

Islamic Finance and Economic Development

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INTRODUCTION

Islamic finance is a growing segment of the global finance industry. Economic development requires, *inter alia*, financial resources, and Islamic financial institutions have an important role to play. Expectations are that Islamic finance is superior to conventional finance because it is based on a comprehensive worldview and tied to religious norms and values. As a consequence, it is expected that Islamic finance promotes economic development better than the profit-driven conventional finance.

However, a closer look at Islamic finance reveals a considerable discrepancy between the theory (or the idealized view) and the practice. The aim of the theory was to outline a financial system *different* from capitalism and communism. It should be based on profit and loss sharing contracts, and Islamic economists demonstrated the superiority of such a system with respect to allocation, distribution, justice, and stability. The practice of modern Islamic banking, however, was driven by the ambition of businessmen to get the *same* financial services as from conventional banks, but in a shari‘a-compliant form.

For practitioners, shari‘a is Islamic law, not Islamic business ethics. Bankers and shari‘a scholars teamed up and replicated a wide range of conventional products, which brought forth the well-known “form over substance” debate.

From a developmental perspective, this debate is not a prime concern. What is more critical is that Islamic banks focused their business initially on short-term trade financing and later added consumer finance (car and house financing) but neglected medium- to longer-term corporate finance. Over the last years *sukuk* became more prominent for corporate finance, but a *sukuk* issue is not a realistic option for most of the small and medium-sized

enterprises and new ventures that are crucial for employment and income generation. Islamic investment banks did not fill this gap. They became more involved in large infrastructure projects. Recent trends in contractual engineering are also critical from a developmental point of view. Contractual engineers—with support from structuring departments of Western banks that made an inroad into Islamic finance—developed prototypes of shari‘a-compliant securities that could be used for profitable financial transactions within the financial sector. This implies a decoupling of finance from the real economy—a major concern from a developmental point of view.

A cursory survey of the Islamic finance sector in selected Islamic countries does not give strong support to the idea that shari‘a-compliant finance institutions have contributed significantly more to economic development than conventional banks. A more vigorous contribution of Islamic finance to economic development requires a type of financial engineering that is different from what is actually in the pipeline: Islamic banks should develop instruments of participatory finance with an innovative risk-return profile that is attractive both for SMEs and for the banks as providers of funds.

DEVELOPMENT AND ISLAM

a) The use of the term “development” is controversial amongst Islamic economists. For some people this is a too value-laden and misleading term: development is understood in the Western world as an economic catching-up process, and the target for “developing countries” is the living standard of the West. The critique is that this reduces development to material progress and ignores the spiritual dimension of Islam. An ideal Islamic society and economy cannot be reduced to a materialistic and morally blind (or even immoral) capitalistic system as in the West. Islam had its material and spiritual “Golden Age” under the guidance of the Prophet Muhammad, and the history of the Islamic world after the period of the rightly guided caliphs is a continuous decay. It can only be reversed by the revitalization of Islamic morals, and the benchmark for development can never be the materialistic Western lifestyle.¹

Other Islamic economists do not reject the Western concept of development as material progress in total, but they are also somewhat cautious in its use. They often point to escalating and unsolved problems of the materially better-off Western societies: volatile markets, increasing gaps between the rich and the poor, the loss of social cohesion, youth unemployment, wasteful consumption and ecological damages, depletion of natural resources, etc. The Muslim world should not catch up with the West in these respects, and to prevent misinterpretations in this direction, many Islamic economists prefer terms such “poverty alleviation” or “need fulfillment” over “development.”²

b) While Western development economists will not find much common ground with the “rejectionist” Islamic economists (for whom moral education is the prime concern), they can agree with Islamic mainstream economists on strategic priorities for poverty alleviation and the improvement of the material living conditions of the poorer segments of Muslim societies. For example, it is recognized that employment and income-generating activities must be encouraged, and it is now widely accepted (although sometimes for different reasons) that private entrepreneurs are better suited to undertake this task than state enterprises or government bureaucracies. Entrepreneurs are people with good ideas for more efficient production processes, improved technologies, or better and new products, but insufficient own resources for their realization.³ This is where financial institutions become crucial: they collect resources from the general public and provide financing for entrepreneurial innovations. Other functions of banks can also be welfare-enhancing, for example:

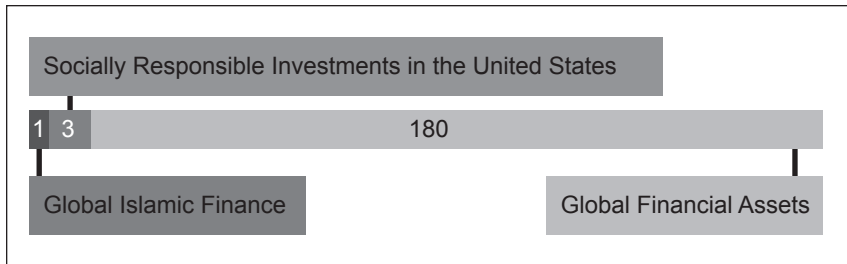
- i) The inter-temporal restructuring of income streams (for higher individual expenditures at younger ages when a family is founded with a repayment at older ages when the income is higher);
- ii) The stabilization of income or consumption levels over a lifetime through long-term savings products and pension schemes;
- iii) The enhancement of risk-bearing capacities by the provision of insurance (*takaful*); and
- iv) The financing of long-term investments into the protection of the environment and the development of sustainable energy resources.⁴

Although socially beneficial, these functions are only supplementary to the financing of job creation and income generation in poor countries. This holds true for conventional as well as for Islamic finance, and it does not change even if further functions are added to the catalogue of functions of Islamic banks such as schemes for the financing of education, the promotion of social cohesion (including the management of *zakat*), or financial support for community development projects.

Such differences are only gradual compared to conventional financial institutions (banks and funds) which strive for more ethics in finance and more socially responsible investments (SRI). Admittedly, ethical banking and SRI are only small segments of the global finance industry, but movements such as “Occupy Wall Street” indicate that they have considerable growth potentials. What is also noteworthy here is the fact that the size of ethical banking and SRI in the US alone (approx. 3 trillion US\$)⁵ is roughly three times the size of global Islamic finance (approx. 1 trillion US\$).⁶

Thus, given that banks in general do contribute to economic development, the relevant question is not whether Islamic banks contribute at all, but whether they do it more extensively, more consistently, or more

Estimated Total Financial Assets 2010 in Trillions of US Dollars



effectively than conventional financial institutions. More precisely, it has to be examined whether the specificities of Islamic finance—notably the prohibition of *riba*, *gharar*, and *maysir*—and their translation into the financial practice imply a superior developmental performance of Islamic banks compared to their conventional counterparts. The paper will show that this, unfortunately, cannot be taken for granted.

CONVENTIONAL AND ISLAMIC ECONOMIC SYSTEMS AND MODELS OF DEVELOPMENT

a) Islamic economists have written extensively on economic development from an Islamic perspective, in particular in the 1980s and early 1990s.⁷ However, standard Western textbooks and handbooks of economic development outline twenty and more theories and models of economic development, but they do not pay any attention to the Islamic perspective.⁸ This may be due to the fact that the character of most of the writings of Islamic economists was (and often still is) more prescriptive (dealing with the developmental qualities of an Islamic economic system and designing policies for an ideal Islamic state) than analytical (= explaining the actual [under]development of Muslim countries), while the realities of Muslim countries depart radically from the ideal.

For most of the 20th century, Islamic development models deviated from mainstream neoclassical economics, and policy recommendations were in conflict with the so-called Washington Consensus (IMF, World Bank, US government). Islamic economists underlined the prime importance of justice, basic needs fulfillment, and poverty alleviation. Distribution was as important as allocation and growth. The Islamic specificity of the models can be seen in two main respects. First, political priorities and strategies were justified and legitimized with recourse to the Islamic worldview. In addition, some models assumed different utility functions of Muslims compared to non-Muslims (“*homo Islamicus*” versus “*homo oeconomicus*”). Second, nearly all models

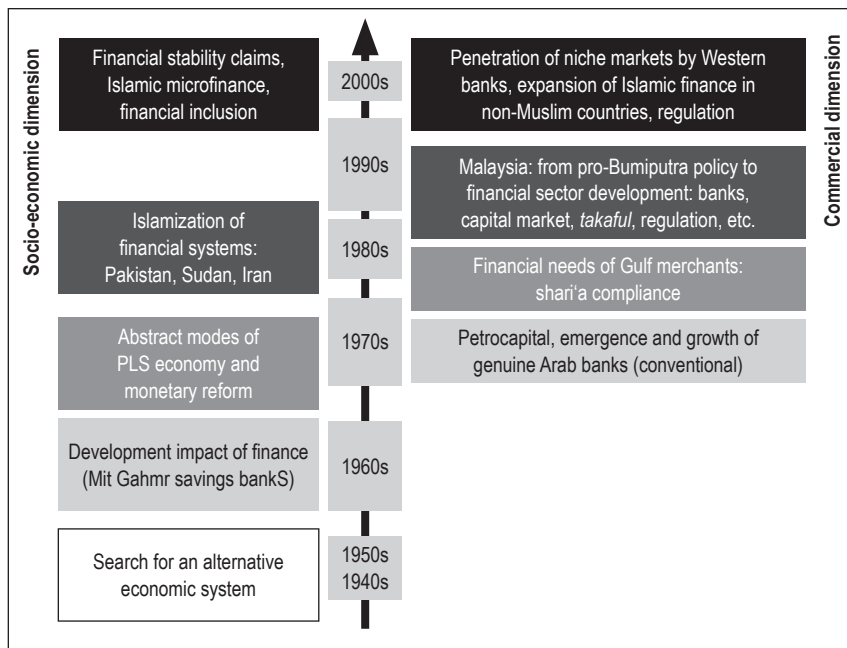
assumed a *riba*-free economy where interest-bearing loans were replaced by profit and loss sharing arrangements.

The distributive, allocative, and stability qualities of an Islamic economic system and its impact on the well-being of people were explicated, and the progress in economic development became apparent when the *status quo* of the Muslim world was compared to the ideal *riba*-free world. Unfortunately, this comparative static methodology did not deal with the necessary process of transition from the *status quo* to the ideal—apart from some indications for policy priorities such as basic needs orientation, poverty alleviation measures, and the prohibition of interest. What was lacking was an elaborate theory of systemic transformation.⁹ Nevertheless, and irrespective of the lack of explicative power, one has to concede that Islamic economists had presented their own models of economic systems and economic development, which were different from the conventional mainstream, and the *riba*-free financial sector played a pivotal role in these models.

It may be that the ideas of Islamic economists had influenced the attempts to Islamize the financial sectors by the order of the rulers of Pakistan, Sudan, and Iran in the 1980s. But this approach has clearly failed in Pakistan, was an integral part of a rather unique system in Sudan, and became hardly relevant in the nationalized Iranian banking sector for more than two decades. In all other Muslim countries conventional finance has been and still is dominant, in spite of persistently high growth rates of Islamic finance. Existing Islamic banks had neither the strength nor—more important—the intention to convert the whole system. This may change in some jurisdictions in the future when governments intervene more strongly in favor of Islamic finance.

Commercial Islamic banking emerged in the 1970s without direct links to models of Islamic economists. While the economists looked at banking from a macro-systemic perspective, the founders and CEOs of the commercial Islamic banks and their shari‘a advisors followed a micro-legalistic approach. It was not before the 1970s that genuine and sizable Arab banks emerged in the Arab region (which was previously penetrated by European and American banks), but all new banks were conventional *riba*-based institutions.¹⁰ The “stylized facts” of the parallel development of the socio-economic and the commercial approach to Islamic economics and finance are summarized in the figure “Evolution of Islamic Economics and Finance.” Businessmen in the Gulf region took the initiative to rectify this shortcoming, and they set up individual Islamic banks (sometimes with the support of governments). But their basic idea was *not* to create financial institutions that follow a completely *different* approach than the existing banks (namely applying widely profit and loss sharing modes of finance). Their idea was to get the *same* range of financial services that was well known from conventional banks (with which the founders had worked in their businesses so far), but on a shari‘a-compliant basis. For the founders

Evolution of Islamic Economics and Finance



of Islamic banks, shari‘a was not a political ideology but first and foremost a legal system. Therefore, shari‘a compliance did not mean to change the substance of the financial system (macro-systemic approach), but to change the legal form of all known products and instruments which should be maintained in their commercial substance (micro-legalistic approach).¹¹

If this interpretation of initial intentions is correct, then the “replication” or “reverse engineering” or “mimicking” of conventional products and instruments and the resulting “form over substance” is not a *deviation* from an original idea (that has to be criticized), but it is the initial idea which the banks have put into practice.

The situation changed, however, when representatives of Islamic banks took over arguments of Islamic economists and claimed that Islamic banks were superior to conventional banks with respect to efficiency, justice, and stability. They used macro-systemic metaphors and aspirations in PR campaigns, keynote speeches, and glossy brochures, but the practice remained micro-legalistic.

b) It seems that in the 1990s Islamic economists diverted their attention from “grand designs” of economic development—which had not found much support in the political arena—to more practical issues, and Islamic microfinance became an outstanding topic by the end of the century.¹² Ironically, this happened at a time when the Washington Consensus lost its

effectiveness or even broke up (in the 2000s). The IMF and (particularly) the World Bank had revised their positions and became far less doctrinal or dogmatic than before. They acknowledged the importance of distribution, the possible usefulness of gradual liberalization and temporary controls of capital flows, and in general the relevance of the proper timing and sequencing of reform packages. These were lessons mainly learned in the 1990s, notably from the transformation experiences of Central and Eastern Europe and from the Asian Crisis. Further, it became widely recognized that religion can be a strong individual motivating factor and a vehicle for social cohesion that supports structural adjustment and development.¹³ So the ideological gap between Western doctrines and Islamic economics narrowed, but Islamic economists seemingly did not respond to it. However, a dialogue with Western counterparts could be very fruitful. Based on historical transformation (= development) experiences and lessons learned from recent events, it might be possible to develop not only a model world where “*homo Islamicus*” and “*homo oeconomicus*” can live peacefully together (i.e., a model with more “realistic” assumptions regarding the behavior of different types of people), but also to outline jointly a transformation strategy.

c) The financial crisis of 2007–08 has again changed the scene.¹⁴ The belief in near-perfect and rational financial markets was widely destroyed, and rules and regulations for the protection of the real economy against destabilizing impulses from the financial sector were high on the political agenda. The greed of bankers, extremely high speculative profits (and losses), and in general the widening gap between the income of top executives and the average wage earners became popular topics.

Issues such as poverty reduction, social security, adequate housing, or basic health care became issues in the US and—sometimes with a different problem setting—in continental Europe. They have been topics in the development-related writings of Islamic economists for a long time. But again, there is not much of a dialogue. Instead, claims about the superior stability of Islamic finance are presented over and again, allegedly with empirical evidence. Although this was echoed in Western media, the empirical evidence is far from decisive. On the one hand, some Islamic financial institutions failed and bailouts took place in a number of Muslim countries. On the other hand, conventional finance did by no means collapse completely. Large numbers of banks in the West with a strong deposit base, little exposure to global interbank and securities markets, and “old-fashioned” prudent lending policies as well as banks in many emerging economies were only scratched by the first-round effects of the crisis.¹⁵

d) The most important event from a developmental perspective is the still ongoing “Arab Spring” which began in 2011—an uprising of suppressed people and revolutions without revolutionary ideologies, motivated by the

hope for a better life. This is a developmental challenge of an unprecedented dimension and urgency. It is probably not the right time to propagate models which cannot improve the living conditions of people within a short period of time. Neither models that require a restructuring of nearly all existing institutions for a better life in the long run nor microfinance for self-employed poor or cottage industries should be the top priorities. The top priority should be an employment-generating growth. This implies and requires the broadening of the entrepreneurial base in the transforming countries.

e) One should encourage the Islamic economists to enter into a new discourse with Western economists who have studied economic orders and transformations of economic systems all around the world. After long academic debates and political controversies, a broad consensus has emerged that an economic system with competitive markets at its core is a prerequisite for development. The implementation of such a market-based system in third world countries often required (and in some cases still requires) a transformation from a socialist or statist system, i.e., from a command economy or from an economy with a dominant public sector, to a market system. Western development models show a considerable variety for the role of the state in a market-driven system. The extremes are, on the one hand, systems inspired by the Anglo-American model with only a minimal role for the state, and, on the other hand, Nordic European welfare state concepts with large (but not dominant) public sectors. Both are based on private property, and they have faced specific challenges and problems. They were not sustainable in their extreme forms, but they still serve as ideals or benchmarks.

Islamic economists mostly refer to the Anglo-American system and emphasize the differences and asserted uniqueness of their own models. What they are rarely aware of is the considerable number of economic orders “in the middle” between extreme market liberalism and excessive welfare states that are in existence in continental Europe. Had Islamic economists taken a closer look, for example, at the German social market economy (both at its concept and its deterioration in practice) they would have discovered a large number of structural similarities.¹⁶ Examples are the social obligation attached to private property, specific laws and an authority to restrict market power and to protect effective competition, the primacy of the real economy over financial markets, an elaborate social security system, and redistributive measures by the state via taxation and transfers. Even a religious background of this system would have been discovered. With knowledge about all these elements in a secular economic order, an Islamic economic system looks far less unique. Its originality boils down to a specific form of legitimation and a few specific institutions such as *zakat* and an interest-free financial sector.

Given these similarities, Western systems “in the middle” and Islamic models have a large overlap when it comes to recommendations for economic development. The establishment of competitive markets, the primacy of

the real economy, the implementation of a social security system (notably for those who are negatively affected by structural changes enforced by competition), the broadening of the entrepreneurial class, private property with a social obligation, legal and monetary stability—all these are major elements of an economic order and development program on which both sides could reach a consensus (even if the underlying justification or legitimation of the various components differs). But one major topic for debates and controversies remains, namely the adequate financial system. In this sense, the financial sector is of crucial importance for the characterization of a development model as “Islamic.”

THE ROLE OF THE FINANCIAL SECTOR IN ECONOMIC DEVELOPMENT

a) In general, the role of the financial sector in economic development is to mobilize funds from the surplus units in an economy and to channel them to the deficit units for productive use. More specifically, the traditional view was that banks collect savings in small amounts and with short maturities from the general public and employ them in larger amounts for investments with longer maturities in the entrepreneurial sector. Thus banks transform amounts and maturities and diversify risk. In most countries, the surplus units are households that do not consume their total actual income but put aside some portions of their purchasing power for later use. This money represents command over real resources and can be utilized for productive purposes in the corporate sector where enterprises are the deficit units. From a developmental perspective, both activities—the mobilization of scarce resources and their productive investment—are equally important.

In the Muslim world, some countries depart fundamentally from this pattern, namely the exporters of energy resources (oil, gas). These countries have huge trade balance surpluses which are at the disposal of the state. Here the state is the surplus unit. Even if the state distributes parts of the surplus to its population, the largest portion of the resource income remains with the state (which sometimes is hard to distinguish from the ruling family). The state can provide financing for domestic enterprises either directly (e.g., by financing large infrastructure projects) or through the banking system. Due to a limited domestic productive capacity, the state will also invest substantial portions in deficit units (enterprises or profitable projects) abroad. The major challenge for banks in these countries is to find profitable investments for the surplus funds at home or abroad, while the mobilization of investible funds is of less relevance. But even in capital surplus countries, a prudent and sustainable employment of surpluses in the real economy should be a prime concern because the financial surpluses come from the extraction of depletable resources given by God to the benefit of present and future generations.

In short, the developmental task of the financial sector is the provision of resources to the real economy in general and for entrepreneurial projects in particular. There is no fundamental difference between conventional and Islamic systems in this regard. However, the Islamic system has to observe the specific prohibitions of *riba*, *gharar*, and *maysir*.

b) The prohibition of *riba* does not automatically imply the substitution of debt financing by participatory modes of financing (*musharaka*, *mudaraba*) as presumed by early models of an interest-free economy.¹⁷ Debt-creating modes of finance such as *murabaha* and *ijara* are permissible. But it is not only the economic closeness of shari‘a-compliant debt financing to interest-based loans that gives good reasons to push for more participatory financing: the engine of economic development is innovation, and innovation is the result of entrepreneurial efforts. Debt financing tends to restrain while participatory financing tends to encourage welfare-enhancing entrepreneurial activities. Entrepreneurial ventures can turn out to be a success, but they can also be a failure—the chance to gain is tied to the risk of loss. It is plausible to assume that entrepreneurial efforts will increase if the financial risk is not borne exclusively by the entrepreneur (as in debt financing), but shared with the financier (as in participatory financing). Therefore participatory financing can significantly contribute to economic development. This is true both for a conventional and an Islamic system, but only proponents of an Islamic system could argue that every individual actor (including the shareholders and managers of banks) is morally obliged to contribute to development—which makes a strong ideological argument in favor of participatory finance.

In a nutshell and in general, the Islamic financial sector should support economic development by:

- i) Preventing the loss of resources as a result of financial instability;
- ii) Providing resources to the real economy;¹⁸ and
- iii) Supporting entrepreneurs through participatory financing.

The first two requirements are mandatory, the third is a desirable addition. It is not unreasonable to expect that the first two requirements are met by private for-profit entities. Things are different with respect to the desirable addition. In countries where corporate governance standards are weak and information asymmetries are widespread, participatory financing may lead to a kind of adverse selection. The participatory instruments attract entrepreneurs with projects that are more risky or/and less profitable than the average projects. This depresses the profitability of the bank and provides finance for projects that fall short of the usual benchmarks.¹⁹ Both is not desirable—neither in a microeconomic (banking) nor in a macroeconomic (developmental) perspective.

EMPIRICAL IMPRESSIONS ON ISLAMIC FINANCE AND DEVELOPMENT

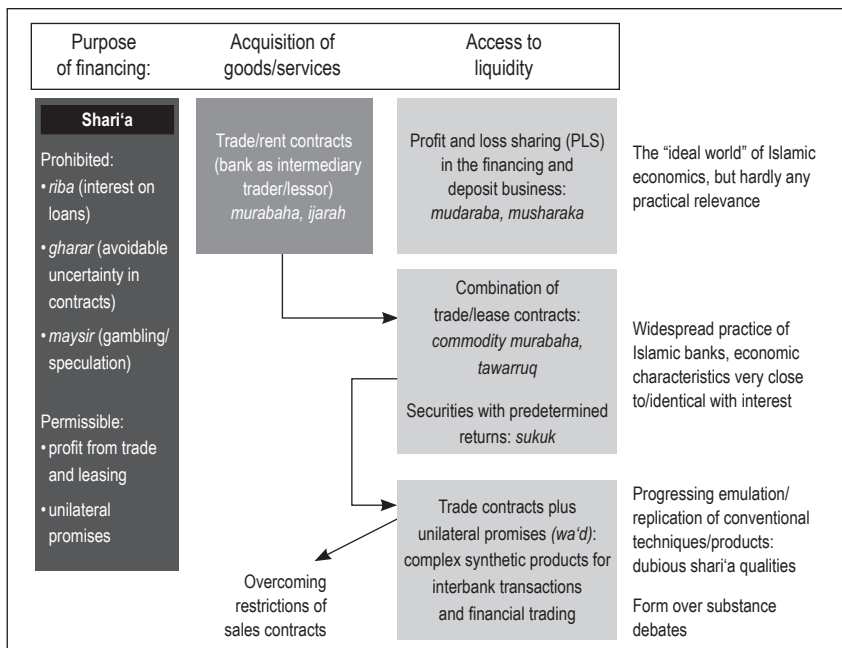
The following is not a comprehensive and systematic empirical study of the contribution of Islamic banks to economic development. It is just a compilation of recently observed trends in the Islamic finance industry with developmental implications and summary comments on the Islamic finance sectors in a number of Muslim countries. Its purpose is more to raise questions than to answer them.

Global Islamic Finance Trends

Islamic banks have developed functional equivalents for a wide range of interest-based instruments. Functional equivalence means that a given project can be financed on terms commercially equivalent to conventional financing—e.g., with respect to the time to maturity, the costs of funds, and the character of the outstanding obligation (debt-like fixed liabilities)—but on a different (shari‘a-compliant) legal or contractual basis. Functional equivalents allow Islamic banks to offer financing in a shari‘a-compliant form (contracts) but with a conventional (interest-like) substance. The widespread use of such instruments led to the “form over substance” controversy.²⁰ The evolution of the *riba*-free financing techniques in response to the needs of the financial institutions is summarized in the figure “Prohibition of *Riba* and Financing Techniques.”

a) One frequently raised concern is the lack of participatory financing. This is factually correct, but there are reasonable arguments why the classical instruments of profit and loss sharing (*musharaka*, *mudaraba*) are not widely applied by for-profit institutions.²¹ A specific version of this criticism recognizes the arguments in defense of the status quo but accuses the Islamic banks of insufficient efforts toward the development of innovative risk-sharing instruments which limit the downside risk (potential loss) of the financier and reduce the burdens of fixed interest payments for the entrepreneur in difficult times. Some governments had used revenue-sharing schemes for the financing of infrastructure projects, but the private banking sector did not adopt similar techniques. It may be that the shari‘a issues are too critical in such schemes where the rate of return is flexible but the possibility of loss is totally eliminated. But there could be alternatives with variable returns and a limited but not eliminated downside risk.²² For example, the traditional Islamic law knows sharecropping contracts; their rationale might be used as an alternative to exchange contracts for the design of modern forms of participatory instruments. An alternative approach can be based on *takaful* arrangements where capital protection is achieved by contributions

Prohibition of *Riba* and Financing Techniques



to a common risk pool, and independent third party guarantees have been used to shield *sukuk* holders from downside risks. If there would have been a will for more participatory instruments, most probably managers, law firms, and shari'a scholars would have found a way.

This optimism is based on the observed pragmatism of shari'a scholars when it comes to the approval of replications of advanced conventional instruments and techniques that enhance the financial efficiency and profitability in the interest of the shareholders of Islamic banks. Examples are, *inter alia*, the tradability of only partially asset-backed papers (as long as the share of fixed assets is more than 50%), the shari'a screening of stocks (with sometimes quite generous tolerance thresholds for the interest income and impermissible activities),²³ the replication of derivatives (including short selling),²⁴ efforts to find equivalents to repo facilities (which are in the making), and swap arrangements which were designed to "plug in" Islamic investors to investment opportunities beyond the limits of the shari'a-compliant universe (which were both approved and fundamentally criticized by leading shari'a scholars).²⁵

b) The lack of interest in participatory finance is not only an annoyance for Islamic economists. The rhetoric of Islamic finance (by proponents who know the realities very well) repeats frequently the claim that Islamic

banking is based on superior ethical principles, including the sharing of risks with partners. But once the addressees of this message realize that substantial risk sharing hardly takes place in practice (only conceptually in the deposit business), they are disappointed and some react very adversely.²⁶

However, the lack of interest in participatory finance becomes understandable once it is noted that most Islamic banks are predominantly engaged in short-term trade financing, medium-term leasing (*ijara*), consumer financing, and real estate transactions. Additional activities in medium- to long-term corporate financing in general and financing for start-ups or for the expansion of small and medium-sized enterprises in particular (where participatory instruments could be of particular relevance) are rare exceptions.

Such a business profile of Islamic banks does not contribute much to economic development. If a bank uses the savings of one group of private households for the financing of the consumption of another group of private households, then it only reshuffles purchasing power within the macroeconomic surplus sector. It is not transforming savings (from the surplus sector) into productive investments (in the deficit sector). Most trade financings and provisions of working capital for enterprises have only a marginal developmental impact. Trade is a useful entrepreneurial activity, but it is in itself neither innovative nor (or only under exceptional circumstances in some capital surplus countries) the engine of growth and employment. It is not too far-fetched to argue that usually trade follows production (manufacturing) and not vice versa. The developmental impact of investments in real estate is quite limited if the financing is for residential objects and for general office space (in contrast to production facilities). It is even less beneficial if all parties involved are less interested in a regular income from the use of the property but mainly in profits from a quick resale of the object to another party. This actually means participation in a real estate price bubble.

c) As long as profits are sufficient, banks do not have a strong incentive to change their policies. In capital surplus countries, this real estate business may be acceptable. But the situation is very different in countries with a shortage of investible funds. There, Islamic banks should not become property traders but invest mobilized savings in the corporate sector. Bank financing is particularly needed by enterprises which cannot directly draw resources from the capital market (e.g., by the floatation of *sukuk*). This is by far the majority of enterprises in most Islamic countries. To meet their financial needs, bank financing is of prime developmental urgency—the form (debt-like or participatory shari‘a-compliant contracts) is secondary.

The actual structure of the Islamic banking industry is not more conducive to economic development than the conventional banking sector: Islamic banks started as commercial banks with a focus on short-term trade finance. Later they added consumer loans and home financing to their retail

portfolio. Medium- to long-term corporate finance (especially for SMEs) was not on their agenda.²⁷ Islamic investment banks emerged in the capital-exporting Arab countries, but the main focus of their investments was public and semi-public domestic infrastructure projects, domestic and international real estate, and investments primarily in developed European and North American markets. In corporate finance these banks did provide working capital and large-scale syndicated loans, but only for well-established customers and not for start-ups or SMEs.

The phasing in of new forms of shari‘a-compliant instruments for transactions among Islamic financial institutions, notably the development of new tradable securities, did not strengthen the links with the real economy. They facilitate the emergence of a market for financial transactions (trading) within the Islamic finance industry. With such an option on the horizon, participatory finance for SMEs (which are crucial for employment-generating growth and economic development) is getting less attractive. However, the trend toward “more vibrant” secondary financial markets is beneficial for well-established and well-known (mostly larger) companies with an excellent track record, which can issue shares or *sukuk*. *Sukuk* are increasingly used for corporate finance, and there is a vast potential for further growth. But even if the *sukuk* volume grows rapidly and all funds raised by the *sukuk* issues are employed in productive ventures in the real economy, this does not prove that Islamic banks (or Islamic finance in general) support the corporate sector better than conventional finance. On the one hand, the growth may be due to tax incentives for the issuance of *sukuk* instead of conventional bonds. On the other hand, the growth may be due to a very strong demand for *sukuk* by Islamic financial institutions (banks, *takaful* operators, fund managers) which are lacking more profitable employments with similar qualities (maturity, rating, etc.) for the funds under their management. This is the result of persistent imperfections in the relatively young, small, and fragmented Islamic financial markets. Excess demand results in cheaper funds by issuing *sukuk* compared to conventional bonds. In such a setting lower costs of funding do not indicate a higher efficiency of Islamic finance but imperfections of this sector.

In total, there is a funding gap for exactly those types of businesses that are crucial for economic development, namely SMEs in general and start-up companies in particular. Islamic finance is not to blame for this gap—it is also a deficiency of conventional finance that has existed for a long time—but Islamic finance in its present form will not fill this gap either.

d) The actual contractual engineering in Islamic finance does not only not help to bridge this gap but it may even drive the system in a very different direction. The latest shari‘a-compliant innovations have brought forth products and instruments that are mainly used for transactions within the financial sector. Derivatives trading among financial institutions was the

main driver of high profits (and losses) in conventional finance before the crisis. The pricing of many traded derivatives was based on divergent expectations of the trading partners with respect to the future development of financial parameters (indices, stock prices, exchange rates, etc.).

It seems that Islamic banks are looking in the same direction. Examples include the design of various structured products and derivatives, hedging instruments, short-selling techniques, repo facilities, and even shari‘a-compliant CDOs. Not all of these products and instruments are already widely used. Some are still under development, but at least “prototypes” have been presented, and all have found the approval of shari‘a boards of high caliber.²⁸ These instruments can enhance the risk and liquidity management capacities of Islamic banks (and in the last instance the shareholder value). But their macroeconomic merits are very doubtful: the conventional counterparts were of particular importance for high-gain and high-risk transactions among banks and for (speculative) financial trading activities.²⁹

e) The universe of financial papers that could be traded within the Islamic financial sector is still very limited, but contractual engineering expands the limits. *Sukuk* with an increasingly thin asset content have been approved, and items such as the air time of a telecom provider have been accepted as assets suitable for securitization.³⁰ Synthetic papers based on such assets (literally created “out of the air”) could open the doors for a completely new asset class for Islamic banks in a knowledge-based economy. If intangible assets such as air time are considered equivalent to tangible real assets, the *sukuk* can be tradable. Suppose a new telecommunications company has a license for a mobile phone frequency, and based on this license the company can create “air time” as an asset for a *sukuk* issuance. The proceeds are used for setting up its business in a competitive market. The interesting topics are how much air time will be created and how this will be priced. In conventional finance such a paper would most likely be classified as (highly) speculative, and it would be well-suited for various kinds of “bets,” i.e., expectation-driven trades. The shari‘a-compliant terminology may differ, but the economic substance will be the same. Most probably more shari‘a-compliant papers of the “air time type” are in the pipelines, and once they find broad acceptance, speculative trading could start within the shari‘a-compliant sector—and with the participation of conventional financial institutions because trading real assets with them is not prohibited.

The relevance for development is this: after the deregulation in the US, many banks have changed their business model. Instead of granting loans and keeping them on the balance sheets until full repayment, loans were securitized and sold off to other financial market players. This model and derivatives trading were much more profitable than the old-fashioned style of banking. It seems that “Islamic derivatives,” “air time *sukuk*,” property swap certificates, and other recent prototypes will create a class of shari‘a-compliant papers

that facilitate the same trading practices in Islamic finance as in conventional finance. Besides potential threats for the stability of the financial system, the most important implication is that trading decouples the financial sector from the real economy, and this erodes the potential contribution of Islamic banks to the development of the real economy.

f) Over the past years, Western banks made an inroad into Islamic finance, and they have made a substantial quantitative and qualitative contribution to the Islamic finance industry. It is very hard to envision that icons of Western capitalism started shari‘a-compliant finance for the sake of the spiritual welfare of Muslims or with the ambition to alleviate poverty in Islamic countries. It is more plausible to assume that they had an eye on their bottom line and their shareholder value. They entered the market with a conventional mindset and experienced structuring departments that teamed up with British law firms and top shari‘a scholars to design functional equivalents for those synthetic products that were highly attractive in conventional finance. Before the financial crisis, large global players had earned much more from trading than from financing. If the Islamic financial services industry follows this trend (and it can hardly be denied that the profit motive is a strong driving force also in Islamic finance), then deposits from the general public could be used to meet margin requirements; they could become tools for shari‘a-compliant forms of leveraging, but they would not be channeled from surplus units to productive deficit units in the real sector.

Admittedly, this is a “speculative scenario” and not the market reality of today. But it can hardly be disputed that there are tendencies in the industry that can cause developmental concerns.³¹

Islamic Banking in Selected Countries

The concerns would be less serious if Islamic finance could point to a number of cases where its contribution to economic development is evident. Indeed, there are success stories, but they are hardly a general proof that Islamic finance contributes more to economic development than conventional finance.

The Islamic Development Bank was set up in 1975 as an intergovernmental institution.³² Initially its activities were funded by the contributions of the member countries and were concentrated on the financing of oil imports of poorer Muslim countries from oil-exporting Gulf countries. Only later were longer-term projects (notably infrastructure projects) added, and the IDB evolved into a group with affiliated institutions with special mandates (for research and training, insurance, private sector development, etc.). The AAA-rated IDB has expanded its financial base considerably by the issuance of a series of *sukuk*. There is no

question about the developmental impact of the IDB activities. However, the experiences of IDB as an intergovernmental development bank cannot be taken as a benchmark for private banks with commercial objectives.

For the rich Gulf countries with small local populations and large numbers of expatriates (UAE, Qatar, Bahrain, Kuwait) it is difficult to define the meaning of development. On the one hand, poverty is not a real issue in these countries (although the distribution of income and wealth is very uneven). On the other hand, economic diversification takes place but is driven by government initiatives and foreign companies. There is no fundamental difference in how conventional and Islamic banks contribute to this process.³³ However, Islamic banks were seemingly more exposed to bubble-prone real estate markets (and more seriously hit by their collapse). The Western influence on Islamic banking is notably strong in Bahrain and the UAE.

The situation in Saudi Arabia is different insofar as all banking operations are considered to be shari‘a-compliant since a couple of years ago, which makes it impossible to identify a specific developmental impact of Islamic banks. In this regard, Iran and Sudan are similar cases where all banks have been “Islamized.” The question of whether Islamic banks did contribute better than conventional banks to economic development is meaningless in such settings; the relevant question (which is beyond the scope of this paper) would be whether banks as such have promoted economic development in these countries.³⁴

In several other Middle Eastern countries (such as Egypt or Tunisia), Islamic banks have existed since the late 1970s or early 1980s, but governments were not in favor of an expansion of Islamic finance because they associated it with political opposition movements. As a consequence, their market share is too small and their businesses are too much influenced (restricted) by politics for any meaningful empirical evaluation of their developmental impact.³⁵

The situation was similar in Turkey for a long time (where Islamic banks are known as participation banks; earlier they were known as special finance houses), but the climate has changed in the 2000s. Nevertheless it is difficult to identify a significant developmental contribution. The aggregate market share of the four participation banks is still very small (around 5%), the banks are focused on Istanbul as the commercial center, and the “Anatolian tigers” (who definitely pushed the economic development of Anatolia) have financed their growth largely by other means. On the other hand, Turkish participation banks seemingly had stronger links with the real economy than conventional Turkish banks, which invested in the past heavily in interest-bearing government bonds. This was not an option for participation banks. Further, the strong growth performance of the Turkish economy in recent years generated relatively high returns from the financing of real transaction, so that the more inward-oriented participation banks are seemingly less involved in the development of tradable structured products than Islamic banks in the GCC and Malaysia.³⁶

The Middle Eastern country where Islamic banking has probably contributed most significantly to economic development is Jordan. This is not because of the original name of the oldest and largest Islamic bank in Jordan (Jordan Islamic Bank for Finance and Development, established 1978, now re-named Jordan Islamic Bank), which has the longest-serving general manager of the Islamic finance industry (Musa Abdul-Aziz Shihadeh). It is because Islamic banks have mobilized additional savings (largely from expatriates abroad) and channeled them into productive employments in the real economy of Jordan.³⁷

Turning to Asia in search of countries where Islamic banking may have made a marked contribution to economic development, the first candidate is Pakistan. Islamic banking has a very eventful history in this country. It started with a top-down enforced Islamization of the whole financial system in the mid-1980s.³⁸ Bankers did not support this political decision, and they found regulatory loopholes that allowed them to practice “Islamized” banking in such a way that the highest shari‘a court declared the whole system to be un-Islamic in 1992.³⁹ Nevertheless the façade lasted nearly ten more years before it was officially terminated and replaced by a mixed system. The factual domination of Pakistan’s financial system by conventional banking practices was “legalized” again and Islamic banking was re-launched as an option after 2002 only.⁴⁰ The country has now five stand-alone Islamic banks and twelve Islamic branches of conventional banks with an aggregate market share of 7–8%.⁴¹ Islamic banks have been financing the real economy, but the same is true for conventional banks. It requires a more detailed analysis to find out whether Islamic banks contributed more or better to economic development than conventional banks.

In two other countries attention should not only be paid to Islamic banking in general but to Islamic microfinance in particular. Bangladesh is the country where conventional microfinance took off in the 1990s. Muhammad Yunus’ Grameen Bank (established as a bank in 1983) has become the icon of microfinance, but in recent years also the focal point of growing critique. It is somewhat surprising that shari‘a-compliant microfinance institutions emerged only after a considerable time lag, and their share in the total microfinance of the country is at best marginal (only about 1% of all microfinance clients).⁴² The situation is somewhat better in Indonesia: Besides eleven stand-alone Islamic commercial banks and twenty-three Islamic windows, Indonesia has about 150 Islamic rural banks (which are a kind of microfinance institutions). But in spite of this impressive number of Islamic banks, their market share is below 4%.⁴³ While quantitatively insignificant on a national scale, Islamic rural banks may well contribute to the development of their communities or regions. But it requires much empirical fieldwork to find out whether the local impact of Islamic rural banks is different from conventional rural banks—the number of which is more than 1,700.⁴⁴

Finally, a note on Malaysia. Malaysia is the country with the most developed and diversified Islamic finance industry and the most elaborate legal and regulatory framework, plus strong support of Islamic finance by the government (through the central bank and securities commission).⁴⁵ Unfortunately this support makes it very difficult to identify the genuine contribution of Islamic finance to the Malaysian economic development because direct and indirect subsidies and various other supporting measures distort the data. For example, *sukuk* issues enjoy a tax advantage over conventional bonds,⁴⁶ and more than half of the “Islamic deposits” originate not from “ordinary savers” but from the public sector and government-supported businesses.⁴⁷ While therefore quantitative analyses can be tricky, a qualitative note is less disputable: Malaysia’s dual banking model (with stand-alone Islamic banks and Islamic windows of conventional banks) opened the door for the conventionalization of Islamic finance. Most of the banks that started window operations were owned and managed by non-Muslims, and at least the ownership structure has not changed. Structured conventional products were developed next door under the same roof, and a “mental spillover” cannot be precluded. It seems that the dominant *shafi’i* school of law was particularly conducive to a comprehensive re-design of complex conventional structures in a shari‘a-compliant form—both on the level of the shari‘a boards of individual banks as well as on the level of the national shari‘a boards of the central bank and the securities commission.⁴⁸

ISLAMIC FINANCE IN PERSPECTIVE

The Islamic finance industry has been growing at high rates, and even if their developmental impact is not yet proven, it obviously had a value proposition for many customers.

a) One obvious value proposition for Muslims is the shari‘a compliance of the financial transactions. This, however, comes at a price: the contracts used by Islamic banks are more complicated and less tested in courts and, from a consumer protection perspective, sometimes more rigid and disadvantageous than conventional contracts. *Sukuk* defaults were an additional eye-opener: many people found out that their particular *sukuk* did actually not transfer the true ownership of assets with a market value to them. In other cases, *sukuk* holders were true owners, but the market value of the specific assets was very low for users other than the *sukuk* issuer. Instead of owning assets, *sukuk* holders may own the right to usufructs which would be worthless in the case of a bankruptcy of the issuer. In conclusion, many *sukuk* holders found themselves in a situation very similar to that of holders of conventional bonds.⁴⁹

The last crisis and its aftermath have also threatened the existence of some Islamic banks. A few Islamic investment banks underwent fundamental

restructurings or were closed down while some other Islamic banks have been bailed out so that no losses were passed on to their “depositors” (who usually have entered into a *mudaraba*-type contract with their Islamic bank).⁵⁰ Would that have happened, savers might have lost their “deposit illusion”: they would have been reminded painfully of their legal status as profit-sharing and loss-bearing investment account holders. It seems that savers consider investment accounts as shari‘a-compliant substitutes to risk-free savings or term deposits. Otherwise it would be hard to explain why they are satisfied with returns not higher than the interest paid to conventional depositors whose money is guaranteed while theirs is not (at least not contractually in most jurisdictions). A bank in their position would definitely have charged a risk premium for such a kind of funding. Deposit illusion may also explain why investment account holders as conceptual risk-bearers accept a governance structure in which they are totally absent: except for the shari‘a board, the corporate governance structure of Islamic banks is identical with the structure of conventional banks. Both are typically joint stock companies and subject to the same corporate law, and most regulators treat investment accounts like deposits. However, the legal status of investment account holders and depositors is fundamentally different. Nevertheless, holders of unrestricted investment accounts do not have specific information rights regarding the employment of their funds or their risk exposure. Participants in *takaful* schemes face basically the same governance problem.⁵¹

Customers of Islamic banks had to learn that it is more difficult to renegotiate the terms of shari‘a-compliant financings than the terms of conventional loans. Conventional banks can easily adjust interest rates to early payments or extended repayment periods. Islamic banks are tied to their sales contracts, and buying back and reselling an object for a restructuring is not only complicated: renegotiated sales profits that vary with the repayment conditions come dangerously close to prohibited interest.

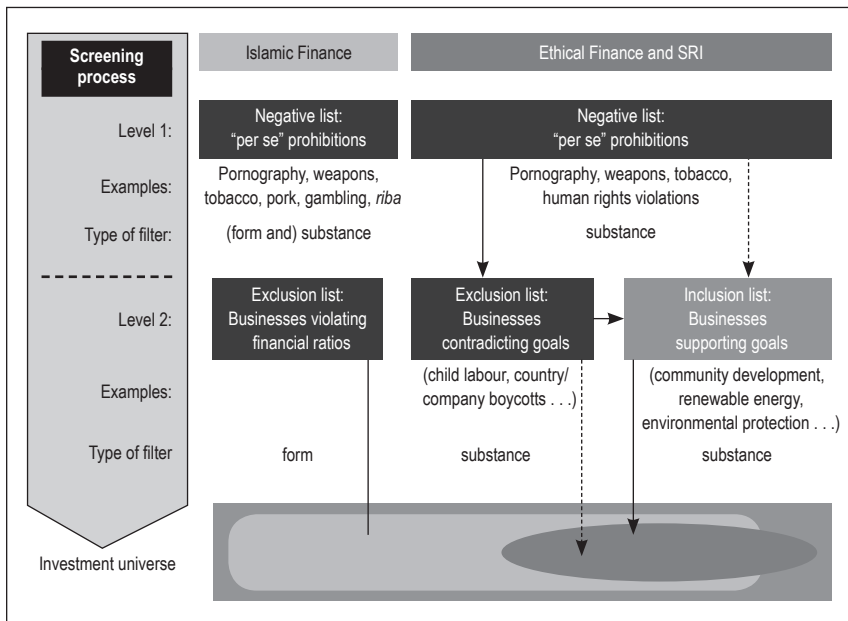
While the list of problems could be extended further, it has to be conceded that not all problems materialized at the same time and with all banks. On the contrary, the list of problems is composed of events and incidents that happened at different times in different places and with different banks. However, the problems point to some structural weaknesses that could affect other banks as well, and therefore have to be taken seriously.

b) Suppose the average bank customers—Muslims or non-Muslims—are not aware of (or do not worry about) such issues. Then the question is what value proposition other than the formal shari‘a compliance (which is not relevant for non-Muslims) has attracted them to Islamic finance. After the banking crisis many people have become concerned about the use of their funds. The average conventional depositors have never benefited from speculative profits from trading, and they would hardly be willing to take the associated risks. In the aftermath of the crisis, banks and funds with ethical or socially responsible

investment (SRI) strategies have received much public attention and gained in attractiveness. Non-Muslims were drawn toward Islamic finance by the claim and the expectation that Islamic finance is more ethical than conventional banking. However, it is neither obvious that the financing business of Islamic banks contributes more to sustainable economic development than the financing business of “prudent” conventional banks, nor is it guaranteed that the shari‘a screening of stocks generates a particular ethical quality of Islamic funds. The figure “Islamic and Ethical Finance: Congruence and Divergence” summarizes the overlapping approaches but also indicates the differences between shari‘a and conventional screening techniques.

There are best practice examples of a strong developmental impact of an Islamic bank financing or of socially responsible stock selections—but unfortunately “best” practice is not “general” practice. The observance of the prohibitions of *riba*, *gharar*, and *maysir* ensure “minimum ethics,” but that is in substance not much more than what would result from the adherence to the principles of prudent conventional banking. Higher ethical expectations are often nurtured by a specific interpretation of the shari‘a governance structure and of the role of shari‘a boards as something like “ethics commissions.” This interpretation is in a marked contrast to the understanding of shari‘a scholars of themselves as lawyers and not as religious leaders, moral authorities, or advocates of investment account holders or *takaful* participants.

Islamic and Ethical Finance: Congruence and Divergence



c) In the coming years Islamic banks will continue to improve their operational efficiency, legal uncertainties will be removed, and more standardization will help to overcome market fragmentation and promote cross-border transactions. Competition will force Islamic financial institutions to become more transparent and to establish mechanisms for an organized communication with investment account holders and *takaful* participants. Compared to the status quo, this may look like a big leap forward. But factually this is not much more than the correction of shortcomings of the existing practice. It does not propel economic development, and it does not create a superior value proposition for the average “man on the street.”

To gain wider recognition and to contribute more vigorously to economic development, Islamic finance must go beyond contractual innovation in form (= replication of conventional substance) and has to come to financial innovation in substance. This means that Islamic financial institutions must create genuine products with distinctive risk/return characteristics. They should address the deficiencies of conventional finance in developing countries, and that could mean priority for medium- and longer-term corporate finance, in particular for employment- and income-generating SMEs with good growth prospects on a participatory basis with a limited downside risk for the capital provider. This is a huge challenge, but Islamic finance can still build on a remarkable goodwill and trust and on a growing pool of qualified human resources. This should also facilitate a more demanding screening of stocks and design of shari‘a-compliant ethical and socially responsible investment funds. Islamic economists should adjust their models to real-world conditions and develop a theory of transformation toward an economic system which is superior to the status quo and in which *riba*-free finance interacts with other Islamic institutions (*zakat*, *waqf*, etc.) in order to promote economic development. But this system must be achievable and not a utopian ideal.

Endnotes

1. Asad Zaman, *Islamic Economics: A Survey of the Literature* 1–5—A Survey of the Literature (Birmingham: International Development Department, University of Birmingham, 2008); Mehmet Asutay and Nazim Zaman, “Divergence between Aspirations and Realities of Islamic Economics: A Political Economy Approach to Bridging the Divide,” *IJUM Journal of Economics and Management* 17:1 (2009): 73–96.
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3. This understanding of Schumpeter (see Schumpeter, Joseph Alois, *The Theory of Economic Development*, [Cambridge, MA: Harvard University Press, 1934]) was further elaborated by New Austrians, for example by Israel M Kirzner, *Competition and Entrepreneurship* (Chicago: The University of Chicago Press, 1973); for a survey see Henrik Berglund, *Austrian Economics and the Study of Entrepreneurship: Concepts and Contributions* (2009). <http://ssrn.com/abstract=1353902> or <http://dx.doi.org/10.2139/ssrn.1353902>.
 4. See also Biagio Bossone, *What Makes Banks Special? A Study of Banking, Finance, and Economic Development* (Washington: World Bank, 2000), and Kent Matthews and John L. Thompson, *The Economics of Banking*, 2nd ed., (Chichester; Hoboken: Wiley, 2008).
 5. “Sustainable and Responsible Investing (SRI) is a broad-based approach to investing that now encompasses an estimated \$3.07 trillion out of \$25.2 trillion in the US investment marketplace today.” <http://ussif.org/resources/sriguide/srifacts.cfm>; for more details see Social Investment Forum Foundation, *2010 Report on Socially Responsible Investing Trends in the United States: Executive Summary* (Washington: Social Investment Forum, 2010).
 6. Humayon Dar and Talha Ahmad Azami, eds. *Global Islamic Finance Report (GIFR) 2011* (London: BMB Islamic, 2011), 35.
 7. Bibliographical references and brief summaries of the literature up to the 1990s can be found in the following bibliographies: Muhammad Akram Khan, *Islamic Economics: Annotated Sources in English and Urdu, Vol 1*. (Leicester: Islamic Foundation, 1983, reprinted 1991); Muhammad Akram Khan, *Islamic Economics: Annotated Sources in English and Urdu, Vol. 2* (Leicester: Islamic Foundation, 1991); Khan, Muhammad Akram, *Islamic Economics: An Annotated Bibliography, Vol. 3 (1988–1997)*, (Islamabad: International Institute of Islamic Economics, 1998); further references can be found in the critical analysis of Timur Kuran, *The Long Divergence: How Islamic Law Held Back the Middle East* (Princeton: Princeton University Press, 2011), and the “response” of M. Umer Chapra, *Muslim Civilization: The Causes of Decline and the Need for Reform* (Markfield: The Islamic Foundation, 2008). Chapra’s book was published before Kuran’s book, but Kuran draws on a number of arguments that he had published before, and Chapra refers to these earlier writings; see also Mirakhor and Hamid, *Islam and Development*.
 8. There is only one page in the over 800-page “Economic Development” by Nafziger (E. Wayne Nafziger, *Economic Development*, 4th ed. [Cambridge: Cambridge

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9. In recent years a process of critical self-reflection has started which is aptly summarized in the following title: Mohammad Omar Farooq, "The Challenge of Poverty and the Poverty of Islamic Economics," *Journal of Islamic Economics, Banking and Finance* (4:2, 2008) 35–58. See also Badr El Din A. Ibrahim, "The 'Missing Links' between Islamic Development Objectives and the Current Practice of Islamic Banking: The Experience of the Sudanese Islamic Banks (SIBs)," *Humanomics* 22:2 (2006): 55–66; Muhammad Nejatullah Siddiqi, "Obstacles to Islamic Economics Research," paper presented at the Seventh International Conference on Islamic Economics (Jeddah, Saudi Arabia, April 1–3, 2008). http://www.siddiqi.com/mns/obstacles_to_islamic_economics_research.htm.
 10. Traute Wohlers-Scharf, *Arab and Islamic Banks: New Business Partners for Developing Countries* (Paris: OECD Development Centre, 1983).
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 12. In recent years Islamic microfinance attracted much attention both from practitioners and academics, and the concepts and practices of Islamic microfinance are now well covered in the literature. See Mohammed Obaidullah, *Introduction to Islamic Microfinance* (New Delhi: International Institute of Islamic Business and Finance, 2008); Mohammed Obaidullah and Tariqullah Khan, *Islamic Microfinance Development: Challenges and Initiatives* (Jeddah: IRTI, 2008); Statistical, Economic,

- and Social Research and Training Centre for Islamic Countries, ed. *Microfinance Institutions in the OIC Member Countries* (Ankara: SESRIC, 2008); S. Nazim Ali, ed. *Shari‘a-Compliant Microfinance* (London: Routledge, 2012).
13. Katherine Marshall, and Marisa van Saanen, *Development and Faith: Where Mind, Heart and Soul Work Together* (Washington: World Bank, 2007); Jeffrey Haynes, *Religion and Development: Conflict or Cooperation?* (Basingstoke: Palgrave Macmillan, 2007).
 14. See, for example, Group of Researchers, *Issues in the International Financial Crisis from an Islamic Perspective* (Jeddah: Scientific Publishing Centre, King Abdulaziz University, 2009); M. Umer Chapra, “The Global Financial Crisis: Some Suggestions for Reform of the Global Financial Architecture in the Light of Islamic Finance,” *Thunderbird International Business Review* 53:5 (2011): 565–579; Ibrahim Warde, “After the Meltdown: New Perspectives on Islamic Finance,” *Building Bridges across Financial Communities: The Global Financial Crisis, Social Responsibility, and Faith-Based Finance*, edited by S. Nazim Ali (Cambridge, Massachusetts: Islamic Finance Project, Harvard Law School, 2012): 19–30.
 15. For more details, see Volker Nienhaus, “Islamic Finance Ethics and Shari‘ah Law in the Aftermath of the Crisis: Concept and Practice of Shari‘ah Compliant Finance,” *Ethical Perspectives* 18:4 (2011): 591–623.
 16. See Volker Nienhaus, “Fundamentals of an Islamic Economic System Compared to the Social Market Economy,” *KAS International Reports* 11 (2010): 75–69; Some classic texts on the German model of a Social Market Economy are collected in Alan T. Peacock and Hans Willgerodt, eds., *Germany’s Social Market Economy: Origins and Evolution* (Basingstoke: Macmillan, 1989); Alan T. Peacock, Hans Willgerodt, and Daniel Johnson, eds. *German Neo-Liberals and the Social Market Economy* (London: Macmillan, 1989); See also Wilhelm Röpke, *A Humane Economy* (Chicago: Henry Regnery Company, 1960); Anthony James Nicholls, *Freedom with Responsibility: The Social Market Economy in Germany, 1918–1963* (Oxford: Clarendon Press, 2000); More recent contributions with references to the systemic transformation in former communist countries can be found in Peter Koslowski, ed., *The Social Market Economy: Theory and Ethics of the Economic Order* (Berlin: Springer, 1998).
 17. See in particular Muhammad Nejatullah Siddiqi, *Banking without Interest* (Lahore: Islamic Publications, 1973); Muhammad Nejatullah Siddiqi, *Issues in Islamic Banking: Selected Papers* (Leicester: Islamic Foundation, 1983); Muhammad Nejatullah Siddiqi, *Partnership and Profit-Sharing in Islamic Law* (Leicester: Islamic Foundation, 1985).
 18. This may require in less developed countries with capital scarcity specific efforts to mobilize (additional) resources from the household sector, and this implies efforts toward financial inclusion. These aspects are not covered in this paper, but the literature documents a long history from the first “experiments” of Ahmed El-Naggar with interest-free savings banks in the 1060s in Egypt up to recent global financial inclusion campaigns; see, for example, R.K. Ready, “The Egyptian Municipal Savings Banks Project,” *International Development Review* 9:2 (1967): 2–5; Ahmed El-Naggar, “Islamic Banks: A Model and the Challenge,” *The Challenge of Islam*, edited by Altaf Gauhar (London: Islamic Council of Europe, 1978), 220–234; Mahmoud Mohieldin, Zamir Iqbal, Ahmed Rostom, and Xiaochen Fu, “The Role of Islamic Finance in Enhancing Financial Inclusion in OIC Countries,” paper presented at 8th International

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19. See Volker Nienhaus, “Profitability of Islamic PLS Banks Competing with Interest Banks: Problems and Prospects,” *Journal of Research in Islamic Economics* 1:1 (1983): 37–47.
 20. A related topic is how to balance innovation and authenticity; see S. Nazim Ali, ed., *Islamic Finance: Innovation and Authenticity* (Cambridge, Massachusetts: Islamic Finance Project, Harvard Law School, 2010).
 21. These arguments range from information asymmetries and moral hazard problems over (“wrong”) expectations of “depositors” and the underdeveloped liquidity management infrastructure (which requires a close match of maturities of bank assets and liabilities) to a lack of entrepreneurial demand for a participatory form of finance.
 22. For example, convertible *sukuk* deserve further examination, in particular those based on *ijara* contracts where the maturity of the *sukuk* and the useful life of the asset match.
 23. See Ulrich Derigs and Shehab Marzban, “Review and Analysis of Current Shariah-Compliant Equity Screening Practices,” *International Journal of Islamic and Middle Eastern Finance and Management* 1:4 (2008): 285–303; Catherine S. F. Ho, Nurul Afiqah Abd Rahman, Noor Hafizha Muhamad Yusuf, and Zaminor Zamzamin. “Comparison of Quantitative Shari’ah-Compliant Screening Methods,” *ISRA International Journal of Islamic Finance* 3:2 (2011): 91–110.
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 25. See Mushtak Parker, “IIFM Repo Opens New Door for Debt Capital Market,” *Arab News*, August 1, 2010. <http://arabnews.com/economy/islamicfinance/article94058>. ece; Deutsche Bank, *Pioneering Innovative Shari’a Compliant Solutions* (London: Deutsche Bank, 2007); Yusuf Talal DeLorenzo, *The Total Returns Swap and the “Shariah Conversion Technology” Stratagem* (2007). <http://www.dinarstandard.com/finance/DeLorenzo.pdf>.
 26. It is correct that the exchange contracts used by Islamic banks in their financing business imply additional market risks (which do not exist in conventional loan contracts), but Islamic banks have developed a wide variety of risk mitigation techniques that minimize or factually eliminate market risks. A summary of risks and risk mitigation techniques can be found in *IFSB-1: Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)*; see also Tariqullah Khan and Habib Ahmed, *Risk Management: An Analysis of Issues in Islamic Financial Industry* (Jeddah: IRTI, 2001); and Tariqullah Khan and Dadang Muljawan, eds., *Islamic Financial*

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27. The same can be observed for conventional banks.
 28. There are many reports and articles on such innovations in industry-related journals and magazines and client reports and newsletters, and they are hot topics in industry seminars and executive briefings.
 29. This was a major topic for Islamic economists who diagnosed the collapse of the Western financial system.
 30. See Craig Nethercott and Harj Rai, "Mobily Leads the Way in Jumbo Refinancing," *Islamic Finance News* 9:18 (2012): 19–20; for comprehensive surveys and discussions of *sukuk* structures, see Abdulkader Thomas, ed., *Sukuk* (Petaling Jaya: Sweet & Maxwell Asia, 2009), and Muhammad al-Bashir Muhammad Al-Amine, *Global Sukuk and Islamic Securitization Market: Financial Engineering and Product Innovation* (Leiden, Boston: Brill, 2012).
 31. For recent innovations see, for example, Simon Archer and Rifaat Ahmed Abdel-Karim eds., *Islamic Finance: Innovation and Growth* (London and Manama: Euromoney, 2002); AAOFI, Ali, *Islamic Finance*; Humayon Dar and Talha Ahmad Azmi, eds., *Global Islamic Finance Report (GIFR) 2010* (London: BMB Islamic, 2010); Dar and Azami, *GIFR 2011*; Al-Amine, *Global Sukuk*.
 32. See Rodney Wilson, "Saudi Arabia: The Islamic Development Bank's Role as a Pan-Muslim Agency," *Islamic Financial Markets*, edited by Rodney Wilson (London: Routledge, 1990), 196–222, 235–236; Shahid Hassan Siddiqui, "Islamic Development Bank: Operations, Prospects and Challenges," *Journal of Islamic Banking and Finance* 16:1 (1999).
 33. For Islamic finance in the Gulf countries see Oliver Agha, "Islamic Finance in the Gulf: A Practitioner's Perspective"; Rodney Wilson, *The Development of Islamic Finance in the GCC* (London: Centre for the Study of Global Governance, 2009); For development in Saudi Arabia see Rasem N. Kayed and M. Kabir Hassan, "Saudi Arabia's Economic Development: Entrepreneurship as a Strategy," *International Journal of Islamic and Middle Eastern Finance and Management* 4:1 (2011): 52–73.
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36. See Filiz Baskan, “The Political Economy of Islamic Finance in Turkey: The Role of Fethullah Gulen and Asya Finans,” *The Politics of Islamic Finance*, edited by Clement M. Henry and Rodney Wilson (Edinburgh: Edinburgh University Press, 2004), 216–239; Savas Alpay, “An Evaluation of Special Finance Houses: A Case Study on Turkey,” *Advances in Islamic Economics and Finance, Vol. 1*, edited by Munawar Iqbal, Salman Syed, and Dadang Muljawan (Jeddah: IRTI, 2007), 369–382; and Participation Banks Association of Turkey (TKBB), *Participation Banks 2010* (Istanbul: TKBB, 2011).
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 38. See Nawazish Ali Zaidi, *Eliminating Interest from Banks in Pakistan* (Karachi: Royal Book Company, 1987); Izzud-Din Pal, *Pakistan, Islam, and Economics: Failure of Modernity* (Oxford: Oxford University Press, 1999); Izzud-Din Pal, *Islam and the Economy of Pakistan: A Critical Analysis of Traditional Interpretation* (Oxford: Oxford University Press, 2006).
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 40. See Mehboob ul-Hassan, “The Islamization of the Economy and the Development of Islamic Banking in Pakistan,” *Journal of Islamic Banking and Finance* 25:3 (2008): 16–40; Shamshad Akhtar, “Pakistan Islamic Banking: Past, Present and Future Outlook,” *Journal of Islamic Banking and Finance* 26:2 (2009): 53–61; Muhammad Ayub, “Islamic Banking in Pakistan: Time to Assess the Achievement,” *Journal of Islamic Banking and Finance* 26:1 (2009): 20–28.
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 42. See M. A. Hamid, “Islamic Banking in Bangladesh: Expectations and Realities,” *Studies in Islamic Banking and Finance in the 21st Century: Theory and Practice*, edited by Muhammad Anwar and Mohamad Aslam Haneef, (Kuala Lumpur: International Islamic University Malaysia, 2005), 241–281; Md Safiullah, “Superiority of Conventional Banks & Islamic Banks of Bangladesh: A Comparative Study,” *International Journal of Economics & Finance* 2:3 (2010): 199–207; M. Mizanur Rahman and Fariduddin Ahmad, “Impact of Microfinance of IBBL on the Rural Poor’s Livelihood in Bangladesh: An Empirical Study,” *International Journal of Islamic and Middle Eastern Finance and Management* 3:2 (2010): 168–190; Dewan A. Alamgir, M. Kabir Hassan, and Hisham Haider Dewan, “A Comparative Review of Islamic Versus Conventional Microfinance in Bangladesh,” paper presented at 8th International Conference on Islamic Economics and Finance: Sustainable Growth and Inclusive Economic Development from an Islamic Perspective (Doha, Qatar, December 19–21, 2011).

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44. See Rifki Ismal. *The Indonesian Islamic Banking: Theory and Practices* (Jakarta: Gramata Publishing, 2011). Muhamad Abduh and Mohd Azmi Omar, "Islamic Banking and Economic Growth: The Indonesian Experience," *International Journal of Islamic and Middle Eastern Finance and Management* 5:1 (2012): 35–47.
45. See Awang Adek Hussin, "The Islamic Financial Landscape in Malaysia," *Studies in Islamic Banking and Finance in the 21st Century: Theory and Practice*, edited by Muhammad Anwar and Mohamad Aslam Haneef, (Kuala Lumpur: International Islamic University Malaysia, 2005), 349–365; Securities Commission Malaysia, *Introduction to Islamic Capital Market* (Petaling Jaya: LexisNexis, 2009); Aishath Muneeza, Rusni Hassan, and Ismail Wisham, *Islamic Banking under the Malaysia Law* (Kuala Lumpur: A.S. Noordeen, 2011).
46. Tax incentives for *sukuk* are listed on the website of the Malaysia International Islamic Financial Centre (MIFC): http://www.mifc.com/index.php?ch=menu_foc_suk&pg=menu_foc_suk_inc; see also "Malaysia Offers Tax Breaks to Secure Dominance of Sukuk Issues," *FTSE Global Markets*, May 23, 2012. http://www.ftseglobalmarkets.com/index.php?option=com_k2&view=item&id=3342:malaysia-offers-tax-breaks-to-secure-dominance-of-sukuk-issues.
47. See Balachandran Shanmugam, "Islamic Banking: Whither the Engine for Growth," *Islamic Finance News* 7:44 (2010): 20–21.
48. For compilations of shari'a resolutions of Malaysia's national shari'a boards see Securities Commission Malaysia, *Resolutions of the Securities Commission Shariah Advisory Council*, 2nd ed. (Kuala Lumpur: Securities Commission Malaysia, 2006); Bank Negara Malaysia, *Shariah Resolutions in Islamic Finance*, 2nd ed. (Kuala Lumpur: Bank Negara Malaysia, 2010); for a critical analysis of the shari'a qualities of the most widely used instruments of Islamic banks see D. Ruse, *The BBA Condrum* (Kuala Lumpur: A. S. Noordeen, 2012).
49. For a list of defaulting *sukuk* 2009–2010 see Mohammed Khnifer, "Alarming Rise in Sukuk Defaults," *Islamic Finance News* 7:39 (2010): 20. Legal disputes and dispute settlement in Islamic finance are topics of an increasing number of publications in recent years; see for example International Shari'ah Research Academy for Islamic Finance, ed., *Dispute Resolution in Islamic Banking* (Kuala Lumpur: ISRA, 2011); Zulkifli Hasan and Mehmet Asutay, "An Analysis of the Courts' Decisions on Islamic Finance Disputes," *ISRA International Journal of Islamic Finance* 3:2 (2011): 41–71; Umar A. Oseni and M. Kabir Hassan, "The Dispute Resolution Framework for the Islamic Capital Market in Malaysia: Legal Obstacles and Options," *Islamic Capital Markets: Products and Strategies*, edited by M. Kabir Hassan and Michael Mahlknecht (Chichester: Wiley, 2011), 91–114; Hakimah Yaacob. *Analysis of Legal Disputes in Islamic Finance and the Way Forward: With Special Reference to a Study Conducted at Muamalat Court* (Kuala Lumpur: ISRA, 2011).
50. Prominent cases are The Investment Dar (Kuwait), Gulf Finance House (Bahrain), and Arcapita (Bahrain); see Mushtak Parker, "Light at the End of TID's Debt-Restructuring Tunnel," *Arab News*, June 19, 2011; Mohammed Khnife, Aatef Baig, and Frank Winkler, *The Rise and Fall of Gulf Finance House*, available at <http://ssrn.com/abstract=1712059>; IFSB, *Islamic Financial Services Industry Stability Report 2013* (Kuala Lumpur: IFSB 2013), 44, 47.
51. The IFSB has dealt with these issues in several standards and guiding notes; see in particular IFSB-2: Capital Adequacy Standard for Institutions (other than Insurance

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Institutions) offering only Islamic Financial Services (IIFS); IFSB-3: Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (Excluding Islamic Insurance [*Takaful*] Institutions and Islamic Mutual Funds); IFSB-8: Guiding Principles on Governance for *Takaful* (Islamic Insurance) Undertakings; GN-3: Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders; and GN-4: Guidance Note in Connection with the IFSB Capital Adequacy Standard: The Determination of Alpha in the Capital Adequacy Ratio for Institutions (other than Insurance Institutions) offering only Islamic Financial Services. All documents are available from the IFSB website: <http://www.ifsb.org/published.php>.