08*	42,172	32451	76.95	1771	4.20
Dec-09	64,678	46001	71.12	2789	4.31
Dec-10	157,803	112833	71.50	3921	2.48
Dec-11	274,268	205157	74.80	3684	1.34
Dec-12	394,376.	310957	78.85	4971	1.26
Dec-13	394,372	299001	75.82	6021	1.53
<b>Avg.</b>			<b>74.84</b>		<b>2.52</b>
<b>St. Dev</b>			<b>3.05</b>		<b>1.41</b>

Source: Islamic Banking Bulletins, SBP

\*Data prior to 2008 is not available for these variables

\*\* The amount of investment over and above these two categories is given under the category "others" in the data set which can't be placed in any of these two categories

### Results for Hypothesis 3

The above hypotheses dealt with the convergence of first objective of Islamic banking. From hence onwards, we continue with the empirical analysis of hypotheses for checking convergence towards second objective (promotion of relatively equitable allocation/distribution of resources/income).

Objective 2, as shown in chapter 4, is reflected (a) in the rising share of financing provided to SME sector relative to the corporate sector (in 'direct effect' sense) in Islamic

banking and (b) in larger financing for SME in Islamic banking relative to conventional banking.

*SME financing of Islamic banks is rising over time relative to corporate financing. Larger financing for SME by IB as compared to that by conventional banking*

Because this hypothesis has two dimensions, we treat them separately.

*a) Trend of Financing Share of SME in Islamic Banking*

**Table 5.8** shows the shares of financing provided to corporate and SME sectors by the Islamic banking industry in Pakistan. It is evident to note that not only the share of corporate financing has been quite significantly larger than that of SME (as indicated in columns 1 and 2), but it has also increased over the period while the share of SME financing has reduced in total financing to these two sectors (corporate plus SME) from 20.5% to 6.6% (some 67% fall) over time.

**Table 5.8: Corporate and SME Financing Shares of Islamic Banking in Pakistan (%)**

	<b>1</b>	<b>2</b>	<b>3 = 2/(1+2)</b>
Years*	Share of Corporate Sector financing	Share of SME Sector financing	SME as ratio of Corporate plus SME financing
2006	0.61	0.16	0.205
2007	0.58	0.12	0.166
2008	0.64	0.10	0.132
2009	0.65	0.08	0.106
2010	0.69	0.06	0.078
2011	0.73	0.05	0.066
2012	0.74	0.04	0.053
2013	0.72	0.05	0.066
<b>Avg.</b>	<b>0.67</b>	<b>0.08</b>	
<b>St. Dev</b>	<b>0.06</b>	<b>0.042</b>	

Source: Islamic Banking Bulletins, State Bank of Pakistan

\* Yearly, instead of quarterly, data is used because the same data is not available quarterly for conventional banking with which Islamic banking has to be compared in table 4.16 on the basis of these sectoral shares

This rejects hypothesis 3 (i.e. financing offered by Islamic banks to SME sector should be rising overtime relative to that offered to corporate sector) which required this ratio to be rising over time for converge to be observed.

For Pakistan, an interesting result can be derived in this regard by comparing the actual share of SME financing with the target (or policy recommended) shares set by the State Bank’s (2008) policy document on *Handbook on Islamic SME Financing*. While this document spells out the importance of SME financing and lays out its procedure, it also sets specific targets in this regard for Islamic banking industry. **Table 5.9** gives the target shares sets for SME sector in the policy document against the actual shares.

**Table 5.9:** Target Vs Actual Financing Shares to SME by Islamic Banks in Pakistan

Years	2008	2009	2010	2011	2012
Targeted % of Islamic Banking Financing to SME	15%	18%	20%	20%	20%
Actual % of Islamic Banking Financing to SME	10%	8%	6%	5%	5%

Source: Handbook on Islamic SME Financing, State Band of Pakistan

The document not only stressed that achieving this target is important for Islamic banking industry to capture the market share of 12% by 2012 (p. 12) but also emphasized that the achievement of this target is possible as “entrepreneurs in SME sector are more inclined towards using *Shariah*-compliant products and services provided that required products are designed with competitive features and pricing. Currently, most of the banks offering Islamic banking products are represented in this sector. Product development is not an issue for this sector as majority of the transactions are *Murabahah*” (p. 12-13). The numbers, however, in the table shows that the actual share of SME not only fell well short

of its target level but also continued to show a reverse (decreasing) trend. This again is tantamount to the rejection of hypothesis 3.

*b) Comparison of SME Financing Share in Islamic and Conventional Banking*

Another method of evaluating the achievement of objective 2 is to compare Islamic banking (IB) shares of financing to corporate and SME sectors with those of conventional banking (CB). As per hypothesis 3, the SME shares in Islamic banking should be larger than the share of financing to SME by conventional banking system. **Table 5.10** lists out the corporate and SME sectors' financing shares in both type of banking systems.

**Table 5.10: Corporate and SME Financing Shares in Conventional and Islamic Banking of Pakistan (%)**

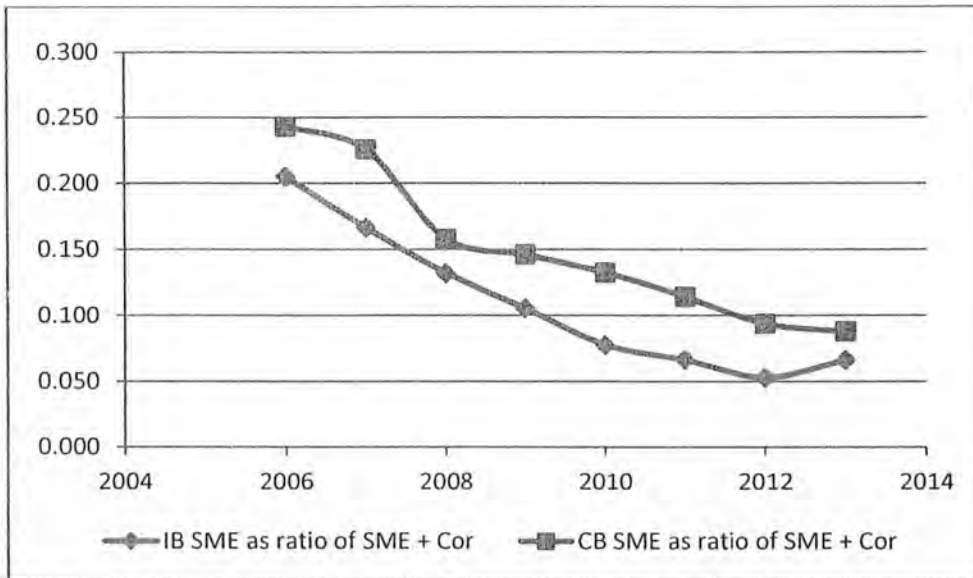
	<b>1</b>	<b>2</b>	<b>3 = 2/(1+2)</b>	<b>4 (Column 3 of table 5.8)</b>
Years	CB Share of Corporate Sector	CB Share of SME Sector	CB SME as ratio of its Corporate financing	IB SME as ratio of its Corporate financing
2006	0.53	0.17	0.243	0.205
2007	0.54	0.16	0.226	0.166
2008	0.60	0.11	0.158	0.132
2009	0.59	0.10	0.146	0.106
2010	0.62	0.10	0.133	0.078
2011	0.64	0.08	0.114	0.066
2012	0.65	0.07	0.094	0.053
2013	0.67	0.06	0.088	0.066
<b>Avg.</b>	<b>0.61</b>	<b>0.11</b>		
<b>St. Dev</b>	<b>0.05</b>	<b>0.040</b>		

Source: Islamic Banking Bulletins & Quarterly Compendiums, State Bank of Pakistan

**Figure 5.2** plots columns 3 and 4 of **table 5.10** (SME as ratio of corporate plus SME in both type of banking systems) against time. The curve for conventional banking (CB) is throughout above to that of Islamic banking (IB) indicating the fact that the relative share of SME financing has been greater in conventional system as compared to its relative

share in Islamic banking. This implies that Islamic banking has had relatively less focus on SME as compared to its counterpart—a trend that should have been reverse for hypothesis 3 to hold and, thus, convergence to be observed.

**Figure 5.2:** SME Vs Corporate Financing in both Banking Systems of Pakistan



*Possible Argument to ‘Explain Away’ Divergence*

The fact that the share of SME financing has been smaller and decreasing over time in both banking systems begs the question ‘what happened’ to this sector over time? Of course, there could be an answer to this question that may help one ‘explain away’ the above divergence claim. Pointing out to some of the inherent issues with SME may provide such a root of argument. Theoretically speaking, decreasing or inadequate financing to SME may be viewed as an outcome of market imperfections in credit market of SME, i.e. demand and supply sides of this financing market do not match due to informational or other market imperfections. For example, on the supply side, the banks are less inclined to offer financing to SME sector due to: (1) lack of collateral, (2) lack of credible data on its market size and (3) higher processing costs. Similarly, on the demand side SME sector struggles to address above banking concerns due to reasons such as: (1)

its smaller size, (2) limited management skills and (3) limited resources to offer to bank as collateral [See State Bank of Pakistan (2010) and Berry (2004)]. The above issues can expose banks to the higher risk of facing non-performing loans in SME sector and hence makes them risk averse to extend advances to this sector. This high risk (leading to less financing to SME sector) of banking system may be explained using data in **table 5.11** which gives the data of *infection ratio*—the percentage of non-performing loans to total loans in a specific sector. This percentage measures the amount of loans that are not being recovered by the banks. Obviously, the higher the infection ratio of a sector the more is its financing risky by the bank. Clearly enough, the infection ratio of SME sector has been larger than corporate sector and it has also increased overtime which can provide a possible explanation for their decreasing share in bank financing.

**Table 5.11: Infection Ratios in Different Sectors of Economy in Pakistan (%)**

Sector	Dec-10	Dec-11	Dec-12	Dec-13
Corporate	15.4	17.1	15.2	13.4
SMEs	28.0	31.4	34.6	32.3
Agriculture	17.9	19.3	14.5	14.0
Consumer	16.9	18.6	17.5	13.6
Commodity financing	1.3	1.1	1.1	1.1
Staff Loans	1.7	1.8	1.9	1.5
Others	15.4	13.3	10.8	8.9
<b>Total</b>	<b>14.7</b>	<b>16.2</b>	<b>14.5</b>	<b>13.0</b>

Source: Quarterly Compendiums, State Bank of Pakistan

However, if this is an ‘explanation’ of SME’s low and decreasing financing share in Islamic banking industry as well, then one would find a dichotomy both in practice as well as in theoretical claim of Islamic bankers of Pakistan. The dichotomy on practical front is shown in **table 5.12** which lists the infection ratios of the industries of the country, with textile industry being the second most infectious after electronics throughout the period. Alongside, the table also lists down the financing shares of these

industries in Islamic banking industry. Interestingly, the second most infectious industry (textile) has persistently enjoyed larger share in Islamic banking financing! More formally, the coefficient of correlation between industry financing shares and infection ratios is expected to be negative—i.e. financing share across industries should decrease as infection ratios across industry increases. But the results are opposite to this expectation as correlation coefficients are positive through the time period which implies that infection ratios cannot provide sufficient excuse for Islamic banks for not extending financing to SM sector.

**Table 5.12: Infection Ratios (IR) and Financing Shares (FS) of Industries in Islamic Banking of Pakistan (%)**

Industry	Dec-10		Dec-11		Dec-12		Dec-13	
	IR	FS	IR	FS	IR	FS	IR	FS
Agribusiness	6.6	2.56	11.7	4.00	9.1	3.70	10.2	3.60
Automobile/Transportation	23.0	1.68	20.3	1.00	19.8	1.40	17.2	1.70
Cement	18.5	4.10	23.2	3.00	29.3	1.50	25.3	0.90
Chemical & Pharmaceuticals	7.9	7.14	9.4	7.00	9.9	7.40	8.9	6.30
Electronics	38.5	1.78	50.3	2.00	41.9	1.50	41.3	1.70
Financial	19.0	1.25	11.9	1.00	10.5	1.40	6.8	0.70
Individuals	16.1	16.54	15.9	15.00	16.2	14.20	12.3	13.30
Insurance	0.1	0.02	0.2	0.00	0.2	0.00	0.2	0.01
Production/Transmission of Energy	3.8	6.55	4.0	10.00	3.7	10.30	3.0	8.90
Shoes & Leather garments	12.5	1.49	10.1	2.00	12.8	0.90	11.3	0.90
Sugar	19.4	2.30	14.6	3.00	10.3	3.80	5.2	3.90
Textile	24.3	21.80	28.5	20.00	29.6	19.00	26.2	19.10
<b>Coefficient of correlation</b>	<b>0.130</b>		<b>0.104</b>		<b>0.110</b>		<b>0.114</b>	

Source: Quarterly compendiums, SBP and Islamic Banking Bulletins

Infection ratio also does not stand as good justification for lower SME financing in Islamic banking on theoretical grounds. The Handbook of SME financing of State Bank of Pakistan attempts to make an important feature of Islamic banking as follows:



“one of the major reasons for huge outstanding portfolio of NPLs (non-performing loans) at various banks remains the misuse of the facility extended. Whereas the very nature of IB products (*Murabahah, Ijara, Istisna, Salam, Wakala, Sukuk* etc.) makes them an excellent banking tool in this era of high inflation, economic distress, political instability etc. The underlying involvement of “asset” itself in every transaction ensures that the funds lent through any IB product are utilized for the purpose for which they were sought, thereby eliminating the risk of their misuse for any other purpose” (p .14)

This advantage (itself claimed by SBP) of Islamic banking further reduces the strength of infection ratio argument for providing less financing to SME sector.

#### **Results for Hypothesis 4**

*Systematic difference between Islamic and conventional banking's financing for different industries; with Islamic banking entertaining the neglected industries/sectors of the economy more than the conventional*

For testing this hypothesis, industry financing shares in both the systems from 2010 to 2013<sup>45</sup> are listed in **table C.5**. To see how different these financing shares in Islamic banking are from its counterpart, we calculate rank-correlation for each corresponding year between the financing shares of the two systems. For this, all industries are ordered in terms of their financing shares in each year for both banking systems (as listed in **table C.6**) and then rank correlation is calculated. These calculated results are shown in **table 5.13**. These positive and almost close to one rank correlation values indicate that there is not much difference between the banking systems when it comes to industry financing concentrations.

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<sup>45</sup> Quarterly compendiums of state banks provides quarterly time series of industry financing shares from 2010 onwards only

**Table 5.13:** Rank Correlation between Industry Financing Shares of Islamic and Conventional Banking Systems in Pakistan

	2010	2011	2012	2013
Rank Corr. Value	0.96	0.93	0.87	0.85

Moreover, an examination of **table C.6** shows that industries which have been lagging behind for financing in conventional banking system (e.g. insurance, shoe and leather garments, automobile and transport equipments, electronics and electrical appliances) have also been low in ranking in Islamic banking system. So the conclusion is no convergence.

### Results for Hypothesis 5

*At least 2.5% Share of Qard Hasan*

One of the most important indicators for testing objective 2 is to examine the share of *Qard Hasan* in the total financing of Islamic banking. As indicated in chapter 3, this financing category reflects the commitment of Islamic banks to the promotion of welfare of needy. Column 1 of **table C.1** shows the share of *Qard Hasan* in the total financing of Islamic banks. Convergence in theory and practice requires significant and rising share of *Qard Hasan*, but the numbers are quite evident to disprove this hypothesis without requiring any detailed analysis.

### Results for Hypothesis 6

*More personal financing by Islamic banks for relatively low income segment of society as compared to that by conventional banks*

As explained in chapter 4, due to data limitations only the method of ‘Consumer Product Features’ could be used for Pakistan. In this regard, car financing schemes of the largest Islamic bank (i.e. Meezan Bank) and conventional Bank (i.e. Habib Bank) are compared. Some of the features of their car financing product are given in **table 5.14**.

**Table 5.14:** Features of Car Financing Products of Meezan and Habib Banks

	<i>Eligibility Criterion</i>	<i>Financing Limit</i>
Meezan Bank	<ul style="list-style-type: none"><li>• ‘Have a net take home income exceeding three times your monthly rental’—this positively relates the income of the person with the amount of financing he can obtain from bank in this scheme.</li><li>• The lowest value car offered by Mezan Bank is Suzuki Mehran VX (@Rs 625,000/-)<sup>46</sup> which gives installment of roughly 15,000/month (at 5% residual value and minimum of 15% initial security deposit). This means that the minimum monthly income required to approach this Bank for Car financing is around Rs 45,000/month. This minimum barrier of Rs 45,000/month is good enough to bar a sizable population segment from approaching this Bank.<sup>47</sup></li></ul>	Customer can get a new car financed up to Rs 5,966,000 (Honda Accord) or even 7,999,000 (Toyota Camry A/T) <sup>48</sup>
Habib Bank	<ul style="list-style-type: none"><li>• <i>Min Income:</i> Rs 20,000 (for salaried persons) and Rs 25,000 (for business professionals)</li></ul>	Customer can obtain any car he wants

Source: Information provided on the websites of Meezan Bank and Habib Bank

The table indicates that the minimum income requirement is higher in Meezan Bank as compared to Habib Bank implying that it is more difficult to approach Islamic bank for a customer as compared to a conventional bank.

<sup>46</sup> These rates are taken from Meezan Bank websites’ on August 3, 2014

<sup>47</sup> What percentage of population segment is denied the Bank access by this minimum limit of Rs 45,000/month in a country like Pakistan with some 20% population living below poverty line is not much difficult to imagine.

<sup>48</sup> This indicates that Islamic banks do not place any significant limit when it comes to curtailing ‘luxuries’ (interestingly enough, Bank Islami Pakistan finances even vehicles like Mercedes, BMW, Range Rover and Land Cruiser).

## 5.2: EMPIRICAL ANALYSIS FOR MALAYSIA

This section presents the convergence empirical results for Malaysian Islamic banking industry using the same methodology. The descriptive statistics of the key variables involved in analysis for Malaysian Islamic banking industry is given in **table 5.15**. The table shows almost the similar stagnancy as the one in Pakistani Islamic banking industry with little variation in practice.

**Table 5.15:** Descriptive Statistics of Advances under Different Modes and for Sectors for Malaysian Islamic Banks

	<b>Equity Based</b>	<b>Debt Based</b>	<b>SME Financing</b>	<b>Corporate Financing</b>
Minimum Share (%)	0.42	75.3	2.47	16.96
Maximum Share (%)	5.54	84.5	8.1	23.42
Average Share (%)	1.8	80.6	3.8	19.9
Standard Deviation	1.7	3.1	2.4	2.6

Source: BNM, Financing by Concept & Bank Islam, Annual Reports

### Results for Hypothesis 1

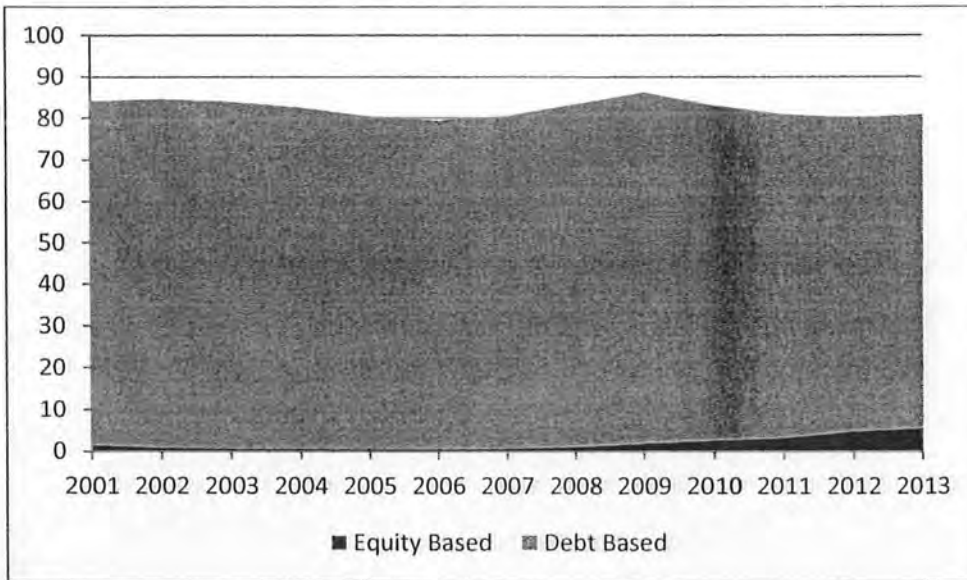
The relevant hypothesis is tested for financing component of Islamic banking industry in Malaysia. The annual average cumulative shares (calculated from monthly data series from Dec 2006 onward) of debt and equity based modes of financing are listed in columns 2 and 3 of **table 5.16**. It is evident from this data that debt based modes have overwhelmingly dominated those of equity based modes in Malaysia. The average share of PLS based ideal modes remained at 1.8 percent while that of debt based has been 80.6 percent (both having standard deviations of 1.7 and 3.1 respectively reflecting a consistent behavior of this series). **Figure 5.3** plots the two data series.

**Table 5.16:** Cumulative Distribution of Advances in Malaysia (% shares)

(i)	(ii)	(iii)
Years	Debt Based	Equity Based
2001	82.7	1.40
2002	84.0	0.70
2003	83.5	0.50
2004	82.1	0.50
2005	80.1	0.30
2006	78.9	0.42
2007	80.0	0.48
2008	82.4	0.96
2009	84.5	1.79
2010	80.6	2.51
2011	77.8	3.11
2012	75.3	4.74
2013	75.3	5.54

Source: BNM, Financing by Concept

**Figure 5.3:** Equity-Based Financing Relative to Debt-Based in Malaysia



For the trend of *ideal* financing shares overtime, monthly series of equity and debt based modes is used to calculate the ratio of equity-based modes in the sum of equity and debt based modes. The results of equation (4.1) are given in **table 5.17** (robust standard errors are obtained due to the presence of Heteroskedasticity in the model suggested by White

Heteroskedasticity diagnostic test. Similarly lag term of dependent variable is used to remove auto-correlation which was suggested by very low DW-stats).

**Table 5.17:** Estimation Results of Time Trend of Equity to Debt Based Modes in Malaysia

*Dependent Variable:* Equity Based financing as ratio of Equity plus Debt Based financing [EB/(EB + DB)]

White Heteroskedasticity-Consistent Standard Errors & Covariance				
<i>Variable</i>	<i>Coefficient</i>	<i>Std. Error</i>	<i>t-Statistic</i>	<i>Prob.</i>
C	0.000047	0.000276	0.170085	0.8654
TIME	0.000063	2.68E-05	2.346533	0.0214
[EB/(EB + DB)](-1)	0.939009	0.029031	32.34520	0.0000
R-squared	0.99			
DW Stats	1.85			

The null hypothesis for  $b$  (time) is rejected at 95% confidence interval. However, the coefficient of  $b$  is very small (0.00006) which implies that the annual speed of convergence towards has remained very slow. This slow speed suggests that, statistically speaking, convergence is taking place as per hypothesis 2 in Malaysia but its speed is almost negligible in Malaysia.

*'Time of Convergence' Criterion*

We now check how long Islamic banking may take to approach to its minimum bench mark level (51%). The results of time plus  $AR(1)$  equation share of ideal modes in total financing ( $Sh_{im}$ ) are shown in **table 5.18**. The solution shows that it would take 654 months (roughly 54 years) for  $Sh_{im}$  to reach to 51% level. Again, the time required for minimum convergence is too large.

**Table 5.18:** Forecasting ‘Time of Convergence’ Equation for Malaysia

*Dependent Variable:* Share of Equity Based Modes in Total financing [ $Sh_{im}$ ]

White Heteroskedasticity-Consistent Standard Errors & Covariance				
<i>Variable</i>	<i>Coefficient</i>	<i>Std. Error</i>	<i>t-Statistic</i>	<i>Prob.</i>
C	0.000095	0.000233	0.418548	0.6767
TIME	0.000052	2.21E-05	2.383264	0.0195
$Sh_{im}(-1)$	0.934567	0.031026	30.12199	0.0000
R-squared	0.99			
DW Stats	2.06			

## Results for Hypothesis 2

Consolidated data on *tawarruq* and *bay-ul-E'inah* finance is not published by the central bank of Malaysia. To test hypothesis 2, the financing shares of Bank Islam Malaysia<sup>49</sup> are used from 2008 to 2013 as case study in **table 5.19**. Bank Islam started *tawarruq* financing in 2009 and within five years its share in total financing has gone up to more than 51 percent—it has become the largest financing source for the Bank superseding even *Murabahah* (also note the use of *bay-ul-E'inah* by this Bank which indicates that the divergence roots are multiple in case of Malaysia. *tawarruq* and *bay-ul-E'inah* together account for almost half, 46.4%, of Bank’s total financing!).

**Table 5.19:** Financing Mix in Bank Islam, Malaysia (% Shares)

Financing mode	2008	2009	2010	2011	2012	2013
Bai' Bithaman A'jil / Murabahah	70.5	69.1	59.7	59.1	50.7	41.3
Ijarah	2.6	3.0	2.8	2.2	1.2	1.0
Mudarabah	0.1	0.1	0.1	0.04	-	-
Musharakah	-	-	-	-	-	-
Istisna	4.9	5.1	2.9	1.7	1.2	0.5
Bay-ul-E'inah	21.9	21.1	13.6	9.9	8.7	5.3
Tawarruq	-	1.6	20.9	26.8	37.8	51.5
Others	-	-	-	0.3	0.4	0.4

Source: Bank Islam Annual Reports

<sup>49</sup> Bank Islam is the oldest Islamic bank in Malaysia operating since 1983

This result indicates that divergence, instead of convergence, is taking place in terms of hypothesis 2 in Malaysia. This tendency is consolidated by the data given in **table 5.20** which highlights the use of some more controversial modes by Bank Islam (five years are considered as case study). This data shows that dealing in these controversial modes has become a regular feature of Bank Islam. This result is in line with the study of Khan (2010) who finds that the largest Islamic corporate bond market of Malaysia is based on controversial modes of financing.

**Table 5.20:** Use of Controversial Modes by Bank Islam, Malaysia (Amounts in RM 000)

	Items	2009	2010	2011	2012	2013
1	Bank Negara Negotiable Notes (tradable <i>sukuk</i> based on <i>Bay-ul-E'inah</i> )	-	2,202,117	1,116,264	846,786	178,058
2	Malaysian Government Investment Issues held for trading (tradable <i>sukuk</i> based on <i>Bay-ul-E'inah</i> )	149,737	50,573	71,804	20,190	726,353
3	Derivative Financial Assets (forward contracts etc.)	-	44,326	15,877	16,736	29,118
4	Bills and acceptance payable <sup>50</sup> ( <i>bay-ud-dayn</i> )	289,469	165,532	262,075	385,138	170,598
5	Islamic Debt Securities held for trading ( <i>bay-ud-dayn</i> )	-	26,757	31,032	683,891	312,484

Source: Bank Islam Annual Reports

### Results for Hypothesis 3

Distribution of financing to SME and corporate sector is not given at aggregate level of entire Islamic banking industry for Malaysia. Hence, Bank Islam Malaysia is used as a case study again for this hypothesis. **Table 5.21** shows the shares of financing provided to domestic business enterprise and SME sector by this bank. It is evident to

<sup>50</sup> Bills and acceptances payable represent Bank's own bills and acceptances rediscounted and outstanding in the market



note that the financing share of SME has been significantly lower than that of business enterprise (as indicated in columns 2 and 3). Moreover, the share of SME financing has reduced relative to these two sectors (as indicated in column 4). This rejects first part of hypothesis 3 (i.e. financing offered by Islamic banks to SME sector should be rising overtime relative to that offered to corporate sector) which required this ratio to be rising over time for converge to be observed. Because aggregate data for these categories is not available, hence testing second part of this hypothesis (comparison of SME financing share in Islamic and conventional banking) is not possible.

**Table 5.21:** Corporate and SME Financing Shares in Islamic Banking of Malaysia (%)

1	2	3	4 = 2/(2+3)
Years	Share of financing to enterprises	Share of financing to SME	SME as ratio of enterprise plus SME financing
2009	23.42	8.10	0.257
2010	16.96	3.27	0.161
2011	18.43	2.69	0.127
2012	21.69	2.47	0.102
2013	19.10	2.60	0.120
<b>Avg.</b>	<b>19.92</b>	<b>3.83</b>	<b>0.15</b>
<b>%change</b>	<b>-18.46</b>	<b>-67.84</b>	<b>-53.3</b>

Source: Bank Islam, Annual Reports

### Results for Hypotheses 4 & 5

Hypothesis 4 relates with the industry financing profile of Islamic banking as compared to conventional banking. For testing this hypothesis, industry financing shares in both type of banking systems are given in **tables D.1(a)** and **D.1(b)** from 2006 to 2013. Rank correlation is calculated for each corresponding year between the financing shares of the two systems after ordering all industries in terms of their financing shares in each year. These rank correlations are shown in **table 5.22**. Again, the values of rank-correlation are positive almost equal one indicating the fact that there is no systematic

difference between financing preferences of Islamic and conventional banks across industries.

**Table 5.22:** Rank Correlation between Industry Financing Shares of Islamic and Conventional Banking Systems

Year	2007	2008	2009	2010	2011	2012	2013
Rank Corr. Value	0.92	0.87	0.92	0.87	0.96	0.98	0.94

Moreover, an examination of **table D.1(a)** and **D.1(b)** shows that industries which have been lagging behind for financing in conventional banking system are also low in ranking in Islamic banking system. An examination of Islamic Banks' financing shares of four top ranked sectors in conventional system further consolidates this tendency as shown in **table 5.23** which gives the average financing shares to these sectors over duration 2007 to 2013. The data reveals that Islamic banks have matched the foot-prints of conventional banks to determine their financing preferences. Therefore, the conclusion is no convergence in terms of hypothesis 4.

**Table 5.23:** Financing to Top Four Sectors by both Banking Systems of Malaysia

Sector	Islamic Banking	Conventional Banking
Household sector	29.53	31.49
Manufacturing	19.98	22.15
Wholesale trade	9.38	13.75
Construction	7.64	5.47
<i>Total</i>	<b>66.53</b>	<b>72.86</b>

Source: BNM, Loans Disbursed by Sector

Conclusion for hypothesis 5 (share of *Qard Hasan*) is more than obviously no convergence as the share of *Qard Hasan* has remained zero in Islamic banking financing.

## Results for Hypothesis 6

The first indirect method (concentration of personal financing) is used here to test this hypothesis. **Table 5.24** shows distribution of financing shares for purchase of residential property across different loan or financing sizes from 2007 to 2013. This data is for all banks (including Islamic and conventional) of Malaysia as separate data for Islamic banks is not provided. Since Islamic banking has been displaying the same patterns as conventional banking on other frontiers (e.g. distribution of financing across industries) and the share of Islamic banks in house financing is less than 10% in Malaysia, hence it is safe to assume that the distribution of financing in Islamic banks for the purchase of residential property would be fairly similar as shown in this **table 5.24**.

**Table 5.24:** Classification of Advances by Amount in Malaysia

Years	<=25K	> 25K to 60K	> 60K to 100K	> 100K to 150K	> 150K to 250K	> 250K
2007	0.83	6.63	13.36	16.55	27.86	34.77
2008	0.66	5.76	11.90	15.39	26.25	40.04
2009	0.57	5.08	10.55	14.73	25.31	43.76
2010	0.57	4.30	9.11	13.46	24.09	48.46
2011	0.39	3.60	7.85	12.13	22.50	53.53
2012	0.36	2.70	6.28	14.43	19.71	56.52
2013	0.35	2.27	5.36	12.92	17.68	61.41

Source: BNM, Classification of loans/financing by purpose

It is clear from this table that the total loans/financing increases as the size of loan or financing amount increases. Interestingly, it is only the share of highest loan amount category (> 250K) that is increasing overtime while all of the other are showing decreasing trend. As per the convergence condition defined above [advances inequality indicator' (*AII*)], this shows movement away from the ideal as it is people with larger incomes who are benefiting from Islamic Banks, and not the other way round, which is not going to decrease income inequality.

## Chapter

# 6

## Conclusion

### 6.1: FINDINGS

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This study sought to develop a theoretical framework which can be used to verify empirically whether and to what extent the practice of Islamic banking meets its stated objectives set by its pioneers. Broadly put, these objectives are two:

- Progressive substitution of equity-based financing for debt-based financing (due to its greater contribution to equity, efficiency, growth, and stability)
- Reducing income inequality and increasing social welfare

To test whether the transition from debt-based to equity-based financing has in fact occurred, Islamic modes of financing/investment were divided in three classes: (i) ideal; (2) permissible but not ideal; and (3) controversial. This classification proposed the tests that the share of ideal modes is greater and rising overtime relative to permissible but not ideal modes and that the share of controversial modes is zero or eliminating overtime. To test whether income inequality is reduced and social welfare is enhanced by Islamic banks, the study proposed several indicators that (a) the financing share to SME sector in Islamic banking is rising and is greater than that in conventional banking, (b) Islamic banks exhibit a preference for neglected industries of the economy, (c) share of *Qard Hasan* is at least 2.5% in Islamic banking and (d) In comparison to conventional banks, Islamic banks offer more personal financing to lower income groups.

The analysis of the preceding chapter led to the following findings regarding the convergence behavior of Islamic banking in Pakistan and Malaysia with respect to the above tests:

- 1) Since the share of debt based modes overwhelmingly dominates that of equity based modes in financing component and this trend has not reversed during the study period in Pakistani and Malaysian Islamic banking industries, this implies that objective 1 of Islamic banking has not been achieved
- 2) Since the growth rate of ideal financing modes has not increased significantly in total financing of Islamic banks (in both countries) and that the time required to approach minimum convergence criterion (51%) is too long, hence (putting along with finding 1), convergence in theory and practice with regards to objective 1 has not only happened so far but also highly unlikely to occur for both countries
- 3) In connection with findings 1 and 2, not only that convergence has not been taking place but also that permission to use *tawarruq* in case of Pakistan and its heavy use by Malaysian Islamic Banks indicates movement away from convergence
- 4) The deposit side of Islamic banking in Pakistan has been modeled almost on the basis of PLS modes which identifies that as far as banks' link to depositors is concerned, objective 1 has been achieved in this regard
- 5) Since the financing share of SME relative to corporate sector has not increased in Pakistani Islamic banking, and that it has also remained less in Islamic banking as compared to conventional banking, it implies that income distribution pattern is not directly helped improve by Islamic banking
- 6) Industry preferences of Islamic Banks are almost the same as those of conventional banks
- 7) Islamic banking industry has completely ignored the use of *Qard Hasan*

- 8) Because the minimum income requirement to avail the car type financing facility from Pakistani Islamic banking excludes sizeable population segment of the society and that this minimum income requirement is greater than that in conventional bank, this implies that Islamic banks have not been much concerned about the needs of the low income population of the country
- 9) Finally, the distribution of advances for the purchase of residential housing is tilted towards higher income earners in Malaysia which reflects that Islamic banks are not targeting lower income people just like their counterparts

The above findings reveal the following three important features of the Islamic banking industries of the two countries:

- i. Except for the deposit side, convergence is not observed to take place in the original theory and current practices of Islamic banking. This is an indication of the fact that Islamic banking has not made inroads to the achievement of its stated objectives
- ii. Instead of converging to its own objectives, Islamic banking has shown a strong tendency of divergence from stated objectives and convergence towards conventional banking system. This is indicated by the facts that:
  - large chunk of investment of Islamic banks has clustered around T-bills type government securities (i.e. *Ijarah Sukuk*) in Pakistan
  - debt-based and fixed rate of return (where even the rate of return is determined around KIBOR) modes have dominated the business profile of Islamic banking industry just like in conventional banking.
  - the tendency to get involved in financing modes like *tawarruq*, *bay-ul-E'inah*, *bay-ud-dayn* and derivatives shows strong tendency of divergence
  - financing preferences of Islamic banks towards different sectors and industries of the economy has been almost the same as in conventional banking

- iii. The above analysis and results indicate that though mainstream Islamic economists, who ask for the revival of PLS based modes, dominate theoretically, but liberals dominate practically.

In short, neither procedural nor consequential convergence is taking place in the Islamic banking of Pakistan and Malaysia.

Islamic banking in both countries has struggled to develop a market niche for the realization of its objectives. The achievement of the declared ideals of Islamic banking depends upon the ability of Islamic banks to develop a niche of market segment (getting larger and larger overtime) wherein they can operate as per their own preference set. Unfortunately, the emergence of such a market segment of Islamic banking has not been observed thus far. The non-existence and non-emergence of such a niche market forces Islamic banks to operate and compete with conventional banks which leads to their convergence to the conventional banking system (both on asset as well liability sides) by frustrating their ideals.

The above failure can largely be explained in terms of the theoretical inadequacies and compromises that the theorists of Islamic banking had been making right from its inception on the name of 'making room for the industry'. While pursuing what may be termed *accommodationist* strategy, they ignore the fact that the room they are creating is *within and is on the footprints of existing industry*—the one they seek to replace to begin with. This is obviously a self-defeating strategy because a strategy that aims at continuous incorporation of Islamic banking within conventional one in the short run cannot model the former different from the latter in the long run. Such a transformation methodology leads Islamic banking to a built-in structural trap in that it guides it into a structural form and practices that is not suited to approach the desired objectives. It is largely due to this ever expanding scope of accommodationist strategy that critical voices against Islamic

banking are going beyond form-vs-substance debate on Islamic banking, such as the issue of fractional reserve banking and political economy of Islamic economics (as discussed in chapter 2). The growing similarity of Islamic banking with the conventional one is strengthening the case of those who ‘reformists political approach’ of liberal and moderate Islamic groups and demand ‘radical change’ in the existing capitalist life world for Islamic teachings to be operational.

## 6.2: ROAD AHEAD

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Development of niche market is, thus, one of the key requirements for dis-associating Islamic banking from the conventional one in order to reverse, if at all, these diverging trends in Islamic banking industry. This key requirement has only recently received some attention from the policy makers of Islamic banking industry in Pakistan. The strategic policy document for Islamic banking industry, namely, *Strategic Plan: Islamic Banking Industry of Pakistan 2014-2018*, sets these targets for the practitioners of Islamic banking industry: “(a) enabling legal, regulatory and *Shariah* compliance framework, (b) promotion of Islamic finance as a distinct and competitive system to serve the financial services needs of the masses, (c) targeted research initiatives to better explore market dynamics and (d) collaboration with the local and international stakeholders for development of competitive and innovative solutions for the diverse financing need of the real economy” (p. 2). In order to realize these targets, four types of strategies are listed: (i) enabling policy environment, (ii) *Shariah* governance and compliance, (iii) awareness and capacity building and (iv) market development. This last strategy involves steps related to product diversification and financial inclusion, especially for agricultural, SME and rural sector of the economy.



But its implantation, especially for market development strategy, begs questions such as (a) do market prices provide enough incentive for banks to offer their products by dis-associating them from KIBOR or discount rates? (b) can Islamic banks avoid moral hazard and adverse selection issues related to ideal financing modes? (c) can low income earners and marginalized segments (such as rural) be accommodated by the Islamic banks given all type of insolvency risks? And above all, (d) can Islamic banking practitioners come out of their comfortable zone of following the available market trends and make effort to take this industry out of the prevailing shackles? It may safely be argued that the first requirement to find answers to these questions is shift in theoretical approach from *accommodationist* strategy to *transformationist*. This approach would determine the legitimacy of contracts in Islamic banking industry not on procedural compliance rather on the basis of the desired substance. It would weigh movement towards the ideal much more than growth within the existing. To implement this alternative strategy into practice, Islamic banking industry requires banking professionals who are *revolution seeking missionaries* and not merely *carrier seeking practitioners*. Zaman (2016) identifies that the underlying spirit of Islam is providing service to others which is at odd with that of capitalism where the primary objective is maximization of personal wealth. Hence, Islamic institutions have a duty to perform differently from conventional ones in their structures.

One of the specific policies that Islamic banks can use for promoting PLS financing is targeting the small venture capitalists. For example, Pakistan introduced youth loan scheme for the start up of small businesses by young entrepreneurs. These new entrepreneurs can be provided financing through *Mudarabah* schemes. Improving the management and monitoring systems within Islamic banks can also promote PLS financing. Finally, some legal restructuring in banking regulations are also needed for the

promotion of PLS. For example, banking regulations in many of the Muslim countries restrict banks from taking ownership rights in businesses [Dar and Presley (2000)]. A more appropriate regulatory structure that allows Islamic banks' participation in management and control processes of the firms can help overcome agency problems involved in PLS modes.

Another practical step, to put regulatory pressures on Islamic banks, could be the development of an *Islamic Banking Index* that assigns ranks to all Islamic banks on the basis of their compliance to the objectives of Islamic banking. This index can serve as bench mark for evaluating the convergence between theory and practice of Islamic banking. Using this methodology, universal ranking of Islamic banks can be issued every yearly. The methodology proposed in this study can be used as a start-up point by the researchers for developing such an index.

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## Appendix A

**Table A.1: Defining Features of the Modes of Islamic Finance**

	<b>Financing/ Investment Modes</b>	<b>Description</b>
1	<i>Musharakah</i> (Operating partnership/Joint venture)	Equity partnership contract where both the bank and its client contribute to capital and entrepreneurship. Profits are shared between the bank and the customer in the pre-agreed ratio. Losses are shared proportionate to their respective capital contributions
2	<i>Mudarabah</i> (Trustee / passive partnership)	In this mode, bank (called <i>rabb-ul-mal</i> ) supplies capital finance for a specific venture indicated by the customer (called <i>mudarib</i> ) who is responsible for the management of the business and provides professional, managerial and technical expertise for initiating and operating the business enterprise or project. Profit is shared according to a pre-agreed ratio. Losses if any, are entirely absorbed by the capital provider – the bank
3	Diminishing <i>Musharakah</i> (Hire-Purchase agreement)	Bank and its client jointly contribute to capital of a venture / asset based on partnership ( <i>Musharka</i> ). The client promises to take asset on lease against a pre-determined rental for a definite time period. Bank purchases the asset for the client who pays the contractual rental to the bank. The rental is apportioned between both parties: one portion of rental flows to bank as its share in rental income and another portion of this rental payment is used to redeem part of Bank's share in partnership. Hence, Bank's share in the asset diminishes each year through partial return of capital by the client. The share of the client in the capital steadily increases over time, ultimately resulting in complete ownership of the asset
4	<i>Ijarah</i> (Operating lease)	It is a rental agreement between bank and client. The client approaches Bank, identifies the commodity/asset he needs, collects relevant information about it such as base price and rent. The Bank buys the asset from a vendor and leases it to its client. The customer pays rent representing an agreed profit (typically calculated using a benchmark, such as KIBOR, plus a margin)
5	<i>Murabahah</i> (Mark-up sale on deferred	Sale on a cost-plus basis. Here, the client approaches Bank, identifies the commodity/asset he needs, collects relevant information about it (such as base price and the mark-up). The

**Table A.1: Defining Features of the Modes of Islamic Finance**

	<b>Financing/ Investment Modes</b>	<b>Description</b>
	payment)	bank buys the asset from a supplier and sells it to the customer at a markup price (typically calculated using a benchmark, such as KIBOR, plus a margin). This price is typically payable to the Bank in installments.
6	<i>Salam</i> (Deferred delivery sale on advance payment)	A forward agreement where delivery of commodity / asset occurs at a future date in exchange for spot payment of price. The client sells a commodity X to Bank on forward basis and receives amount equal to its price $P$ today. The Client delivers commodity X to the Bank a later date. The Bank sells this commodity to another buyer at price ' $P + \text{mark-up}$ '. The subject commodity of <i>Salam</i> contract must be freely available and tradable in the market
7	<i>Istisna</i> (Manufacture sale on advance payment)	In contrast to <i>Salam</i> , here the seller undertakes agreement to develop or manufacture a commodity to be delivered at a future date at an agreed future price (payable in in parts over agreed time period or in full at the end of the time period). It is the only forward contract where obligations of both parties relate to the future. The Client asks Bank to develop/manufacture an asset X, Bank asks Manufacturer to develop/manufacture asset X, manufacturer develops/manufactures asset X, receives payments from Bank as per agreed terms, delivers the asset to the Bank. The Bank gives delivery of the asset to Client; and Client pays in full or in parts over agreed period of time
8	<i>Bai-ul-E'inah</i> (Repurchase)	<i>Murabahah</i> changes into <i>bai-al-E'inah</i> if vendor and client are the same. It involves sale and buyback transaction of assets by a seller. The bank purchases a commodity from its client on a spot basis and sells it back to the client at a cost-plus price and on a deferred basis
9	<i>Tawarruq</i> (Reverse <i>Murabahah</i> + Liquidation)	A mode through which the Bank facilitates cash needs of their clients. The client—the <i>mutawarrig</i> —buys X on deferred payment from the Bank and sells X for a cash amount less than the deferred price to a third party



**Table A.1: Defining Features of the Modes of Islamic Finance**

	<b>Financing/ Investment Modes</b>	<b>Description</b>
10	<i>Sukuk</i> (Securities / Debentures)	A Shariah compliant financing instrument equivalent of conventional financial instruments known as security or bond. They represent an undivided ownership share in an underlying asset or interest held by the issuer. Since these can be issued both on equity ( <i>Musharakah</i> or <i>Mudarabah</i> ) as well as debt (e.g <i>Ijarah</i> and <i>Morabaha</i> ) based contracts, hence they are placed under both elbows in the above diagram
11	<i>Bai-ul-Dayn</i> (Sale of debt / Discounting bill of exchange)	It is sale of a debt. To its proponents, it is defined as “a sale of payable right either to the debtor himself or to any third party.” <sup>51</sup> It is used for sale and purchase of debt certificates (such as bills of exchange) to buying issued by a debtor to a creditor as evidence of indebtedness.
12	<i>Qard Hasan</i> (Benevolent loan)	A loan contract basis of social welfare or to fulfill a short-term financial need of the borrower. The loan is payable without any increment to the lender with or without stipulating clear date of maturity

See Obaidullah (2005) for details

<sup>51</sup>Thani, NikNorzrul; Mohamed Ridza Mohamed Abdullah; Megathizaini Hassan (2003)

## Appendix B

### Action Plan of “Strategic Plan Islamic Banking Industry of Pakistan 2014 – 2018” related to Market Development Strategy

#### D: MARKET DEVELOPMENT

##### 1. PRODUCT DIVERSIFICATION

Action Plan	Time line	Responsibility
9.1: Develop “ Diminishing Musharaka” (DM) products based on market prices and rentals	2017	IBD in collaboration IH& SMEFD with the industry
9.2: Develop incentive mechanisms and enabling policy environment to stimulate “Musharaka” and “Mudaraba” based financing	2015	IBD
9.3: Develop policy guidelines for project/infrastructure specific ”Sukuk”	2015	IBD

##### 2: FINANCIAL INCLUSION

Action Plan	Time line	Responsibility
10.1: IBIs to make collaborative efforts to: a) Increase market share by 50% (to 15% from existing 10%) b) Increase branch network by 100% (to 2,000 branches from existing 1,000 branches) c) c) Improve “advance to deposit ratio” to be at least at par with that of conventional banking system	2018	IBIs/PBA sub-committee on Islamic Banking and IBD
10.2 Continuously interact and collaborate with IBIs to enhance: a) Agriculture financing to; at least 5% of the deposits or 10% of financing whichever is higher	2015	IBIs with IBD, AC & MFD, IH and SMEFD

b) Small enterprises financing to; at least 5% of the deposits or 10% of financing whichever is higher		
10.3 Facilitate Islamic Microfinance through initiatives like capacity building, product development, focused research and pilot projects	2018	IBD with AC & MFD and IBI
10.4 Encourage Islamic Low Income Housing finance through capacity building, product development, focused research and pilot projects etc.	2018	IBD with IH & SMEFD
10.5 Enhance use of Alternative Delivery Channels by IBIs.	2018	IBD with AC & MFD, PSD and industry
10.6 Develop/revamp refinance schemes for Islamic banking industry specially; a) Islamic Long Term Financing Facility (ILTFF) b) Islamic Export Refinance Scheme (IERS)	2015	IBD with IH & SMEFD and industry

Source: Strategic Plan Islamic Banking Industry of Pakistan 2014 – 2018

## Appendix C:

### Selected Data Tables for Pakistan

**Table C.1: Bank Advances by Modes of Financing in Pakistan (% shares)**

	1	2	3	4	5	6	7	8	9	
Time	Mushar- kah	Mudar- bah	Qard Hassan	Mura- baha	Ijarah	Dim. Mush.	Salam	Istisna	Others	Total
Dec-03*	1.3	0.0	0.0	62.7	19.3	0.1	2.0	13.3	1.4	100.0
Dec-04*	4.6	0.0	0.0	39.1	25.9	5.5	2.2	21.8	0.9	100.0
Dec-05*	0.5	0.0	0.0	42.7	25.7	14.5	1.3	14.7	0.6	100.0
Sep-06	0.7	0.0	0.0	38.8	33.1	12.3	4.5	1.2	9.4	100.0
Dec-06	0.8	0.0	0.0	40.3	29.9	16.1	0.7	1.4	10.8	100.0
Mar-07	0.8	0.0	0.0	41.0	29.7	17.4	0.8	0.6	9.7	100.0
Jun-07	0.7	0.0	0.0	44.9	30.2	19.9	1.2	1.0	2.1	100.0
Sep-07	1.6	0.1	0.0	40.9	28.8	26.1	1.4	0.0	1.0	100.0
Dec-07	1.6	0.3	0.0	44.5	24.0	25.6	1.4	1.0	1.6	100.0
Mar-08	2.0	0.0	0.0	44.0	22.0	25.0	2.0	3.0	2.0	100.0
Jun-08	1.3	0.3	0.0	38.0	21.5	29.4	1.4	2.6	5.5	100.0
Sep-08	1.7	0.3	0.0	41.0	21.3	30.1	1.5	2.5	1.8	100.0
Dec-08	2.1	0.2	0.0	36.5	22.1	28.9	1.8	2.9	5.4	100.0
Mar-09	0.9	1.2	0.0	37.6	21.3	31.6	2.2	3.2	1.9	100.0
Jun-09	2.6	0.6	0.1	40.2	18.2	31.4	2.0	3.3	1.6	100.0
Sep-09	2.6	0.4	0.2	36.5	21.5	27.4	1.2	4.4	5.7	100.0
Dec-09	1.8	0.4	0.0	42.3	14.2	30.4	1.2	6.2	3.6	100.0
Mar-10	1.7	0.2	0.0	37.5	14.0	31.6	4.0	6.5	4.3	100.0
Jun-10	3.7	0.2	0.0	44.1	14.5	28.3	2.0	3.9	3.3	100.0
Sep-10	1.2	0.2	0.0	43.3	13.6	32.1	0.8	5.4	3.5	100.0
Dec-10	2.9	0.2	0.0	44.9	12.7	29.5	1.4	5.8	2.6	100.0
Mar-11	3.0	0.2	0.0	45.4	12.4	29.4	2.5	4.0	3.1	100.0
Jun-11	2.8	0.2	0.0	45.0	11.8	31.8	2.1	3.3	3.1	100.0
Sep-11	2.8	0.2	0.0	41.5	11.9	33.2	1.5	3.8	5.2	100.0
Dec-11	2.4	0.1	0.0	43.8	10.4	32.1	2.4	4.4	4.3	100.0
Mar-12	0.8	0.1	0.0	40.1	10.7	35.1	3.9	5.3	3.9	100.0
Jun-12	1.1	0.1	0.0	40.1	11.0	35.8	3.5	5.2	3.2	100.0
Sep-12	1.0	0.1	0.0	38.6	10.5	37.1	2.2	6.1	4.2	100.0
Dec-12	0.8	0.2	0.0	39.7	9.3	36.2	3.0	6.5	4.3	100.0
Mar-13	1.4	0.2	0.0	36.0	9.2	35.8	5.2	6.5	5.6	100.0
Jun-13	1.5	0.2	0.0	39.9	8.5	32.9	4.9	5.5	6.7	100.0
Sep-13	4.1	0.2	0.0	40.2	8.6	33.1	3.4	4.8	5.6	100.0
Dec-13	6.7	0.2	0.0	40.6	7.7	30.8	4.0	5.6	4.4	100.0

Source: Islamic Banking Bulletins, State Bank of Pakistan

\* Quarterly data before September 2006 is not available

**Table C.2:** Share of ideal modes in total financing in Pakistan (% shares)

1	2	3	4	5	6
Time	Share of ideal modes (Sh <sub>im</sub> )	Seasonally adjusted Share (SaSh <sub>im</sub> )	Time	Share of ideal modes (Sh <sub>im</sub> )	Seasonally adjusted Share (SaSh <sub>im</sub> )
Sep-06	0.661	0.623	Jun-10	3.902	4.256
Dec-06	0.811	0.523	Sep-10	1.405	1.324
Mar-07	0.825	1.136	Dec-10	3.052	1.969
Jun-07	0.731	0.797	Mar-11	3.166	4.359
Sep-07	1.656	1.560	Jun-11	2.913	3.177
Dec-07	1.808	1.166	Sep-11	2.910	2.742
Mar-08	2.000	2.754	Dec-11	2.550	1.644
Jun-08	1.600	1.745	Mar-12	0.866	1.192
Sep-08	1.993	1.877	Jun-12	1.242	1.355
Dec-08	2.352	1.517	Sep-12	1.192	1.123
Mar-09	2.131	2.934	Dec-12	1.033	0.666
Jun-09	3.188	3.476	Mar-13	1.634	2.250
Sep-09	2.960	2.789	Jun-13	1.632	1.780
Dec-09	2.142	1.382	Sep-13	4.321	4.072
Mar-10	1.974	2.718	Dec-13	6.814	4.395
<b>Avg.</b>				<b>2.18</b>	
<b>St. Dev</b>				<b>1.29</b>	

Source: Islamic Banking Bulletins

**Table C.3:** Seasonal Factors

Quarter	Average $i_{th}$ Q	Seasonal factor
1	3.011	0.73
2	3.802	0.92
3	4.400	1.06
4	6.429	1.55
Overall	4.146	

**Table C.4: Annual growth rate of share of ideal modes (Shim) in total**

1	2	3
Time	Sh <sub>im</sub>	Annual Growth rate of Sh <sub>im</sub>
2003	1.283	
2004	0.801	-0.375
2005	0.482	-0.398
2006	0.811	0.681
2007	1.808	1.230
2008	2.352	0.300
2009	2.142	-0.089
2010	3.052	0.424
2011	2.550	-0.164
2012	1.033	-0.594
2013	6.814	5.596
		<b>Avg. = 0.661</b>

**Table C.5: Industry wise financing shares in Islamic and Conventional Bankings (%)**

Sno	Industry	Islamic Banking Shares				Conventional Banking Shares			
		2010	2011	2012	2013	2010	2011	2012	2013
1	Agri-business	2.56	4.00	3.70	3.60	5.95	8.33	8.44	7.55
2	Automobile and transportation equipment	1.68	1.00	1.40	1.70	1.28	1.43	1.34	1.35
3	Cement	4.10	3.00	1.50	0.90	2.56	2.17	1.39	1.21
4	Chemical and pharmaceuticals	7.14	7.00	7.40	6.30	3.86	3.92	3.58	3.33
5	Electronics and electrical appliances	1.78	2.00	1.50	1.70	1.66	1.61	1.36	1.31
6	Financial institutions	1.25	1.00	1.40	0.70	1.12	1.88	1.95	2.69
7	Individuals	16.54	15.00	14.20	13.30	12.01	8.97	7.94	8.50
8	Insurance	0.02	0.00	0.00	0.01	0.04	0.01	0.01	0.01
9	Production/Transmission of Energy	6.55	10.00	10.30	8.90	9.43	9.87	11.74	10.94
10	Shoe and leather garments	1.49	2.00	0.90	0.90	0.62	0.83	0.57	0.59
11	Sugar	2.30	3.00	3.80	3.90	1.98	2.24	2.52	2.67
12	Textile	21.80	20.00	19.00	19.10	18.99	18.16	16.67	17.29

Source: Islamic Banking Bulletins & Quarterly Compendiums, State Bank of Pakistan

## Appendix D:

### Selected Data Tables for Malaysia

**Table D.1(a): Industry wise financing shares in Conventional Banking (%)**

		2006	2007	2008	2009	2010	2011	2012	2013
1	Primary agriculture	2.60	2.40	2.18	3.01	3.26	2.77	2.84	3.10
2	Mining and quarrying	0.28	0.34	0.36	0.32	0.38	0.51	0.72	0.79
3	Manufacturing	23.61	23.84	23.44	20.11	20.42	22.14	23.13	21.95
4	Electricity, gas and water supply	0.25	0.19	0.36	1.21	0.67	0.72	1.01	0.95
5	Wholesale trade	12.27	12.07	13.47	11.91	13.51	13.77	16.13	15.38
6	Retail trade	3.46	3.80	4.28	4.05	4.10	4.20	3.89	4.18
7	Restaurants & hotels	1.04	0.50	0.59	0.64	0.38	0.36	0.57	1.00
8	Construction	6.28	5.48	5.25	5.94	5.60	5.50	5.03	5.50
9	Real estate	1.55	2.14	2.49	2.98	3.09	3.66	4.01	3.86
10	Transport, storage and communication	1.57	4.81	2.78	2.93	2.34	2.13	1.80	1.67
11	Financial intermediation	5.14	3.16	4.19	2.87	3.93	3.30	3.39	2.67
12	Renting & business activities	0.37	0.46	0.46	0.46	0.49	0.38	0.50	0.24
13	Research & development	0.00	0.01	0.01	0.01	0.04	0.01	0.02	0.04
14	Education, health & others	0.76	0.90	1.66	1.99	1.69	1.64	1.27	0.93
15	Household sector <sup>2</sup>	27.77	29.61	29.81	33.48	33.24	33.48	29.08	31.70

Source: BNM, Financing by Sector

**Table D.1(b): Industry wise financing shares in Islamic Banking (%)**

		2006	2007	2008	2009	2010	2011	2012	2013
1	Primary agriculture	3.99	3.78	4.60	3.72	4.19	3.05	4.36	4.55
2	Mining and quarrying	0.02	0.22	0.36	0.45	0.99	1.11	1.78	1.50
3	Manufacturing	28.46	23.73	26.35	18.38	17.85	20.04	17.06	16.43
4	Electricity, gas and water supply	0.73	0.69	0.48	0.84	1.03	0.58	0.91	1.18
5	Wholesale trade	5.41	7.18	10.19	12.80	8.57	8.63	8.76	9.50
6	Retail trade	3.75	3.64	4.01	1.81	3.28	3.73	4.19	5.09
7	Restaurants & hotels	0.15	0.08	0.24	0.13	0.39	0.60	0.22	0.22
8	Construction	8.70	10.33	6.65	7.06	7.54	5.90	7.09	8.94
9	Real estate	1.06	2.47	2.75	3.90	4.17	5.97	6.37	7.37
10	Transport, storage and communication	12.73	6.15	2.08	5.36	4.68	3.50	2.98	2.36
11	Financial intermediation	0.00	1.15	1.33	1.43	2.50	4.17	5.76	5.70
12	Renting & business activities	0.47	0.59	0.44	0.24	0.49	0.89	0.77	1.03
13	Research & development	0.00	0.10	0.80	0.19	0.01	0.01	0.03	0.01
14	Education, health & others	1.96	1.88	2.03	3.41	5.86	2.62	3.07	1.88
15	Household sector <sup>2</sup>	24.75	28.31	22.35	30.79	32.84	31.54	31.17	29.72

Source: BNM, Financing by Sector