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Towards an Islamic Financial System.**

*M. U. CHAPRA.**

1 INTRODUCTION

A developed and efficiently operating financial system is indispensable for an expanding economy. It serves as the hub of the overall economic system by facilitating the transfer of financial resources from surplus units to deficit units. The ease of transferability not only ensures liquidity for holders of financial assets, thereby reducing the volume of idle balances in the economy but also enables the optimum use of savings for long-term productive activity. It thus helps sustain economic growth and prosperity at a higher level. What is therefore important for the efficient operation of a financial system is the use by one party of the liquidity held by another. However, the purposes for which the liquidity is used and the mechanism through which this takes place are also questions of crucial importance, because the answers to these questions determine in essence the overall efficiency of the financial market in helping actualise the goals of an economy. Since financial markets are equally indispensable for Muslim countries, the question that automatically arises in the mind is : What will be the impact of Islamic injunctions on the efficiency of financial markets and on the nature and mechanics of financial institutions and instruments? This paper tries to answer these questions. Firstly, it deals with the likely effect of Islamic teachings on efficiency, and subsequently addresses the issues related to institutions and instruments.

2 THE EFFICIENCY

In the conventional interest-based capitalist system, efficiency of a financial market is measured by the criteria of liquidity and

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transferability - both of which indicate the ease, promptness and economy with which the flow of funds is arranged between the surplus and the deficit sectors, thus facilitating the payments and investments needed to promote economic growth and prosperity. It is assumed that the free interaction of market forces would establish a market clearing rate of interest and this would automatically bring about an efficient allocation of financial resources. No questions are raised about realizing socio-economic justice through need fulfilment and equitable distribution of income and wealth because this would involve value judgements, which are considered to be out of bounds for a secularist society. Islam however, has an economic system which gives utmost weight to the realisation of *maqasid* (goals of) *al-shar'ah*, including socio-economic justice. Hence, it considers value judgements not as anathema but rather indispensable. All systems and all activities in the economy must converge towards the goal of socio-economic justice. The ultimate efficiency of the financial system must also be measured by the extent this goal is realised.

2.1 *Justice, Distribution and Economic Activity.*

Justice in the Islamic value system requires that the financier, like the entrepreneur, must participate in the risks of business by sharing in the ultimate outcome of business, whatever it be, profit or loss. He cannot be given the right to have a predetermined positive rate of return (interest or *riba*) irrespective of the net outcome of the business. It is an unflinching conviction of Muslims that putting the entire risk of business on the entrepreneurs do not only vitiate the Islamic norms of justice, but also tends to promote concentration of wealth and to violate long-term commitment of funds for productive investment.

The undeniable fact is that interest rates are not determined anywhere by the free interaction of market forces. Administrative fiat, including central bank policy, has a great deal to do with interest rates. Moreover, the market clearing rate of interest exists in the imaginary ideal world of economists.¹ In reality there is a host of short and long-term interest rates with sizeable differences in their levels.²

¹MALINVAUD, E., "Interest rates in the allocation of resources" in F.H. Hahn and F.D.R. Brechling, *The Theory of Interest Rates*, New York: St. Martin's Press, 1963, p. 215.

²See MAYER, Thomas, *The Structure of Monetarism*, New York: W.W. Norton, 1978, p. 10; and also G. Santoni and C. Stone, "Navigating through the Interest Rate Morass: Some Basic Principles", Federal Reserve Bank of St. Louis, *Review*, March, 1981, p. 11.

Even if the market forces did determine freely a market clearing rate of interest, an "efficient" allocation of resources would take place only if there was an equitable distribution of wealth in society. However, given the substantial inequalities of wealth that are actually prevailing, there is little chance of an allocation of resources that would fulfill the needs of all and reduce inequalities of income. Firstly, the rich are able, by the sheer weight of their wealth and the votes they can cast in the market place, to get substantial resources diverted to the production of luxuries, leaving inadequate resources for the production of needs.

Secondly, in an interest-based system with substantial inequalities of wealth, the perfectly logical tendency on the part of a lender, who does not share in the risks of business, is to lend mainly to the rich. This is because only the rich are able to offer collateral, which carries a preponderant weight among the criteria for 'credit-worthiness', and which the lender demands to assure himself of the repayment of principal along with interest. This tends to accentuate concentration of wealth in society.³ If however, the lender shares in the risk, he would be concerned more about the nature and profitability of the business, in which case even a poor but promising entrepreneur would stand a chance and ownership of businesses would tend to become decentralised.

However, it is not just the amount of credit which favours the rich; it is also the rate of interest which reflects price discrimination in favour of the rich, the more 'credit-worthy' a borrower is the lower is the rate of interest he pays. The result is that big business gets more funds at a lower price because of its 'higher' or 'favourable' credit-rating. Thus those who are most able to bear the burden because of their bigness or higher productivity bear the least burden.

³E. S. Mishan has rightly observed that, "Given that differences in wealth are substantial, it would be irrational for the lender to be willing to lend as much to the impecunious as to the richer members of the society, or to lend the same amounts to each". MISHAN, E. S., *Cost Benefit Analysis: An Introduction*, New York: Praeger, 1971, p. 205.

The greater flow of credit to the rich in an interest-based system is a widely acknowledged fact. Galbraith, for example, says, "The large corporation of the planning system, when it must borrow, is a favoured client of the banks, insurance companies and investment banks". GALBRAITH, John Kenneth, *Economics and the Public Purpose*, New York: New American Library, 1975, pp. 186-187. See also p. 297 where he says, "Those who least need to borrow and those who are most favoured are in the planning system. Those who most rely on borrowed funds, or are least favoured, are in the market system". See also MOFFITT, Michael, *The World's Money: International Banking from Bretton Woods to the Brink of Insolvency*, New York: Simon and Schuster, 1983, pp. 210-211.

In contrast, medium and small businesses, which are often more productive in terms of contribution to the national product per unit of financing used and at least equally credit-worthy in terms of honesty and integrity, are only able to secure relatively smaller amounts at substantially higher rate of interest.⁴ Hence, many promising entrepreneurs wither away and potentially high-yielding investment do not get initiated because of lack of access to funds which flow instead into less productive but 'secure' hands. Thus big businesses become bigger beyond the point dictated by economies of scale. This contributes to large enterprises through vertical as well as horizontal expansion and to monopoly power, and throttles medium and small businesses through lack of access to adequate financing.

The interest-based system creates other problems as well, irrespective of whether interest rates are high or low. High interest rates serve as a deterrent to investment. Since interest costs are at the expense of profits, they erode profitability and serve as a key factor in the weakness of the overall volume of long-term productive investment.⁵ By depressing long-term investment, high interest rates reduce rates of growth and raise unemployment. In contrast to this, equity financing allows an equitable sharing of the risk and the total return between the financier and the entrepreneur and creates a more favourable climate for long-term investments.

Low interest rates hurt savers, particularly small savers, who make their savings available to deposit taking institutions, thus exacerbating inequalities of income and wealth. Low interest rates also stimulate borrowing for consumption by both households and governments and thereby increase inflationary pressures. Low interest rates also promote speculation in commodity, stock and foreign exchange markets and not only reduce the availability of funds for productive long-term investment, but also contribute to instability in commodity and stock prices and to erratic movements in exchange rates. They also induce excessively labour-saving investments which generate long-run unemployment.

The creation of a positive and invigorating investment climate

⁴According to a study conducted by Michigan State University, small firms in the industrial sector consistently generate more output per unit of capital than do their larger scale counterparts. Experience has also established the impressive loan repayment record of micro-enterprises. See, *Banking for the Poor: Alleviating Poverty Through Credit Assistance to the Poorest Micro-Entrepreneurs in Developing countries*, Report of the Select Committee on Hunger, U.S. House of Representatives, Washington: U.S. Government Printing Office, 1986, pp. 4-7, particularly Chart 2 on p. 5.

⁵LEIBLING Herman, p. 78 and BIS, *Fifty-Second Annual Report*, Basle, June 1982, p. 3.

requires the perennial maintenance of justice and balance between financiers and entrepreneurs. It would be realistic to assume the abolition of *riba*, reliance on equity-financing and ensuring an equitable sharing of profits (profit + interest of the capitalist system) among financiers and entrepreneurs can provide such a climate and lead to a substantial and steady rise in the demand for risk capital. Moreover, the discipline introduced by the need to 'participate' in risk should tend to shift resources from 'speculative' loans to 'productive' investments and thus exercise a healthy influence on economic activity in general.

Most interest-based modern-day economies, experience erratic movements in interest rates. These are primarily due to speculative forces and not due to changes in economic fundamentals which do not vary from hour to hour, or even from week to week. However, the erratic movements in interest rates inject an additional but unnecessary and unhealthy dimension of uncertainty in economic calculations and drive borrowers and lenders alike from long term end of the debt market into the short-term end. This has an adverse impact on the allocation of resources between users, sectors of the economy and countries. Since the share of the entrepreneur in the venture or enterprise keeps on fluctuating with every change in the rate of interest (not only in absolute but also in percentage terms), it becomes difficult to make long-term investment decision with confidence. This has no doubt serious implications for economic growth and stability.⁶

The abolition of interest and its replacement by profit-sharing according to a fair ratio between the financier and the entrepreneur

⁶VOLCKER, Paul A., Chairman of the Board of Governors of the US Federal Reserve System, while testifying before a Congressional sub-committee on May 21, 1980, remarked that, in the recent silver speculation, the Fed. had been worried that transactions financed by credit had contributed to speculation, had diverted financing from more productive uses and had been excessive. The use of credit in this way could ultimately threaten the safety and soundness of financial institutions. P. A. Volcker further remarked that the recent speculation in the gold and silver markets had contributed to inflation and other such speculation could do likewise. *BIS Press Review*, May 23, 1980, p. 2.

The Bank for International Settlements, a highly reputed international institution, rightly observed in its 1982 *Annual Report*, *op. cit.* that "increased volatility of short-term interest rates may have added another sort of uncertainty premium to long-term rates" (p. 5). The Report further observed that "The greater volatility of both interest rates and the monetary aggregates, at the same time, have joined forces with the budget to push real long-term rates upwards" (p. 5). Later on the Report made a stronger statement saying "... extreme volatility in interest rates can contribute to sharp fluctuations in economic activity and may lead to structural problems in the economy and in the financial system" (p. 89).

should remove one of the major sources of uncertainty and injustice and be more conducive to growth. It must be appreciated that the entrepreneur is the primary force behind all investment decisions and removal of one of the basic sources of uncertainty and injustice is bound to have a favourable effect on his decision making. By turning "savers into entrepreneurs", using the words of Ingo Karsten, the risks of business can be more equitably distributed, thereby improving the investment climate. Moreover, the involvement of the savers as well as the financial institutions in the success of the entrepreneur's business, may make greater expertise available to the entrepreneurs, leading to an improvement in the availability of information, skills, efficiency and profitability. Higher productivity and more entrepreneurship carries the potential for increased investment and higher growth.⁷

2.2 *Health of Financial Institutions*

An equity-based system should also be able to promote the development of healthier financial institutions. In the interest-based system, banks operate under the assumptions that their loans will be repaid with interest because they do not share in the risk of business. Hence, their concentration is more on the collateral and less on the quality of the project financed. Thus, the quality of loans suffers. Even though the banks require collateral and do not theoretically participate in the risk of businesses financed, there are loan losses. Deposits have nevertheless to be repaid with interest. Hence the nominal value of bank assets and liabilities may not always be equal due to realised or impending loan losses.⁸

This divergence between bank assets and liabilities and the uncertainty about when and how it is to be corrected carries the potentiality for instability. In the Islamic system, since all time and fixed (but not demand) depositors, like shareholders, also participate in the risks of banking, the nominal value of liabilities to such depositors will always be equal to the assets held against them. The imperative of risk-sharing will also induce depositors to be cautious about the institutions (the quality of their management, assets, past records, reserve position and future prospects) with which they place their deposits. It will also make the banking institutions more careful in selecting projects for investment because it is the quality of their investments which will build their reputation,

⁷KARSTEN, Ingo, "Islam and Financial Intermediation", *IMF Staff Papers*, March 1982, p. 131 as well as pp. 129-136.

⁸See KHAN, Mohsin S., "Islamic Interest-Free Banking: A Theoretical Analysis" *IMF Staff Papers*, March 1986, p. 19.

make it possible for them to attract funds and depositors and enable them to survive. Weak institutions, with poor management and unhealthy investment policies, will have a hard time getting ahead on the crutches of deposit insurance, which will be available only for demand deposits in the Islamic system, and the backing of collateral, which can have erosion in value with the slide in economic prospects.

In the absence of ceilings on interest rates payable on deposits, banks tend to compete aggressively for deposits and loans. They offer higher rates to depositors and accordingly seek larger spreads by choosing the higher credit risk, lending to low quality borrowers who are willing to pay larger front-end fees and higher rates. There is hence a deterioration in the quality of many depositor institutions loan portfolios. According to Lowell L. Bryan, Director of McKinsey Company, many of the United States depository institutions are "full of poor quality debt to farmers, real estate developers, independent oil producers, Third World countries, subser-vient grade corporations, and free-spending consumers, and as a result, their problem loans are far too large for their earnings and capital".⁹ This position is true for not only "weaker" institutions but also for some of the most prestigious American banks, the impending losses on whose loans to Third World countries are far in excess of their capital and reserves.

Imposition of ceilings on interest rates payable by banks on deposits, however, create problems of a different nature. Controlled lower interest rates tend to be at the expense of depositors, particularly the smaller ones who suffer from a lower return on their meagre savings. While this discriminates against the depositors, it may not necessarily improve the quality of loans. Interest rate ceilings may only provide the banks with an opportunity to widen the spreads without exerting a significant influence on the quality of their loans. In fact the ability to build higher reserves for loan losses may tend to reduce the pressures for attaining better quality loan portfolios.¹⁰ Healthy institutions more concerned with the quality of their loan portfolios may thus stand at a disadvantage if they have to operate in a competitive environment.

The equity-based system would not put healthy institutions at a disadvantage. The return they have to pay will depend on their ex-post performance and the weaker institutions will not find it possible to out-bid the healthier ones on an ex-ante basis. The

⁹BRYAN, Lowell L., "The Credit Bomb in Our Financial System", *Harvard Business Review*, January-February 1987.

¹⁰See *ibid.*

depositors will also be more careful and not be misguided by the ex-ante promises of the weaker institutions. This will help inject health into the whole system.

It must however be admitted that risk/return sharing will make financial intermediation a more challenging task for banks. Financial institutions will have not only to evaluate projects and project managers but also monitor the progress of projects financed. Unless the financial institutions developed the expertise needed for this purpose and unless efficient auxiliary institutions are established to help them in this task, they will not be able to meet the challenge effectively.

2.3 *Resource Mobilization*

Capital formation is essential for all countries to attain higher growth, create employment opportunities, and realise the general well-being of society. Capital formation however requires a high rate of savings and the efficient mobilization of these for investment. It may be asked here that while inculcation of simple living and the abstinence from ostentatious consumption (as required by Islam) may promote savings, would the imperative of participating in risk to get a return induce savers to shy away from financial institutions, thus immobilizing savings? The possibility of suffering a loss has not deterred savers from either investing in their own businesses or purchasing the shares of joint stock companies and mutual (equity-based) funds. Hence there is no valid reason to believe that the prohibition of *riba* will discourage risk taking.

Nevertheless, it may be argued that all savers do not wish to take risk and do not have the ability or the time to evaluate risk. It should not however be difficult for the Islamic financial system to provide financial assets involving varying degrees of risk and maturity so as to provide investment opportunities even for those savers who wish to minimise risk. This could be done by ensuring the development of a large network of well-managed, properly-regulated, and healthy financial institutions with a sufficiently diversified portfolio of assets to inspire the confidence of savers. A network of such institutions may also help provide the necessary institutional framework for those who are not able, or do not wish, to evaluate the risks of business themselves. Savers who are not willing to take any risk must remain satisfied with the nominal value of their finances, which must be guaranteed (only in nominal terms) if they provide these to commercial banks in the form of demand deposits. There is no possibility within the Islamic system for a financier to remain on the sidelines and yet be assured of a positive rate of return.

The conventional financial institutions have been unable to penetrate a predominant part of the rural as well as urban population in practically all Muslim countries because of a number of factors, an important one being the aversion of the Muslim masses to interest-based banking institutions. The establishment of Islamic institutions may help draw the masses into the fold of the banking system and thus contribute richly to capital formation. Hence, the greater the success of Islamic financial institutions in mobilising savings, the greater will be the service they will be able to render to the *Ummah*. This may also help reduce the need for freezing savings in unproductive assets like gold and jewelery, which are at present the main available outlets other than land and real estate for savings. As Dr. V. Nienhaus has rightly pointed out, the "Islamic banks can be an instrument for the integration of the vast majority of the population into the financial system", and "the probable impact of well-designed Islamic banks for the initiation of a self-supporting process of capital formation can hardly be overestimated".¹¹

The levy of *zakat* on all net worth, including financial assets, should help discourage the holding of idle currency balances. The absence of any return on demand deposits should also have a similar effect. Demand deposits, being withdrawable on demand and also fully insured, would not be entitled to any return because, according to the *Shari'ah*, a share in profit is not permissible without a share in risk. Hence, balances held in demand deposits would, like currency balances, tend to be not more than transactions and precautionary needs. It would hence be logical to assume that if the Islamic values are revived and healthy Islamic financial institutions are established, savings would tend to move into equity and *mudharabah* deposits, thus enlarging the availability of savings for investment and making a significant contribution to economic growth, reduction of unemployment and need fulfilment.

It may however not be possible to induce people to get into equity until a larger volume of shares is made available and unless there is confidence that corporations will give a reasonable return on savings. Requiring the corporations to reduce their debt by increasing equity and large partnerships to convert into corporations may help expand the volume of shares available in the market, thus providing the needed depth to the securities market and increased investment opportunities to savers. The performance of joint stock companies with respect to dividends has not been very

¹¹NIENHAUS, Volcker, "Islamic Banks - Philosophy, Performance and Policy", an unpublished paper, p. 7.

encouraging in many Muslim countries. Due to corruption, the return to shareholders, historically has not been very attractive. The tax system has also been partly responsible for this. Unless corporations are reformed, properly regulated and effectively audited, manipulation of accounts may be difficult to prevent.

Similarly, financial institutions will need to be regulated and reformed so that *mudharabah* depositors are able to get an honest reward. This is not a problem in interest-oriented financial institutions, or even in Islamic institutions as long as they operate on the basis of *murabahah* and *bay' al-mu'ajjal*¹² because the depositor knows in advance what return he will earn. Once the Islamic system of risk participation comes into force, depositor's confidence in the integrity of financial institutions will be indispensable for mobilising *mudharabah* deposits. While market forces will take care of this problem in the long-run, social and economic reform to ensure greater honesty in management and auditing are also essential.

There are however uses of funds where the sharing of risk and reward may not be feasible, as in leasing, instalment and hire-purchase. It would be necessary to provide financing even for such purposes, without violating Islamic norms. Islam, being a realistic faith, has allowed a fixed charge on real assets (like machineries, vehicles, buildings) even though it has not allowed a fixed return on financial assets. This is because by converting financial into real assets, the financier has already taken the risk. Nevertheless, some *fuqaha* believe that this concession or relaxation should be used with caution and preferably, only where profit and loss sharing is not possible, as otherwise there is a possibility that it may lead to interest indirectly. Relaxation has also been made in the case of instalment purchases by allowing a difference between cash and instalment prices to cover the additional costs and risks of such sales because profit and loss sharing may not be possible.

Hence, even though the Islamic system carries a great positive potential it may not be able to bear fruits unless the Muslim countries make a satisfactory institutional arrangement to enable

¹²*Bay' al-mu'ajjal*: Sale against deferred payment, either in lump sum or instalments. The Council of Islamic Ideology (Pakistan) has, however, used it in the same sense as *murabahah*.

Murabahah: Sale at a specified profit margin. The term is, however, now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in instalments or lump sum. The seller undertakes all the management needed for the purchase and also bears the risk for the goods until they have been delivered to the buyer.

funds to flow "efficiently" from the surplus sectors to the deficit sectors regardless of whether the savers are risk takers or risk averters. The system should also provide a sufficiently large stock of financial assets which are readily transferable, so that anyone with surplus funds can buy them and anyone needing liquidity can readily sell them. Thus the institutional arrangement should ensure a high degree of liquidity and transferability. Given a proper institutional arrangement it may be rational to expect that the Islamic equity-based system would not only be more conducive to socio-economic justice, but would also carry a greater potential to contribute positively to better economic performance through a more efficient allocation of resources, increased investment, higher growth and lower unemployment.

3 THE INSTITUTION

The above discussion has clarified the goals and the criteria for efficiency of an Islamic financial system. Since the financial institutions would be the agents through which the goals of the system would be realised, it is necessary to discuss the reorganisation of the conventional money and capital market institutions to enable them to serve the socio-economic objectives of Islam.

An efficient financial system can bring together savers and investors in two principal ways. The first is via the traditional intermediation process whereby the financial institution makes loans and investments with the funds it has generated through deposits and other sources of funding. The financial institution makes the investment decisions and also bears the risk. A pattern of faulty investment decisions will ultimately jeopardise its capacity to raise and retain funds. The second mechanism is via the securities markets wherein investment instruments are sold directly to investors. The financial institution passes the risk to the buyer of the instrument. The stability and viability of the system requires that the decision-making process be rigorous enough to screen out investments without making it too difficult, time-consuming and costly for entrepreneurs with productive and profitable investment proposals to raise funds. The system should enable the absorption of losses in an orderly way since some losses, particularly in a risk/reward framework, are an inevitable part of financing and development.

Both these forms are possible within the Islamic system. These methods include a number of techniques available within the framework of the *Shar'ah*. The most important and unanimously agreed upon forms of financing are *mudharabah*, *musharakah* and the acquisition of shares of joint stock companies.

In the case of *mudharabah*, the financial institution does not

participate in the management of the business financed. It can, however, exercise adequate supervision to ensure that the funds are being used in accordance with the *mudharabah* agreement. Of the total financing agreed between the financial institution and the *mudharib*, a part may be provided for the entire period agreed, while a part may be available for short periods to offset the *mudharib's* funds in transit or to take care of seasonal or unforeseen shortages of liquidity.

In the case of *musharakah*, the financial institution also participates directly in the management of the business. The financial institution and the entrepreneur pool their talents and expertise for furthering the business. However, since financial institutions may not be adequately equipped with the human infra-structure needed for this purpose, the *musharakah* participation may be possible in only a few businesses. A major part of the financing, will of necessity, have to be in the form of *mudharabah*.

Investment in the stocks and shares of joint stock companies, whether public or private, should be an attractive avenue for the employment of funds by financial institutions. In fact, the stocks of well-established and high-dividend yielding companies may serve as an alternative for interest-bearing government securities and bonds of private companies. With the presence of a well-organised and properly regulated stock market, the financial institutions may be able to transfer such stocks whenever they desire, thus ensuring liquidity - an advantage which *mudharabah* or *musharakah* financing may not be able to offer.

A number of other alternative financing arrangements within the general framework of Islamic values, have been suggested in the literature on Islamic banking. The major alternatives recommended are *ijarah* (leasing) and *ijarah wa-ibtina* (hire-purchase), *bay' al-mu'ajjal* or *bay' murabahah*, and *bay' al-salam*.¹³ There is however a difference of opinion about the permissibility of some, though not all of these alternative forms.¹⁴ The general principle which is

¹³ *Bay' al-salam*: a forward sale of specified fungible (mainly, agricultural) goods for which full advance payment is made by the buyer against an obligation to deliver the specified goods on an agreed future date. This sale is not the same as a speculative forward sale because full, and not just margin, payment is required.

¹⁴ For a discussion see CHAPRA, M. U., *Towards a Just Monetary System*. (Leicester, U.K. : The Islamic Foundation, 1985), pp. 166-173.

Dr. Ziauddin Ahmad makes the following observation about these techniques: "though far simpler to operate compared to profit/loss sharing, cannot be commended for widespread use as they cannot be of any material assistance in achieving the socio-economic objectives of an Islamic economy. The fact that replacement of interest by *Bay' al-mu'ajjal* (mark-up), for example, does not represent any substantive change becomes apparent if one views it in the perspective of the philosophy

beyond dispute as being the criterion for determining the permissibility or otherwise of any method of financing is that the financier cannot avert the taking of risk if he wishes to derive an income. To put this in the form of an adage, one could state with respect to all financing operations: "no risk, no gain". As already indicated above, this requirement to share in the risks of business will compel financial institutions to be more careful in financing.

The fundamental change in the nature and objectives of intermediation will naturally demand a significant transformation in the nature and responsibilities of all financial institutions in an Islamic economy. They will have to undergo a significant reform and even though they may outwardly appear to be the same, they will be significantly different. The institutions whose reform will be needed will include the central bank as well as all money and capital market intermediaries - the commercial banks, the auxiliary institutions and the stock market.

4 CENTRAL BANK

The central bank cannot remain a passive onlooker in the process of Islamisation of the financial system. It must play a pivotal role. Without its conscientious and creative effort, the Islamic financial system cannot achieve its self-actualisation. It has to play an important role in four different areas of its responsibility - training, stability in the value of money, development and strengthening of the financial system, and handling of liquidity crisis.

Training is crucially important because of the lack of general understanding in even the Muslim elite about the nature and

behind the prohibition of interest. As mentioned earlier, the interest system is disallowed by Islam because intrinsically it is a highly inequitable system. The feature that makes the interest system inequitable is that the provider of capital funds is assured a fixed return while all the risk is borne by the user of these capital funds. Justice, which is the hallmark of the Islamic system, demands that provider of capital funds should share the risk with the entrepreneur if he wishes to earn profit. It is easy to see, therefore, that the mark up system, and for that matter all other devices which involve a fixed predetermined return on capital, are no real substitutes for interest."

ZIAUDDIN, Ahmad, *Concept and Models of Islamic Banking: An Assessment*, paper presented at the Seminar on Islamisation of Banking held in Karachi on 27-29 November 1984 under the auspices of the Institute of Bankers in Pakistan, published by the International Institute of Islamic Economics, Islamabad, 1984, p. 11.

For some other views on the subject, see MIRAKHOR, Abbas, *Short-term Asset Concentration and Islamic Banking*, unpublished paper, pp. 2-6. Dr. Mirakhor refers to these techniques as "weakly" and argues that "even in the transition to full Islamic banking, the policy of heavy reliance on weakly Islamic measures as a means of minimising risk may not be optimal", p. 6.

functioning of an Islamic financial market. Not only their own staff but also the staff of other financial institutions and the public at large will need to receive an orientation in the goals and nature of Islamic economy and financial system and the change in the role that the central bank is required to play in it. Central banks in all Muslim countries are used to arranging training programmes. But what is needed for an Islamic system is training of a different nature and this cannot be provided in a vacuum. Proper training material will have to be developed to make everyone aware of what is involved.

Since stability in the value of money is an important goal of Islam, the central bank will have to take all possible measures to ensure that monetary expansion does not lead to inflation. However, without the willing and wholehearted support of the government it is not possible for the central bank to realise single handedly the goal of price stability.

The central bank will also have to play an important role in the development and strengthening of an Islamic financial market. Businesses will have to be gradually induced to resort to more and more equity financing and to reduce their dependence on interest-based loans. This goal cannot however be actualised without the transformation of commercial banks and the development of necessary auxiliary institutions. The central banks will have to play an important role in the promotion, regulation and supervision of such institutions with the objective of helping them and making them healthier and stronger. All existing laws related to interest-based financial institutions will have to be reviewed and amended or reconstituted in the light of Islamic teachings to reflect the different needs of the Islamic system.

The central bank will also have to create an appropriate mechanism to handle liquidity crisis to which the Islamic banks may be susceptible to, particularly in the initial phase when their investments may not be adequately diversified or properly organised to make the maturities of their assets match their liabilities. In a profit-and-loss sharing framework, the bank may not be able to withdraw its equity-oriented loan until the project or the venture has reached a successful fruition. Hence an appropriate framework must be designed to help banks to overcome their liquidity shortages. In the interest-based system, it is possible for banks to resort to the money market or the central bank. Access to the money market may not always be possible because of the difficulty of profit-sharing in isolated loan transactions undertaken mainly for arranging liquidity. Interest-free access to the central bank may lead to a misuse of the facility while *mudharabah* lending by the central bank may be available only within an agreed framework

determined by the extent of the economy's need for high-powered money to attain a given monetary expansion and not necessarily when banks run short of cash.

Three alternative arrangements may be made to solve this dilemma. First, banks should reach an understanding with other banks for mutual credit facilities, as is the usual practice of conventional banks, but within the profit-and-loss sharing framework. Second, there should be an interbank cooperative arrangement to extend reciprocal accommodation to each other on condition that the *net* use of this facility is zero (mutual borrowings cancel out mutual lendings) over a given period. Third, the banks should create a common fund at the central bank as a part of the statutory reserve requirement to provide mutual accommodation. Of course, banks which have more frequent recourse to each other for funds would be better off having a mutual profit and loss sharing arrangement. It would help banks to place surplus funds and to balance their short-term assets and liabilities. In a crisis situation, when all banks face a liquidity squeeze, or the individual banks are unable to get enough assistance through all the three alternatives indicated above, the central bank would be the only recourse left and should act as lender of last resort with appropriate penalties and warnings accompanied by a specially-tailored corrective programme.

It may be argued that all the three methods would make a smaller overall contribution to the Islamic banks' funds than is the case with conventional banks. This should in fact be healthy and make banks more reliant on their own resources and have access to other banks only when it is necessary. Excessive reliance on funding from other banks is a weakness of the conventional banking system which gains limelight whenever there is a banking crisis. "How extra-ordinary it is", remarks Michael Lafferty, "that banks do not take the same precautions when they lend to other banks", and that they do not even bother to "take the trouble to look up a set of the banks' published accounts"¹⁵ This laxity leads to an abuse of the interbank facility in an interest-based environment.

¹⁵LAFFERTY, Michael, "Why Banks' Financial Information May Contribute to their Crisis", *The Financial Times*, 10 September, 1982. See also MONTAGNON, Peter, "A Jolt to be Remembered", in *The Financial Times*, 1 March, 1983. According to Moffitt, "A major point of vulnerability is the banks' heavy reliance on borrowed funds", which come "primarily by borrowing from each other". In 1981 these borrowings funded more than half of the major assets of American commercial banks, up from 45 per cent five years ago. MOFFITT, Michael, *The World's Money: International Banking from Bretton Woods to the Brink of Insolvency*, New York: Simon & Schuster, 1983, p. 225.

The limitation and discipline of the interbank market within the profit-and-loss sharing arrangement should exert a healthy influence.

5 MONEY AND CAPITAL MARKETS

The abolition of *riba* and the absence of any possibility of an interest-based intermediation will change the nature of all money and capital market institutions including the commercial banks, auxiliary institutions and the stock market. New challenges will have to be faced and innovative devices found, not only to solve the problems they may face but also to help realise the socio-economic objectives of Islam, by injecting a social welfare dimension in financial intermediation.

5.1 Commercial Banks

The commercial banks in an Islamic economy will have to play the role of a cross-breed of commercial and investment banks, investment trusts and investment management institutions. A spectrum of other reforms must also be introduced in the organisation and operation of commercial banks to eschew their excesses and imbalances which promote inequalities, conspicuous consumption and unhealthy monetary expansion. It would be necessary to convert all the conventional interest-based banks into Islamic institutions, irrespective of whether they are of domestic or foreign origin. Exempting any of the banks even though foreign, would be tantamount to sabotaging the whole system. People with no moral conviction would tend to shift their allegiance between Islamic and conventional banks depending on the level of interest rates and profit expectations, thus weakening both types of institutions.

It would be necessary that a substantial part of the resources of all commercial banks, as of all other financial institutions, should come out of equity capital. There is no reason why in the essentially equity-oriented Islamic system, banks, like other businesses, should not have a substantial equity base. Safety of the demand depositors' funds also requires higher equity. Moreover, savers would also like to have a greater opportunity to invest in the shares of financial institutions.

It would also be necessary that the conversion starts with a clean slate - without past encumbrances. All possible measures should be taken to recover or write off totally or at least substantially the heavy burden of non-performing loans that some private and almost all nationalised banks are now carrying on their books in a number of Muslim countries due to inefficiency, corruption or political pressures. The extent of such loans is so high in some cases that even if the equity and accumulated reserves are written

off completely, a substantial amount would still remain uncovered. It would be highly unjust to write off such loans out of the profits accruing to *mudharabah* depositors. In case the banks continue to be in the public sector, the Government should provide fresh equity to the banks to provide the necessary capital base. In the case of private banks equity should be raised substantially to provide the banks with a stronger and more widespread equity base.

5.2 *Deposit Insurance and Loss-offsetting Reserve*

Even after the non-performing loans have been recovered or written off, it may be necessary to reassure depositors that their savings placed with the Islamised banks will not be eroded by any losses that the banks may suffer on their *mudharabah* financing. It would be desirable to educate them that under normal circumstances, an efficiently managed Islamic bank with a properly diversified portfolio of *mudharabah* investments is not likely to suffer a net loss. While the banks may suffer losses on some of their investments they will make profits on others, such that they may have a net profit. Nevertheless, two measures could be adopted to provide a further reassurance to depositors.

With respect to *demand* deposits, which would give no return, the reassurance could be provided through a system of deposit insurance, guaranteeing the safety of demand deposits from any losses that the banks may suffer. Even according to the *Sharfah* it is perfectly legitimate for the depositors to demand such an assurance, because, since they do not share in the profits, they cannot be required to share the risk of losses.

With respect to *mudharabah* deposits, which would share in profits or losses, the reassurance could be provided by requiring the Islamic banks to build a loss-offsetting reserve from their annual profits. An objection could be raised against the above on equity grounds - why should the present *mudharabah* depositors provide for the losses that may be incurred in the future. Such a reserve could however be defended on the principle of public interest which plays an important role in *fiqh* discussions. The public's confidence in the health and viability of Islamic financial institutions would depend on the ability of these institutions to absorb losses in an orderly manner. Hence the small sacrifice that the depositors would be required to make from their profits should be acceptable.¹⁶

¹⁶The *Sharfah* recognises the infliction of a smaller loss to prevent a bigger loss (see Article 27 of the Hanafi *fiqh* Compendium *Majallah al-Ahkam al-Adliyyah*), the bigger loss in this case is the weakening of the Islamic banking system which can cause a significant damage to the Islamisation process.

5.3 *Socio-economic Justice through Financing*

Since bank financing comes out of funds belonging to the public, it is natural to expect that its benefit, like that of other public goods, should permeate to as large a proportion of the population as is possible. Hence the mere abolition of *riba* would not be sufficient for the Islamisation of the financial system. It must also help in the realisation of socio-economic goals. This may be done by ensuring that bank resources finance an optimum number of businesses in society to realise a widespread ownership of businesses and lead to an optimum production and distribution of goods and services needed by the majority.

No other system in the economy carries as great a potential for creating a broad-based ownership of businesses and industries as the financial system. Unfortunately, as the Report of the Select Committee on Hunger has rightly pointed out, the conventional financial institutions "do not recognise the viability of income-generating enterprises owned by the poor". They "prevent the poor from gaining access to legal credit through extensive collateral requirements and difficult repayment schedules" even though the provision of "small amounts of credit to micro-enterprises in the informal sector economy can significantly raise the living standards of the poor, increase food security and bring about sustainable improvements in local economies".¹⁷ Hence it is desirable to create a mechanism which would help divert a significant proportion of the resources of commercial banks to the financing of small and micro-enterprises in harmony with the *maqasid al-Shari'ah*.

The reason normally given by the commercial banks for diverting a very small proportion of their funds to small - and medium-sized businesses is the greater risk and expense involved in such financing. Hence small firms are either unable to get financing from banks or do so at highly unfavourable terms (cost as well as collateral) compared with their larger counterparts. Thus the growth and survival of small firms is jeopardised even though they carry a great potential for increased employment and output and improved income distribution. It would therefore be desirable to reduce the risk and expense of such financing for banks.

5.4 *Risk and Expense*

The risk may be reduced by introducing a loan guarantee scheme underwritten partly by the government and partly by the commercial banks. In the case of Islamic banks, the guarantee

¹⁷Report of the Select Committee on Hunger, *op. cit.*, pp. 1 and v.

scheme cannot guarantee the repayment of loan with interest as is the case in the conventional system. The scheme should, however, relieve the bank of the need to ask for collateral in the case of small businesses whose general credentials have been registered with or certified by the guarantee scheme. The scheme would do this after a proper investigation of the firms concerned. It will also arrange to train the businesses to maintain proper accounts and to have them properly audited.

The loan guarantee scheme should not operate just at the peripheries as is the case in the capitalist countries where it has been introduced. The scheme should be implemented extensively with at least as much priority given to its objective as to national defence - to enable a fairly large number of small and micro-enterprises to get financing for the production of needs-satisfying goods and services without being able to offer the collateral required. The bank will receive its money back in case of moral failure of the business. The scheme may also be made to include most non-commercial risks desired to be covered for increasing the availability of funds to small and micro-enterprises. In case of market failure and the resultant loss, the bank will of course share the consequences with the business in proportion to the financing provided by it.

This should not create any apprehensions about the viability of the loan guarantee scheme due to heavy loan losses. The experience of the International Fund for Agricultural Development (IFAD) is that credit provided to the most enterprising of the poor is quickly repaid by them from their higher earnings.¹⁸ The report of the Select Committee on Hunger also indicates that the : "Micro-enterprise projects have recorded significant and impressive loan repayment rates"¹⁹ Testimony from the Grameen Bank in Bangladesh indicates a constant repayment rate of 99 percent since the bank's inception.²⁰ Other micro-enterprise credit programmes have yielded similar results. Hence, there is no need to be unduly apprehensive about loan losses from such financing.

The additional expense incurred by the commercial banks in evaluating and financing small businesses should be partly or wholly offset by the Government depending on the nature of the case and the objectives to be served. The cost to the Government exchequer arising from the above two schemes is justifiable in the larger interest of the goals of the Islamic economy. After all, large

¹⁸See *Economist*, 16 February, 1985, p. 15.

¹⁹Report of the Select Committee on Hunger, *op. cit.*, p. 7.

²⁰See YUSOF, Muhammad, *Group Based Savings and Credit for the Rural Poor*, Grameen Bank, Dhaka, Bangladesh: November, 1983.

businesses have been subsidised by Muslim governments for decades through various ways including tax incentives, concessionary financing, import licenses, overvalued currencies, and subsidised inputs. There is no reason why the balance should not now be tilted in favour of small and micro-enterprises when the promotion of such businesses is in conformity with the *maqasid al-Shar'ah*. Nevertheless, if it is felt that the cost would be a heavy burden on the public exchequer, it could be partly or fully offset through a share in the profits earned from such financing by the banks and the small businesses.

5.5 Auxiliary Institutions

The participation of financiers in the risks of business will, as indicated earlier, require a fundamental change in the whole process of financial intermediation. Savers, financiers, entrepreneurs and even financial institutions will all need the services of different types of investment management institutions, consulting firms and auditors. If such services are not available the task of equity financing may be rather more difficult.

One set of such institutions will be the non-bank financial institutions which will basically provide investment-management and consulting services to savers and entrepreneurs. They will also act like investment trusts or mutual funds and use the funds they have received to acquire equity in other businesses and to provide financing in any of the several Islamic financing methods. They will also act as intermediaries to bring together financiers and entrepreneurs. They, along with other commercial banks, will make it possible for savers to attain the needed diversification in their investments, thus minimising the risk that equity investment involves.

For the sake of better money management these institutions should not be allowed to accept demand deposits. Their resources should come out of equity, *mudharabah* deposits and special funds placed with them for short, medium, or long-term management. They should be properly regulated, like the commercial banks, to ensure healthy financing practices, fairness in their dealings and safety of the *mudharabah* depositors' funds.

Since such institutions will be under a market compulsion to declare a competitive rate of return on their shares and *mudharabah* deposits, there will be a natural urge on their part to demand from the users of their equity and *mudharabah* financing a high rate of efficiency in the use of funds. Thus it is not realistic to assume that in an interest-free banking system the *mudharib* or entrepreneurs will cheat the financial institutions by declaring lower rates of profit. If any *mudharib* resorts to such practice he will likely deprive

himself of future *mudharabah* financing. Since such financing may be an important source of funds for most traders, agricultural and industrial entrepreneurs, they could hardly be expected to resort to such a self-defeating policy.

Government-sponsored specialised credit and investment institutions have been playing a pioneering role in the development of industry, agriculture, housing and exports in many Muslim countries. Their activity should be continued, but within the framework of Islamic teachings. It may also be desirable to promote properly-regulated and efficiently-operating cooperative societies among small-scale businesses to enable them to make mutual arrangements for their short-term financing needs, organise bulk purchases and sales of their inputs and outputs, and solve their other problems mutually.

An equity-based financial system would also need the services of consulting firms to evaluate the feasibility of projects suggested for *mudharabah* or *musharakah* participation. Institutions may also have to be established to collect and provide data on the trustworthiness of individuals and businesses. This task may however be taken over substantially by the loan guarantee scheme after its establishment.

In the Islamic financial system where the investor is not assured of a predetermined positive return, it is important for the investors to have confidence that they will get a fair share in the profit of the company in which they have invested or of enterprises to whom they have provided financing. Such an assurance may be provided by the proper regulation and organisation of audit firms so that they are able to determine the fair level of profit. It may be helpful if an investment audit corporation (IAC) is established under government umbrella to audit the accounts of *mudaribs* who have obtained *mudharabah* financing or equity funds from others directly or through commercial banks and non-bank financial institutions. Since it is not possible to carry out the audit of all the users of *mudharabah* funds, the IAC may carry out the audit of a random sample of *mudaribs* or those specifically referred to it by financiers, financial institutions or investors. Such audit will keep the users of equity and *mudharabah* funds on their guard and create a deterrent to under-reporting of profits, thus safeguarding the interests of financial institutions, depositors and equity holders.

The creation of IAC would save the individual financial institution the need to hire a large staff of auditors. It will thus create a substantial economy in expenses for all financial institutions. It will also provide an assurance to investors who provide their funds directly to businesses that, in case of need, they will be able to have the accounts properly examined by a qualified, impartial institution. The creation of IAC would answer the major, though

invalid criticism against the Islamic banking system, that it would require each banking institution to hire a large staff of auditors and would make bank management very expensive. In the absence of such staff, it is argued, the banks would not be able to determine the accuracy of accounts. The market forces would automatically take care of this problem, but nevertheless, the creation of IAC would further safeguard the interest of investors.

5.6 The Stock Market

The development of a primary capital market, is difficult if an efficient secondary market is not developed simultaneously. The secondary market provides the investor with the assurance that he can 'liquify' his investments when he wishes to do so. While the financial intermediaries should be able to arrange the sale of *mudharabah musharakah* and other closed-ended investments, the stock exchange will provide a mechanism for the exchange of shares.

If the existing joint stock companies are required to issue additional shares to replace their interest-based borrowings, the value of shares available in the market will rise and provide a broader base for stock market transactions. However, the existing stock markets with erratic movements in stock values and risk of substantial capital loss may serve as a deterrent for investors. The investor is attracted to buy shares if (i) the shares pay a fair dividend to the shareholder in keeping with the economic opportunities enjoyed by the corporation, and (ii) their prices are relatively stable and do not change in response to speculative forces but to underlying economic conditions. Hence it is important to reform the stock market as well as the joint stock companies to bring about a rational behaviour in stock prices and to ensure a fair rate of dividend to inspire the investors' confidence in stocks and shares.

A number of factors generate erratic and unhealthy movements in stock prices. One of the most important of these is destabilising speculation, which consists (in the forward purchases or sale) of stocks without the intention of taking or making actual delivery. The seller does not possess the stocks sold and the buyer makes only a margin payment. Both intend to make an offsetting purchase or sale before the maturity of the contract to strike a profit or settle the loss. While forward purchases or sales of certain agricultural commodities or of manufactured goods perform an economic function by allowing a sufficient time period to produce or import the goods, thus providing the producers as well as the users the assurance that they can sell or receive the goods when ready or needed, the

forward market in shares performs no such function. The quantity of shares is constant and the forward seller has no role to play. He sells "something he cannot consume or use in his business, upon which he performs no work and to which he adds no value"²¹

Similarly, the ability to make margin purchases creates unnecessary heat in the market by providing the speculator with a high degree of leverage and enabling him to make a larger purchase with a smaller amount. Thus speculative sales combined with margin purchases bring about an unnecessary expansion or contraction in the volume of transactions and hence contribute to fluctuations on stock prices without any change in the fundamentals. Variations in margin requirements and interest rates tend only to add a further dimension of uncertainty and instability into the stock markets. Hence it would be desirable not to allow forward sales and margin purchases in the stock market. Even banks should not be allowed to extend credit for the purchase of shares.

The reduction as well as the dampening of fluctuations in the turnover through the abolition of speculative sales and margin purchases would help maintain sanity in the stock markets and enable stock prices to reflect underlying economic conditions. Largay has concluded, on the basis of his analysis of 71 New York Stock Exchange and 38 American Stock Exchange stocks placed under special margin requirements during 1968-69, that "The empirical results support the 'a priori' hypothesis that banning the use of credit for transactions in individual issues is associated with a 'cooling off' of speculative activity in these stocks"²² Bach has also observed that "if rising stock prices have been financed by borrowed money, a downturn in the market may precipitate a major collapse in stock prices, as lenders call for cash, and may place serious financial pressure on banks and other lenders. A market based on credit is thus far more vulnerable than a cash market and is more likely to be a cyclically destabilising force"²³

According to the Majma al-Fiqhi, forward purchases and sales of shares and commodities in the stock and commodity markets are not permissible because these involve the sale of items the seller does not have and the *Sharī'ah* has prohibited such sales.²⁴ Furthermore, the *Sharī'ah* does not allow a forward purchaser

²¹RIX, M. S., *Stock Market Economics*, London: Pitman, 1965, p. 204.

²²Reported by Irwin Friend in his paper "Economic Foundations of Stock Market" in BICKSLER, James L., *Handbook of Financial Economics*, Amsterdam: North Holland, 1979, p. 156.

²³BACH, G. L., *Economics: An Introduction to Analysis and Policy*, 9th ed., Englewood Cliff, N.J.: Prentice Hall, 1977, p. 182.

²⁴'Idarah al-Majma' al-Fiqhi of the Rabitah al-Alam al-Islamiyah, Makkah, "Suq, al-Awraq al-Maliyyah wa al-Badai (al-Bursah)", p. 5.

to sell until he has acquired formal possession of the goods. Forward sales and purchases unnecessarily inflate the total volume of business through a chain of transactions starting from the first seller who sells items he does not have and the subsequent buyers selling without acquiring possession of the shares or commodities. Such transactions create an unnecessary "heat" in the market and generate erratic fluctuations in prices.

The Majma al-Fiqhi has also ruled, and rightly so, that although the *Sharfah* allows forward sales in the form of *salam* speculative sales in the stock or commodity markets are not in the nature of *salam* because in a *salam* sale the purchaser is required to make full payment for his forward purchase while in a speculative forward purchase the purchaser makes only a margin payment. The wisdom behind the constraint imposed by the *Sharfah* is rational and understandable because such a constraint would prevent an artificial expansion (or contraction) in the volume of transactions and considerably reduce the amplitude of price instability in the stock and commodity markets.

The abolition of *riba* from the Islamic economy would itself tend to minimise stock market speculation based on margin purchases because when the lending bank is aware that it has to share in the risk of speculative business, it will tend to be extra careful in its lending for speculative purchases. Nevertheless, lending against the collateral of stocks to purchase stocks is an unhealthy practice. It breeds speculation and needs to be discouraged. The purpose of credit should be to finance productive investments for supplying need-satisfying goods and services and not to encourage speculative buying or hoarding. Federal Reserve Chairman, Paul Volcker, in a letter to the chief executives of all member banks, warned against speculative loans, loans made to retire stocks, loans to finance takeovers, and loans involving any extraordinary financing "except as they may clearly involve the improvement in the nation's productive capabilities".²⁵ This warning of Mr. P. Volcker may remain unheeded under capitalism because the system is not tuned to its acceptance.²⁶ In the Islamic system, however, every effort should be made to minimise the use of scarce credit resources for all unproductive purposes.

The abolition of *riba* and speculative sales along with the introduction of a system of only cash purchases in the stock market should undoubtedly help bring about an orderly behaviour of stock prices, and protect investors. Nevertheless, some other

²⁵ *Fortune*, 17 December 1979, p. 110.

²⁶ See the view of Prof. Horvitz following Volcker's warning, *ibid.*

reforms would also have to be introduced in the light of Islamic teachings to eliminate all those unhealthy practices which create destabilising conditions in the stock market and hurt public interest. These should include: requirement of full disclosure of all material facts on stocks and shares sold in the primary and secondary markets; curbing of unfair trading practices; and elimination of the manipulation of share prices by brokers and jobbers, and directors or large stock holders, on the basis of their insiders' knowledge of the stock market or company affairs. Directors of companies and management of trusts should not be allowed to levy a fixed initial or annual charge because their role is in the nature of *mudaribs* and a *mudarib* is not allowed a fixed remuneration by the *Sharfah*. They should be allowed only a share in the profit as a reward for their services. If there is a loss they get no reward. The linking of the reward to performance should tend to have a salutary effect on the performance of directors of companies and the management of trusts. The securities market should also be well regulated to ensure fair play and to remove speculative transactions. Short sales and forward purchases against margin have to be prohibited if speculative heat is to be removed.

6 FINANCIAL INSTRUMENTS

The most challenging issue facing the process of creating an Islamic financial system is the development of risk-return bearing instruments that can provide the investors a sufficient degree of liquidity, security and profitability to encourage their holding. The conventional financial markets have two types of instruments: open-ended equity-based instruments for indefinite periods and closed-ended interest-based instruments for definite (long, medium or short) periods. Since there is no possibility of recourse to interest-based instruments in the Islamic financial market, it is necessary to provide closed-ended Islamic instruments of different maturities to cater to the need of both savers and entrepreneurs.

For supplying a larger stock of open-ended securities, existing joint stock companies will have to be encouraged to reduce their debt by expanding their equity. Large partnership companies may also have to be induced to convert into joint stock companies to enable them to reduce the debt portion of their financing. While the greater availability of shares of joint stock companies will provide depth to the market, it will not help small savers to diversify their stock holdings. The creation of investment trusts and mutual funds would thus be essential. These, along with financial institutions, would help savers diversify their risk and increase the possibility of getting a positive return on the diversified

portfolios of such institutions. The ease of selling or redemption of such securities would also make them relatively more liquid. The lower risk due to diversification and the ease of transferability would make their shares attractive even for risk-averse and those who are uncertain about how long they can invest their funds.

In addition to shares of joint stock companies and of investment trusts, mutual funds and financial institutions, profit-and-loss sharing investment certificates of varying degrees of risk and maturity could play an important role in an Islamic financial market for mobilising funds for investment. These may include *mudharabah*, *musharakah* and *murabahah* certificates, leasing certificates and deposit certificates.

In short the Islamic financial markets should be able to satisfy the needs of investors with different attitudes towards risk and varying needs for liquidity. Thus the mobilisation of surplus funds for investment by deficit sectors should not be a problem in an Islamic financial market.

While the raising of equity capital could be handled in the normal manner, access to closed-ended financing could be handled more efficiently with the help of financial intermediaries. This is because they would be better equipped than most individual investors to evaluate investment projects in a profit-and-loss sharing framework. Commercial banks and non-bank financial institutions would thus have to play a crucial role in the money and capital market of an Islamic economy.

As far as the secondary market is concerned, it is very likely that open-ended and medium and long-term instruments may tend to be more liquid in an Islamic financial market than short-term instruments (other than those for *mudharabah* and leasing). This is because the price of securities depends on the capital as well as the prospective income. Whereas in the case of medium and long-term instruments, the past performance of the company and the future prospects are of importance and can enable the determination of a price by market forces. In the case of short-term *mudharabah* and *musharakah* instruments income would be unknown while past performance and future prospects may be of little relevance. Income on short-term instruments is determined by immediate factors and it would require substantial research on the part of the buyers to know the nature of the project or the consignment in which the company is using the funds and the prospects for income. Since the issuing company may know this better than anyone else, it may be the only agency able to redeem short-term securities. Hence short-term *mudharabah* and *musharakah* instruments may in general have to be held by the investor until maturity, if not redeemed by the issuing company. In contrast with this, short-term

murabahah and leasing instruments may tend to be relatively more liquid because the rate of return on these would be known. Nevertheless, since there are risks associated even with these methods of financing if the conditions laid down by the *Shari'ah* are abided by, even these instruments may, in general, tend to be less liquid than some short-term interest-based instruments. Hence investors who are not sure of their liquidity may have to seek the longer rather than the shorter end of the securities market.

It must however be borne in mind that even in the conventional market, the liquidity of short-term commercial papers is not necessarily assured and banks generally hold such instruments until maturity. There is however the market for treasury bills where short-term employment of funds is possible and the liquidity is assured. The conventional system also has the interbank market where banks can borrow if they wish to tide over their liquidity shortages or lend if they wish to profit from surplus funds available for a short-term period. The absence of the treasury bills market and the interbank market may pose difficulties unless a viable alternative is found.

While it may be possible for business firms, investment and unit trusts and non-bank financial institutions to remove their liquidity shortages by making an arrangement with banks within the framework of profit-and-loss sharing, what could be done by banks to get liquidity in case they need it? Since banks are exposed to different types of risks, they may fall short of liquidity against their expectations. The banks could of course maintain a substantial amount of liquidity; this would reduce their profitability. Therefore some alternate arrangement must be made.

Hence it is necessary to create an alternative for the interest-based treasury bills market and the interbank market. Development of a short-term treasury bills market may be difficult within the profit-and-loss sharing framework because the government need not necessarily use the funds mobilised through the sale of treasury bills to finance a profit-oriented project or consignment. The government could however issue treasury bills on the basis of the 'normal' or the 'representative' rate of return in government enterprises or the economy as a whole. The concept of a 'normal' or 'representative' rate of return would however not be able to pass the test of the *Shari'ah* and would thus not be acceptable. Hence the three alternatives to the inter-bank market already suggested under the role of the central bank would be of great importance to provide short-term liquidity to banks when they need it.

The problem however is that the proposed interbank arrangement is not possible in most Muslim countries except Iran and Pakistan because there are very few Islamic banks, generally only one or two, in these countries. These banks are moreover small in

terms of their resources and may not be able to provide sufficient accommodation to other Islamic banks. Exchange controls prevailing in most Muslim countries rule out the possibility of the Islamic banks being able to create any international arrangement for mutual assistance. The central bank hence remains the only hope for Islamic banks in case they are in difficulty. The central banks in Muslim countries should therefore provide the necessary assistance. If they do not do this, they will hurt the cause of Islamic banking because the failure of even one Islamic bank will be a great setback to the movement. While the central banks should be ready to provide such assistance, they should keep the Islamic banks under close examination to ensure that the management is sound and the banks are operating along healthy line.

The proper regulation of joint-stock companies, investment trusts and mutual funds, non-bank financial institutions and commercial banks and also auditing firms would be crucial for realising efficiency and fairness in an equity-based Islamic securities market. It would also be desirable to change the tax regulations in such a way that companies are encouraged to resort more and more to equity in place of interest-based financing. The present tax structure encourages interest-based financing by allowing interest paid to be tax-deductible whereas dividends paid are taxable.

7 CONCLUSION

The goals of socio-economic justice and equitable distribution of income and wealth command a place of such overriding importance among the *maqasid al-Shar'ah* that unless they are actualised, the true manifestation of the ethos of Islamic economic system cannot be said to have taken place. But how to actualise them? Islam offers a package, which if implemented, can help realise them without going to the extreme of abolishing property rights or regimentation of the economy. One of the primary elements of the package is a revolutionary change in the philosophy, organisation and operation of the entire financial system to make the financier share the risks of business, to bring about a broad-based ownership of means of production, and to promote an optimum production of goods and services that satisfy the needs of all.

Even though a number of Islamic banks have been established in several Muslim countries, the creation of an Islamic financial market committed to the realisation of the *maqasid al-Shar'ah* remains a fond dream. The Islamic banks that have been established over the last decade are small, still in their infancy, and have thus not been able to create a perceptible impact on the financial

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