ISLAMIC ECONOMIC STUDIES

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ARTICLES

ISLAMIC RESEARCH AND TRAINING INSTITUTE
A Member of Islamic Development Bank Group

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Articles

Islamic Research & Training Institute (IRTI)

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The Islamic Research and Training Institute (IRTI) was established by the Board of Executive Directors (BED) of the Islamic Development Bank (IDB) in conformity with paragraph (a) of the Resolution No. BG/14-99 of the Board of Governors adopted at its Third Annual Meeting held on 10th Rabi-ul-Thani, 1399H corresponding to 14th March, 1979. The Institute became operational in 1403H corresponding to 1983. The Statute of the IRTI was modified in accordance with the resolutions of the IDB BED No.247 held on 27/08/1428H.

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بسم الله الرحمن الرحيم

In the name of Allah, the Most Merciful, Most Beneficent

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Redefining Islamic Economics as a New Economic Paradigm

NECATI AYDIN

Abstract[1]

The more recent literature on Islamic economics is largely about Islamic financial instruments and institutions. It might give an impression as if the main difference between conventional and Islamic economics is in the instruments, rather than foundational aspect. Islamic economics is not about the prohibition of certain goods and services. It is a vastly different economic system whose answers to the core economic questions vary significantly. It is important to start from the foundation Islamic economics by redefining assumptions, developing new theories of microeconomics and macroeconomics, and offering testable models from the Islamic paradigm. This paper is an attempt to redefine Islamic economics as a new economic paradigm based on the distinctive axiomatic feature of Islamic worldview. In order to do that, the paper first presents evidences of the crises of capitalism and search for alternative paradigm. Second, it outlines the origin of capitalism within the Western secular worldview. Third, it presents the Islamic worldview from anthropological, epistemological, and teleological perspectives. Fourth, it redefines Islamic economics as alternative economic paradigm to capitalism.

1. Introduction

The more recent literature on Islamic economics is largely about Islamic financial instruments and institutions. It might give an impression as if the main difference between conventional and Islamic economics is in the instruments, rather than foundational aspect. Islamic economics is not about the prohibition of

[1] This research paper was supported by King Saud University, Deanship of Scientific Research, College of Business Administration Research Center.

certain goods and services. It is a vastly different economic system whose answers to the core economic questions vary significantly. As currently done, mimicking conventional economics and finance is only creating Islamic economics and finance by name. The secular essence and soul of capitalist system is largely untouched. It is important to start from the foundation Islamic economics by redefining assumptions, developing new theories of microeconomics and macroeconomics, and offering testable models from the Islamic paradigm. As Nasr indicates the theoretical works in Islamic economics has "failed to escape the centripetal pull of western economic thought, and has in many regards been caught in the intellectual web of the very system it set out to replace" (Nasr 1991, p.388). Indeed, the differences between Islamic and capitalist financial institutions are getting blurry every day. As Asutay points out, "The realities of financial markets which prioritizes economic incentives rather than religious behavioral norms has forced Islamic finance to become part of the international financial system, in which it is recognized as heterogeneity of financial products deprived of their value system... the difference has been reduced to technicality, and the value system is no longer mentioned beyond describing the prohibition of *ribā* by quoting verses in the Qur'ān." (Asutay 2007, pp.3-18)

This paper is an attempt to redefine Islamic economics as a new economic paradigm based on the distinctive axiomatic feature of Islamic worldview. In order to that, the paper first presents evidences of the crises of capitalism and search for alternative paradigm. Second, it outlines the origin of capitalism within the Western secular worldview. Third, it presents the Islamic worldview from anthropological, epistemological, and teleological perspectives. Fourth, it redefines Islamic economics as alternative economic paradigm to capitalism.

2. Crises of Capitalism and Need for New Economic Paradigm

With the fall of socialist regimes at the end of last century, the free market capitalism, which started in Europe a few centuries ago, has become the dominant system across the world. During and after the 2008 financial crisis, many people began to raise questions about the fate of capitalism. Even though it was not the first crisis of capitalism, it was the biggest one since the Great Depression. Three years later, we are still struggling to recover the crisis. Indeed, with the ongoing debt crisis in Europe, we might see another global financial meltdown shaking the foundation of capitalism. Unlike many economists, I think that the 2008 financial crisis and the current debt crisis are essentially moral crises. It is a "moral crisis" with its root going back as far as the Enlightenment. Adam Smith's famous metaphor of "invisible hand" is well-known among economists. Indeed, it is an extremely powerful metaphor explaining the strength of free market economy. According to Adam Smith, shaped by self-interested human nature, supply and demand is sufficient enough to deal with most if not all economic problems. However, as seen in the recent financial crises, the invisible hand without moral compass could turn to a "stealing hand". In my view, the 2008 financial crisis was the greatest theft in the history of mankind. It was not seen as a theft perhaps because of the invisibility of the hand involved. In my recent paper on the 2008 financial crisis and capitalism, I argue that the 2008 crisis was essentially a moral crisis of capitalism with its root going back as far as the Enlightenment (Aydin 2011). The paper suggests that during the crisis, the "invisible hand" of free market turned to "stealing hand" through market games driven by the irrational and irresponsible behaviors of politicians, creditors, and consumers.

Like any other disease, the real solution is only possible if we deal with its root causes rather than relieving its symptoms such as high fever. Indeed, sometime temporary relief with general medicine could deceive the patient by giving a wrong signal and worsen the conditions in the long-term. In 1929, when the free market system failed, we came to the understanding that government intervention is necessary sometimes to deal with economic crises. Similar to the Great Depression, the recent and ongoing financial crises could be another great opportunity to understand and fix a major flaw of free market capitalism. If the fix is not possible, this might mean a shift to new paradigm. This might be the case because capitalism has produced morally driven economic and financial crises (Aydin 2011) as well as failed to deliver its promise of paradise in this world. I am talking about the crisis of happiness.

It was Easterlin (1974) who first came up with some quantitative signs of happiness crisis in capitalism. In his study which covered the years between 1946-1970, he found that despite a great increase in the real income per capita, there was not a significant change in subjective well-being. He later did a similar study for Japan and found that the average self-reported happiness level did not increase in Japan between 1958 and 1987 despite a fivefold increase in real income. Since this study, we have seen a surge in studies on happiness. Most of them confirm Easterlin's findings in terms of the impact of monetary wealth on happiness. A recent study shows that the case is not quite different for China which has been experimenting with consumer culture for the last two decades. The study found that remarkable economic growth from 1994 to 2005, with real income per capita increase of 250 percent, ownership of color television sets rose from 40 percent of households to 82 percent, and the number of people with a telephone jumped from 10 percent to 63 percent. Yet, this did not translate into higher life satisfaction.

Rather, the percentage of people who say they are dissatisfied has increased, and the percentage who says they are satisfied has decreased (Kahneman, Krueger 2006).

Easterlin Paradox claims that the lack of a direct correlation between average life satisfaction to income per capita across nations. In other words, even though rich people report higher life satisfaction than the poor in a given country, wealth does not explain differences in self-reported life satisfaction across countries and in even in the same country over time. For instance, Frey (Frey 2008, p.39) finds that income per capita jumped in Japan by a factor of 6 between 1958 and 1990, while average life satisfaction remained unchanged at a level of 2.7 out of four point scale. Layard (Layard 2005, p.33) shows that “for countries above $20,000 a head, additional income is not associated with extra happiness.” Nevertheless, “within a single country, at a given moment of time, the correlation between income and happiness exists and it is robust”(Bruni, Porta 2007, p.xv).

Despite some evidence of its failure in providing happiness (Lane 2000, Hamilton, Denniss 2006, Kasser 2002, Diener, Suh & Oishi 1997, Easterbrook 2003), the globalization of consumer culture and materialistic values is rapidly displacing traditional values. Indeed, those questionable new values are spreading all over the world. They have entered every realm of human life, including even spiritual places like churches, synagogues, and mosques. They have turned a human being into a consumption machine. But not only does a consumer culture fail to bring happiness, it also fails to protect the environment. It has produced many environmental problems, including unchecked growth in the production of solid waste and in greenhouse gas emissions. Therefore, it is not sustainable in the long run (Aydin 2010b). It is not just weapons of mass destruction; it is also the products of mass consumption that are threatening the future of all living beings on this planet. Indeed, while the former threatens the outer universe, the latter threatens the inner universe. With more and more consumption, people are no more, and sometimes even less, happy. This is neither desirable nor sustainable. In short, wealthy capitalist nations are currently experiencing a serious “happiness crisis”. It is spreading around the world with the globalization of capitalism. Actually, it is more dangerous for capitalism than the current financial crisis because of its complexity. There are many studies presenting evidences for the existence of the happiness crisis without delving into its root causes (Lane 2000). In other words, they are discussing symptoms without diagnosing the disease. Therefore, there is an urgent need to examine and modify or replace the existing dominant economic paradigm, which is based on always more consumption, in order to achieve more happiness while reducing consumption to sustainable levels.

Since both moral and happiness crises of capitalism could not be solved within the existing paradigm, according to Thomas Kuhn's following statement, we need to develop a new paradigm: "Scientific revolutions are inaugurated by a growing sense, again often restricted to a narrow subdivision of the scientific community, that an existing paradigm has ceased to function adequately in the exploration of an aspect of nature to which that paradigm itself had previously led the way. In both political and scientific development the sense of malfunction that can lead to crisis is prerequisite to revolution." (Kuhn 1970, p.92) However, it is not easy for scientists to get out of the existing paradigm and offer solutions to crises from a new perspective. In Kuhn's terms, "Normal research, which is cumulative, owes its success to the ability of scientists regularly to select problems that can be solved with conceptual and instrumental techniques close to those already in existence."(Kuhn 1970, p.96) Revolutionary research has to build upon new concepts and instruments. They have to offer something new and contradictory with the existing ones. This is the case because "scientific revolutions are here taken to be those non-cumulative developmental episodes in which an older paradigm is replaced in whole or in part by an incompatible new one." (Kuhn 1970, p.92)

Communism which emerged as the anti-thesis of capitalism failed to be an alternative due to its misunderstanding of human nature. It wrongly associated the problems of capitalism to "private ownership" and established its foundations on "collective ownership" which killed the individual incentive. Seeing religion as poison for people, the system attempted to create a caring society based on strictly secular values. At the end, the system collapsed from its own contradictory maxims. With the recent global financial crisis of capitalism, there is ongoing search for a possible alternative paradigm. Islamic (moral) economics could attract great attention if it could go beyond the existing frame of conventional economics. For that matter, if Islamic economics would offer an alternative paradigm, it has to contradict with the existing ones. It has to offer new "conceptual and instrumental techniques". It has to be non-cumulative, rather than cumulative development of the existing knowledge. In my view, Islamic economics based on Islamic anthropological, epistemological, and teleological perspectives could form an alternative paradigm over time. In this paper, I attempted to outline the distinctive features of Islamic worldview and its consequences for Islamic economics. .

It is important to note dissident voices of Islamic economists on the need for a new paradigm in economics. For instance, Zubair Hasan (1992) claims that the basis features of the capitalistic system were evolving during the era of Muslim

Spain in Europe before even it emerged in England. Hasan argues that Islamic economists make mistakes by comparing the ideals of Islamic system with the realities of capitalist system, not its ideals (Hasan 2011). Therefore, he considers their writings being a sort of apple-orange comparisons. He calls for a step-by-step approach to Islamizing economics rather than comprehensive approach (Hasan 1998). In my view, this judgment is due to equating free market system with capitalism. Indeed, it is possible to claim that the Prophet of Islam himself was functioning within a capitalist economic system if we see private property and free enterprise as the defining features of capitalism. Actually, this is the core argument of a recent book titled as Islamic Capitalism and Finance (Cizakca 2011).

3. The Enlightenment Project

The emergence of capitalism in the Western Europe coincided with the Enlightenment. [2] Indeed, one could claim that capitalism is the economic pillar of the Enlightenment project. Therefore, we need to examine the Enlightenment in order to understand capitalism as a materialist economic system. The Enlightenment was a project to release human minds from the chains of churches in the Dark Ages. In his famous essay titled as "What is Enlightenment?" Immanuel Kant (1996) described the Enlightenment simply as freedom to use one's own intelligence. The Enlightenment thinkers believe that humans are generally good and perfectly rational. Therefore, they should shape their destiny, not the dogmas of churches. The thinkers ultimately succeeded to gain freedom for human minds. Their victory helped to remove the darkness in the Europe and replaced with the light of human minds. They did not stop there. They expanded their wars against all religions assuming that they are no different than Christianity in the Dark Ages. Indeed, they labeled religions as myths. Of course, in the age of reason, there was no room for myths. Ironically, even though they fought against the ancient mythos, they created modern ones. They put logos against mythos.

The chart below outlines the key components/pillars of the Enlightenment project. First, it was a project against Christian trinity. As historian Peter Gay (1996) asserts, the Enlightenment broke through "the sacred circle," whose dogmatic teaching had confined thinking. In C. Wright Mills words, “Once the world was filled with the sacred – in thought, practice, and institutional form. After

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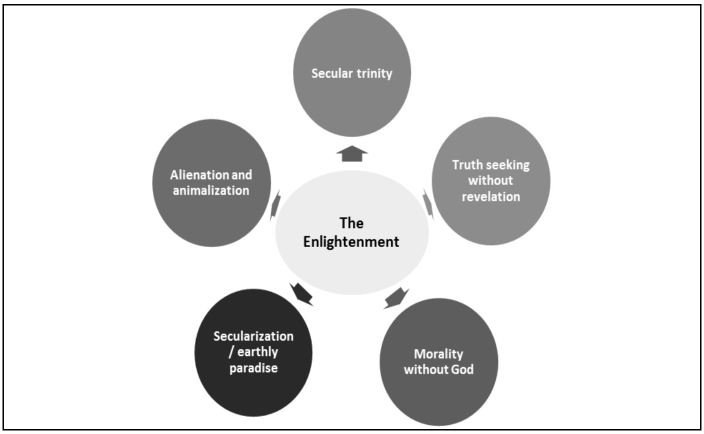
[2] For the comparison Islam and the Enlightenment in terms of their understanding of human nature, science, and technology, please refer to my following article: “Human Nature vs. the Nature of Science and Technology,” in Henk Jochemsen (ed.) “*Our Common World. A Cultural Dialogue between Christians and Muslims about the Role of Technology in Our Global Society,*” Rozenberg Publishers, March 2010.

the Reformation and the Renaissance, the forces of modernization swept across the globe and secularization, a corollary historical process, loosened the dominance of the sacred. In due course, the sacred shall disappear altogether except, possibly, in the private realm." (Mills 1967, pp.32-33)

Most Enlightenment thinkers had difficulty to embrace logically inconsistent Trinitarian idea. They came up with an alternative explanation to explain the reality. I call it "secular trinity" because it mimics Christian trinity to a large extent. It consists of causation, nature, and chance. In other words, rather than explaining the reality as the work of Father, Son, and Holy Ghost, the Enlightenment thinkers offer deterministic cause-effect chains, Mother Nature, and chance as the determining forces behind the reality of the universe. Second, the Enlightenment was a project of truth seeking without revelation. For the Enlightenment thinkers human minds were the only source of knowledge. No need to seek guidance from divinely guided individuals because in reality there is no evidence for any Divine Being. Third, since God was dead, there would be no need for morality based on revelation. However, as strongly articulated by Kant, even without God, it is still possible to reach moral principles through reasoning (Reath, Timmermann 2010). Thus, the Enlightenment is a project of morality without God. Fourth, since God is dead, no need to aim for paradise in the hereafter. We are left with no option, but establishing a worldly paradise. In this regard, liberal capitalist economic system has been seen a great tool to accomplish such a goal. Finally, the Enlightenment is a project of alienation and animalization because as argued by Karl Marx capitalism alienates humans and treats him a sort of robot or thinking animal.

Chart-1
The Pillar of Enlightenment



The Enlightenment project also redefined the purpose and meaning of life for individuals. It asked individuals to act free from the restrictions of churches and do whatever they consider is to be best for their interests. The main purpose is not to please God anymore; rather, it pleases the desires of animal souls. The Enlightenment thinkers reject the idea of being servant to God. Instead, they turn humans into the masters of the universe. The ultimate purpose is to gain control over nature, rather than living with her in harmony. The measure for morality is not the Divine revelation anymore. It is internal compass of pain and pleasure or pure reason. Indeed, Bentham suggests that utility calculation should be yardstick for everything including what is good and what is bad (Bentham 2007, p.14).

The "Enlightenment" project is designed to make people believe in themselves instead of believing in god(s). It turns the human "self" to a kind of "inner god." It promotes "self-belief", "self-help", "self-actualization", "self-motivation", "self-confidence", and "self-sufficiency." It boosts the self by ascribing its accomplishments to the self. It transforms the self to the "inner god."3 It sets the goal of conquering and mastering the universe for the inner god by defeating, controlling, or stealing from nature.4 However, it does not understand that the life of the "inner god" depends on the life of nature. In Horkheimer and Adorno's terms, "the system the Enlightenment has in mind is the form of knowledge which copes more proficiently with the facts and supports the individual most effectively in the mastery of nature."(Horkheimer, Adorno 1976, p.83)

While the Enlightenment turns the self to an "inner god", it also makes him the slave of his desires (I will call it the elephant). He does everything to serve his desires. He sacrifices everything, even his own life, for the desires of his elephant. Indeed, a capitalist consumer views the ultimate goal in life to be the fulfillment of his/her desires. The common saying of "life is fun" in capitalist American society

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[3] "Man's likeness to God consists in sovereignty over existence, in the countenance of the lord and master, and in command. Myth turns into enlightenment, and nature into mere objectivity. Men pay for the increase of their power with alienation from that over which they exercise their power. Enlightenment behaves toward things as a dictator toward men. He knows them in so far as he can manipulate them. The man of science knows things in so far as he can manipulate them." (Horkheimer, Adorno 1976)

[4] The following excerpt from Francis Bacon reflects the mindset of the Enlightenment thinkers on the power and purpose of gaining knowledge: "no doubt the sovereignty of man lieth hid in knowledge; wherein many things are reserved, which kings with their treasure cannot buy, nor with their force command; their spials and intelligencers can give no news of them, their seamen and discoverers cannot sail where they grow. Now we govern nature in opinions, but we are thrall unto her in necessity; but if we would be led by her in invention, me should command her in action." ((Bacon 2008)

reflects this philosophy of life for many people. The overwhelming majority who embrace this philosophy work very hard during the week in order to have fun over the weekend. That is why some of them choose to end their lives once they lose their ability to gain expected pleasures.5

4. Capitalism as Economic Pillar of the Enlightenment Project

The Enlightenment project relies on capitalist ideology to create earthly paradise. Capitalism pursues this goal through market mechanism. However, capitalism is not the market mechanism. It is a worldview that relies on the market mechanism. Capitalism is much more than a free market system. It is an ideology that makes money (capital) the central purpose of life for all individuals. In Karl Marx's terms, "Money degrades all the gods of man -- and turns them into commodities. Money is the universal self-established value of all things. It has, therefore, robbed the whole world -- both the world of men and nature -- of its specific value. Money is the estranged essence of man's work and man's existence, and this alien essence dominate him, and he worships it" (Marx, Lederer 1958). In this sense, the main goal of a capitalist person is to accumulate/gain money wealth. For such a person, money is considered as a god that can open any door. In Marxist terms, capitalism is an ideology, which has turned money into the god of the world. It is a secular ideology, which promises to build a "technological paradise" in this life, not in the next life as promised by many religions. We can call capitalism a secular religion in this context. Capitalism relies on the magical power of the free market mechanism to fulfill its promise of earthly paradise.

The fathers of free market capitalism were strongly influenced by the Enlightenment thinkers. Indeed, the laissez-faire capitalism aims the freedom of market from any government intervention. It relies on the assumption that individuals follow their self-interest. According to Adam Smith, it is part of human nature to act on self-interest: "Every man is, no doubt, by nature first and principally recommended to his own care; and as he is fitter to take care of himself than of any other person, it is fit and right that it should be so. Every man, therefore, is much more deeply interested in whatever immediately concerns

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[5] The well-known movie, The *Matrix*, is a good description of the world created by capitalism. The Matrix is defined as follows by a key actor in that movie: "It is an illusionary world. …It is all around us. Even now in this room. You can see it when you look out of your window, or when you turn on your TV. You can feel it when you go to work, when you go to church, when you pay your taxes. It is the world that has been pulled over your eyes to blind you from the truth…. That you are a slave…. Like everyone else, you were born into bondage, born into a prison that you cannot smell or taste or touch. A prison for your mind."

himself, than in what concerns any other man” (Smith 1976, pp.82-83). From his understanding of human nature, Smith concludes that “it is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest” (Smith 1976, pp.26-27). (Smith 1976, p.26-27) In the Wealth of Nations, Smith argues that in order to enhance wealth, every man should be "free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of other(s)."(Smith 1990, p.687).

If self-interested individuals are allowed to make their own decisions, they will do whatever is best for them. The market mechanism determines what and how much to produce if we simply let everyone act based on his or her “self-interest.” Individuals will demand and supply the optimum amount of goods and services for their self-interest. Thus, supply and demand driven by self-interest work like an invisible hand pushing the market mechanism toward an efficient production and consumption. Since society is nothing other than the collection of individuals, overall what is good for each individual is also good for society. In other words, Adam Smith assumes no dichotomy between private and social interests. Therefore, he suggests that the invisible hand driven by supply and demand alone should decide on production and distribution of goods and services. There is very limited, if any, role for the government hand to get involved in this process.

While Adam Smith establishes his theory of supply and demand on self-interested human nature, Bentham shapes his utility theory on pleasure seeking and pain avoiding human nature: “Nature has placed mankind under the governance of two sovereign masters, pain and pleasure. It is for them alone to point out what we ought to do, as well as to determine what we shall do... They govern us in all we do, in all we say, in all we think: every effort we can make to throw off our subjection, will serve but to demonstrate and confirm it. In words a man may pretend to abjure their empire: but in reality he will remain subject to it all the while.”(Smith 1976, p.14) This means that we do not need to do anything other than letting individuals to follow their nature for utility maximization through exchanges in the market. The end result will be good for both individuals and society as a whole.

As Frey and Stutzer (2002, p.1), pioneering researchers in the field of economics of happiness, say “everyone want to be happy. Economic activity – the production of goods and service—is certainly not an end in itself but only has value in so far as it contributes to human happiness.” The mainstream happiness model in capitalism is based on Bentham’s hedonistic model, Aristotle’s eudonic model. In his book called Introduction to the Principles of Morals and Legislation, Bentham argues that the utility principle is the main determinant of human behaviors. Every individual acts according to the utility principle and tries to maximize their utilities by calculating the expected pain and pleasure of their behaviors.

Even though Polanyi gave credit to Aristotle for being first to write on economics, it is obvious that Aristotle did not foresee modern free market capitalism in which luxury consumption and pursuit of bodily desires become symbol of happy life. He did not imagine that rational human beings will subject themselves to a hedonic calculus of maximizing pleasures. He would expect that prudent people would limit their sensual desires for the sake of intellectual and virtues ones rather than inflating them. Aristotle argues that those who pursue bodily pleasures will be occupied with wealth accumulation and could have no time to seek virtue: "those who fix their aim on the good life [and] seek the good life as measured by bodily enjoyments, so that inasmuch as this also seems to be found in the possession of property, all their energies are occupied in the business of getting wealth."(Aristotle. 1944, pp.1257b- 1257a)

While Aristotle distinguishes between natural and excessive desires, modern economy views the role of market to satisfy any kind of desire. It actually turns everything to marketable objects. The ultimate goal is to invent "pleasure pills" or "experience machine" with no side effects because nothing else matters than the experience of pleasure. In Vicenti's terms, "the homo oeconomicus seems to be thrown into the world, its existence has no final end, apart from death, and each end is meant to be overcome and to be turned into another mean to constitute an open chain of means-ends."(Visenti 2011) In Aristotle's view, hedonistic happiness is not even worthy to be called a good life. Indeed, Aristotle calls the life dedicated to pleasure as the life of "grazing cattle"(Aristotle 1999, p.1095b 21).

5. The Islamic Worldview

As discussed in the previous section, free market capitalism did not emerge in vacuum. It is the product of the western materialist worldview. In order to identify any differences between Islamic economics and its counterparts, it is important to understand the Islamic worldview which is based on the Qur'ān, Hadiths, and views of Muslim scholars.[6] Islam is not a marginal religion dealing with dealing spiritual life alone. It is a religion providing guidance and well-being for both this life and the hereafter. Therefore, the word *falāh* (real well-being) and its

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[6] For the further analysis on the comparison of Islamic and western worldviews please refer to the following paper I presented at the 10th Harvard Forum on Islamic Finance: "Islamic Economics and Finance: New Paradigm or Old Capitalism", Harvard University, 24-25 March 2012.

derivatives have been used in the Qur'ān many times. In the five time daily azan (call to prayer), people are also invited to *falāh*. Islam aims to achieve its goal through its value-based and God-centered moral and spiritual worldview. It is important to recognize the overlapping goals between the worldviews of major religions. Islam is not a completely new religion. It is considered to be the last chain of Abrahamic religions. Therefore, it is not surprising to see that Christianity and Judaism have many values in common with Islam. However, the enlightenment movement in Europe deviated from these values and embraced secular, value-neutral, materialist worldview (Aydin 2005).

6. Epistemological Perspective

Choudhury claims that Islamic economics relies on different epistemological paradigm which is significantly different from the western secular paradigm. He suggests that Islamic economics should be upon Islamic paradigm which requires different "methods" and "methodology" in terms of gathering and analyzing data about reality. He asserts that "the prevailing Islamic socio-scientists" are distance from "any substantive reference to the Qur'ānic worldview, it's epistemology of Oneness of the Divine laws (*Tawḥīd*), the causal understanding of unification of knowledge in world-systems by the epistemological methodology embedded in ontology and ontic learning domains."(Choudhury 2007b, p.76) He strongly criticizes the current efforts in Islamic economics due to its lack of epistemological foundation and required data. He argues that the existing literature on Islamic economics has become trapped in the neoclassical framework which is based on secular western epistemology. He discusses the different views on tastes and preferences to support his argument. Neoclassical economics takes consumer tastes and preferences as exogenous in its economic models while Islamic economics provides certain values to guide tastes and preferences. Therefore, according to Choudhury, Islamic economics should focus on endogenizing preferences and tastes through interactive learning.

As Choudhury states, "if the Islamic worldview is premised on its distinctive epistemology, ontology, and the unified ontic (evidential) way of organizing the world-system, then such as revolutionary doctrine cannot be accumulative in thought as normal science. It must be distinctive and out of the ordinary lineage of normal thinking. The Islamic worldview shares this (Kuhnian) attribute of scientific revolution. Without fundamental invocation, there cannot be a substantive theory and premise for Islamic economics and finance, and thereby, the construction of the Islamic worldview and world-system." (Choudhury 2007b, pp.76-77)

Choudhury argues that the irrelevance of ethics in economic theory in general and macroeconomics in particular is due to the inability of explaining preferences and tastes through endogenous models (Choudhury 2004). “Preferences and menus at both the individual and aggregate level are formed of bundles of such independently and exogenously assigned behavior. The dynamic and complex nature of learning preferences remains foreign to economic and financial theory… The *Tawḥīdi* epistemological, ontological and ontic methodology thoroughly replaces the missing issues of unity of knowledge in learning and process at the microeconomic and economy-wide levels.”(Choudhury 2007b, p.78)

While the materialist worldview relies on the light of human mind alone, the Islamic worldview relies on both reason and revelation. Islam does not ask people to shut down their minds and blindly follow the Divine message. Indeed, it is important to note that the very first message from God to the Prophet Muhammed (pbuh) (and humanity) was not “believe!” or “worship!”. It was “*iqra* (read!)”. It is reported that the Archangel Gabriel came to the Prophet when he was in isolation in a cave and brought him the following verses: “Read in and with the Name of your Lord, Who has created – Created human from a clot clinging (to the wall of the womb). Read, and your Lord is the All-Munificent, Who has taught (human) by the pen – Taught human what he did not know.” (The Qur’ān , 96:1-5)

By referring to the creation of human, the message was clear on where to start reading the vast book of the universe. In other words, following the Divine guidance, we should start reading ourselves first. Then, we could accurately read the universe. We should read ourselves only in the name of God, meaning with His infinite light and guidance. In this regard, the Qur’ān is a “study guide” which shows how to read ourselves and the book of the universe. However, the Qur’ān is not in delusion regarding the human response. It accurately predicts how people will respond to this Divine call: “No indeed, but (despite all His favors to him), human is unruly and rebels. In that he sees himself as self-sufficient, independent (of his Lord). But to your Lord, surely is the return (when everyone will account for their life). (The Qur’ān, 96:6-8) In other words, seeing himself as self-sufficient is the primary cause of the human denial of God. This is also the primary source of the Western dialectic as suggested by Dooyeweerd (1997).

From an Islamic point of view, it can be said that God makes Himself known to humanity through His words and works. If we listen to the Divine Revelations and read His works in the universe, we will know His attributes. We should begin our reading from ourselves because the knowledge of the self will help us to know

God. Once we understand that we are absolutely impotent and needy, we will realize that nature could not produce anything on her own. Everything from an atom to galactic systems is the works of God and under His control at every moment. He is not the god of gaps. He is the God of everything at every moment according to the Qur'ān. Thus, the oneness of God (*Tawḥīd*)7 becomes the source of ontological-epistemological knowledge in the Islamic worldview. In other words, the *Tawḥīdi* paradigm provides the unity between ontological and epistemological level of reality. Therefore, there is no dichotomy between the revealed knowledge and reasoned knowledge.8 While the former comes from the Divine Words (Al-Kalaam), the latter comes from the Divine Power (Al-Kudrah). They are just the different expressions of the same reality which comes from the One (Al-Ahad and Al-Waheed). Due to the unity of knowledge in the Islamic worldview, no contradiction is expected between genuine scientific and religious truth.

As discussed before, the "Enlightenment" project rejects any heavenly God, but embraces the earthly one. It has created a "secular trinity" which consists of nature, cause-effect, and chance. It has also turned the human self to an inner god. The main error stems from its understanding of human nature. In order to correct this mistake, we need to begin with ourselves. We need to discover our inner universe. Once we do that, we will understand that we are not self-sufficient, but contingent. Therefore, we cannot do it by ourselves. We need to rely on the Divine power and mercy at every moment. We are infinitely needy creatures. Our life depends on the entire universe. Our desires are as big as our imagination. However, we have absolutely no power to fulfill our needs and desires. We are like a completely paralyzed person. In reality, we cannot even feed ourselves because we do not have control over our digestive system. It is the Divine power working within us. It is the Divine mercy providing everything for us. Therefore, we should give up arrogance and become truly humble. We should give up complaining and become truly thankful. We should give up serving our desires and ego, and become a true servant of God. The Qur'ān clearly states the purpose behind the creation of human beings: "I have not created the jinn and humankind but to (know and) worship Me (exclusively)." (The Qur'ān, 51:56) As described by Ghazali, the transcendental

[7] *Tawḥīd* is the epistemology of the Oneness of God which becomes the foundation of the unity of knowledge. God is the source and beginning of all knowledge. In other words, "this is to accept the divine roots of knowledge as the primal foundation of all knowledge, hence of all configurations of world-systems." (Choudhury 2007a, p.24).

[8] "While from the point of view of the One, the Absolute, there is no 'otherness' or 'separation'. All things are one, not materially and substantially but inwardly and essentially. Again it is a question of realizing the levels of reality and the hierarchy of the different domains of being." (Nasr 1997, p.30)

achievement would be possible through God-centric life: "The purpose of life is to reach the '*Martaba'* the status of *tawḥīd* (oneness of Allah), understand it, inculcate it in his being to follow His dictates to reach the pedestal of the *Akhlaqe Alaia* (the grandeur of conduct). It would mean a singular achievement of transcending from the Bashari'at'(Being a human being: fallible) to the '*Maqame Haqiqat'* i.e. the position of verity and the truth sublime."(Ghazali 2001, p.747)

7. Anthropological Perspective

From the Islamic perspective, knowing self is very more important. As the Prophet says, "he who knows himself knows his Lord." In other words, knowing self is the key to know God. However, as Gazhali points out, knowing self is not an easy job. Human nature is composed of complex characteristics. It contains animal character in terms of eating, drinking, sleeping, and reproducing. It contains beast character like harming others for his benefits. It contains Satanic and angelic characters. Each of these potential characters is developed through certain nutrition: "Each one of these qualities has its own distinct food that nourishes it, sustains and promotes it's growth, resulting in the promotion of goodness and the approved behavior." (Ghazali 2001, p.2) In other words, human conveys propensity to become animal, Satan, and angel. Animal are two kinds, good and bad ones. If a person only pursues animal desires, he would be like a good animal. If he pursues his interests at the cost of others, he will become like beast. The goal is to become like angels "to behold the glory of Allah" and to be "freed from immoral sensual pleasures and arrogant anger on your fellow men." (Ghazali 2001, p.4) Every person has a potential to become like animal, beast, Satan, or angel.

Inspired largely by the writings of some Muslim scholars such as Al-Ghazali[9] and Nursi, I recently developed a new theory of human nature: "A Grand Theory of Human Nature (GTHN)", using the palace and resident metaphors that follow (Aydin 2012a). If we compare the human body to a luxury recreational vehicle

[9] Here is how Ghazali describes the element of human nature: "The body is like a city. The hand and the feet are like workmen in this city. The desire is its prime-mover. The anger is the city \`Kotwal\` i.e. it's police chief. The heart is its king and the reason it's Wazir the Prime Minister. The king needs all of them to run the government but the lust which is a strong motivating force, is evil and provocating. On the other hand, the Ration which is like the wise Wazir always apposes him, so the funds of the government are not misappropriated or usurped. The anger, like mischief mongering city \`Kotwat\`, the chief of the police is always diversive and reactionary. He tends to be sadistic. Under the circumstances, the king, who is above them all; takes stock of things firmly, consults his \`Wazir\`, and does not allow matters to go out of his hand. It clearly indicates that desire and anger play their respective subversive roles and to nip the evil in the bud becomes the prime duty of the king. That is the position of the heart." (Ghazali 2001, pp. 9-10)

(RV), the following elements of human nature would be the companions on this vehicle: King, Judge, Wazir, Elephant, Showman, Dog, and, Driver. The King is the spiritual heart that is the source of love and inspirational knowledge. The Judge is the conscience that is the source of positive feelings after performing "good things" and negative feelings experienced after doing "bad things". The Wazir (prime minister) is the mind. The Elephant is the animal spirit, which is the source of animalistic desires. The Showman is the self-centric ego that pursues power and possession to show its importance to others. The Dog is an inner drive for protection of personal belongings with potential to oppress others for their possessions. The Driver is the deciding self (free will) that drives that the vehicle under the influence of the residents.

7.1. The King: The Spiritual Heart

Metaphorically speaking, the spiritual heart of an individual is like the King in a human vehicle. He has the capacity for love, compassion and inspiration. He also has certain needs and desires for the fulfillment of his potential and he takes actions to acquire what he needs and desires.

Gazhali describes inner self as the essence of what we are. They can be seen by the eyes of Batin. The heart (or soul) is the core of human existence. Everything else is subservient to the heart who is the king of the human vehicle/city: "The heart is the rider of the body. It's purpose is for the rider to ride its mount. The horse is for the rider and not the rider for the horse."(Ghazali 2001, p.44) According to Ghazali, "the heart is in control of the whole body." This is because of the fact that all desires emerge from the heart. For instance, "when the heart is in anger, the entire body starts perspiring. Similarly, when the heart inspired sexually the relevant organs of the body are stirred and affected. Also when the heart thinks of eating, the agility in the lower portion of tongue is aroused to serve him. Hence, it is evident that the heart has superintendence over the entire body."(Ghazali 2001, p.29) The key qualities of the heart could be summarized as follows:

First, the King has almost infinite capacity to love. He needs/desires beauty, perfection, and benefits in his lover(s). This is because the fact that nature of love is satisfied by beauty, perfection, and benefit. According to Ghazali, the King finds true satisfaction only with the knowledge, submission, and love of God: "the heart is the knight-rider of the body. The rest of body is official of this force. It's principal duty is the attainment of the '*Marafat* of Allah' the perception and acquisition of His sublime beneficence due to the inherent characteristics bestowed by Him in the man's heart to this effect. It throbs in His love. All the time it is vocal, reciting His praise, that He alone, He alone is worthy of being worshipped. Only He, it is continuously intoning, has the power to grant mercy or levy punishment on His people… Thus, in whole-heartedly striving to possess the '*Marafat'* of Allah is the key to this goal." (Ghazali 2001, p.4) This is the case because "The '*Marafat'* of Allah is the food of the soul, as meals are taken man are nourishment for his body." (Ghazali 2001, p.4)

Second, the King has capacity for compassion, which is the source of empathy for the wellbeing of other individuals. For example, compassion for children, the elderly, and the poor comes from the King. Through exercising compassion, he makes us care about those who need help and desires to share our resources with them. He receives pleasure from exercising this compassion and feels pain when not able to exercise compassion.

Third, the King has capacity for inspiration. The King demonstrates curiosity for the life and the world around him. This is the source of learning the arts and sciences. Concentration and contemplation of objects of amazement or novelty inspire the King to gain knowledge. The King seeks the company of people, objects and events that provide inspiration.

According to Ghazali, the heart and its kingdom is provided to reach to the highest of high (*allayi illiyin*). He must consider this world as temporary house and for the Hereafter as permanent residence. He should use all of his forces under the command of the king to reach his final destination. If they all follow the command of the heart, there will be peace and happiness in the life journey. Otherwise, there will be chaos and misery.

7.2. The Judge: The Human Conscience

Conscience, which is defined as the ability to distinguish right from wrong, is like an inner judge in the human vehicle. The Judge makes judgments about an individual's decisions in life. If we treat someone unfairly, the inner judge causes us to be aware of this injustice and feels guilty for being unfair to others. The Judge is affected by perceived unfairness in his community or broader society. He desires "fairness" in relationships and seeks equitable social arrangements in which the individual trusts and is trusted by other members of society. Feelings of inner peace exist when community norms and social policy reflect values consistent with those of the Judge. In order to make the inner Judge happy, an individual must develop a code of ethical behavior and consider fairness in every action.

7.3 The Wazir: Mind

Mind which consists of intellect, logic, and memory serves as Wazir to the King, the ruler of the human vehicle. If the Elephant described below is in power, the Wazir will serve him by providing guidance on available choices for pleasure. Thoughts that are deemed logical and rational also serve as guidance to the King (heart) and the Judge (conscience). However, if the Wazir is pre-consumed with helping the Elephant, he may not have resources to serve the King and the Judge. The Wazir has the capacity of reasoning and memorization. His fulfillment comes with gaining knowledge by comprehending objects in the environment and through events that he experiences. The Wazir acts to learn, reason, and contemplate the inner and outer universes. He performs the role of making rational decisions for the King and other residents such as the Elephant and Judge. However, he has no power to endorse his decision and may be silenced if the Elephant is too strong. When this analogy is applied to free market capitalism, individuals often exhibit behaviors that are dominated by the Elephant despite attempts at guidance from the Wazir.

7.4. The Elephant: Animal Spirit

The Elephant is an animal spirit in the human vehicle. In traditional Islamic literature, it is known as Nafs. Al-Ghazzali calls it horse. He argues that if we spend all our time looking after it and feeding it, we would never get anywhere. Instead we should train and give it just enough attention so that it can carry us where we want to go (Ghazali, Winter 1997). I prefer to call it the Elephant because of its similarities to what is described by Jonathan Haidth in his book titled The Happiness Hypothesis. Haidth suggests that we have a divided self, which consists of a rider and an Elephant. The rider is the reasoning part of the mind and the Elephant is the part seeking pleasure. To Haidth, “the rider is an advisor, or servant, not a king, president, or charioteer with a firm grip on the reins” (Haidth 2005). The Elephant has the capacity for sensual experience through using the five senses. He needs and/or desires many things such as food, drink, sleep, sex, etc. His fulfillment is determined by the acts of eating, drinking, sleeping, sexual activity and so on. Nursi, (1996c, 1996b, 1996a) wrote extensively on what the Elephant desires and how to train/control him. In his view, the Elephant is addicted to pleasure. The Elephant pursues instant gratification and selects present pleasure over any greater reward that could be achieved through deferment. Blind to the future, he wants to gain pleasure and avoid pain now with no ability to conduct long-term cost and benefit analysis. He is never satisfied with what he has and always asks for more. Due to the phenomena known as Hedonic Adaptation, he is very adaptable to his current situations. He ceases to appreciate what he has and always look for new sources of pleasures. He resists limits and without external restraint will consume anything and everything that provides instant gratification. He collaborates with the Showman and consumes "positional goods and services". In Nursi's view, one of the key purposes of religion is to provide restraint and control of the elephant, guide and train him

7.5. The Showman: The Self-centric Ego

The self-centric ago is like a showman in the human vehicle. He enjoys working for the Elephant because of recognition he receives from the latter's activities. He is motivated by acts that acquire recognition, identity, fame, etc. and frequently compares his own possessions with those of others. However, if the Showman gains too much power in the vehicle, he will act like a dictator trying to control other people and nature. Indeed, he might even claim to be a sort of God. Relying on his assumed power, he will attempt to oppress others for his interests. He will not accept his imperfection and impotence. In modern consumer society, individuals are in a continuous process of constructing their personal identity through consuming material goods as social and cultural symbols. Cushman said that the "empty self" of a consumer is constantly in need of "filling up" through material consumption.(Cushman P 1990) Companies are quite successful in providing positional goods and services to conspicuous consumers. They do not sell "just" products; they sell brands, prestige, visions, dreams, associations, status, etc. (Klein 2001)

7.6. The Dog: The Oppressive Ego

The Dog is an inner drive for protection of personal belongings with potential to oppress others for their possessions. If unchecked by moral and religious values, he will act like a dictator trying to control other people and nature. Indeed, he might even claim to be a sort of God. Relying on his assumed power, he will attempt to oppress others for his interests. He will not accept the innate impotence and neediness. According to Ghazali, the power of anger (Quvate Ghazab) is "like a hunting dog". It is given "to suppress the devil in man" in two ways: 1) By remaining in the confines of the code of conduct of the Shariat. 2) By overcoming the savage, the sensual and self-aggrandizing urges."(Ghazali 2001, p.733) Ghazali elaborates on the outcome of being overtaken by the dog as follow: "then the damaging traits that will develop in you will be those of being rash and unmindful of consequences, impurity, bragging, arrogance, wanton flaunting of your faults, taunting and torturing others, picking up flights and squabbles with others." On the other hand, "if you prevail over this dog of destruction, you will acquire the added qualities of patience, suavity, forgiveness, stability, bravery, tranquility and saintliness."(Ghazali 2001, p.15)

7.7. The Driver: The Deciding Self

The observing/deciding self is like a driver in the human vehicle. He is the source of self-awareness and serves as a conduit for relationships with other human beings and the external environment. He is the reference point to know everything including other beings and God (Nursi 1996c, Al-Ghazali 2007). He is in charge of the vehicle. He is aware of his possessions and protects them from intruders. As seen in the diagram below, the Driver pursues self-esteem, awareness, and identity formation.

8. Teleological Perspective

From the Islamic point of view, as everything in the universe is created for certain purposes, human being is also created for certain purposes. The main purpose of human is not to boost the self, turning him to an inner god. The purpose is also not to serve the elephant, as becoming his slave. Rather, the purpose is to understand our nature embedded with infinite impotence and poverty, and act accordingly. It is to disclose our almost infinite potential by relying on the Divine power and mercy through understanding our true nature. In other words, the purpose is to excel spiritually, intellectually, and morally and be "*insan-i kamil* (perfect human) by disclosing our human potentiality as much as we can.

A story told by the 13th century poet Rumi (2004) fits well in explaining what the "Enlightenment" has done to human potential. In his masterpiece Mathnavi Ma'navi "Spiritual Couplet", Rumi compares the human to a goose's egg along with many hen's eggs placed under a hen for incubation. Even though the chick from the goose's egg will become a goose, if she imitates her siblings, she can only walk. However, if she becomes aware of her potential, she can walk on the ground, swim in the water, and fly in the air. Similarly, if we truly become aware of the key elements of our nature, we can have many different experiences and reach a higher level of enjoyment in our life.

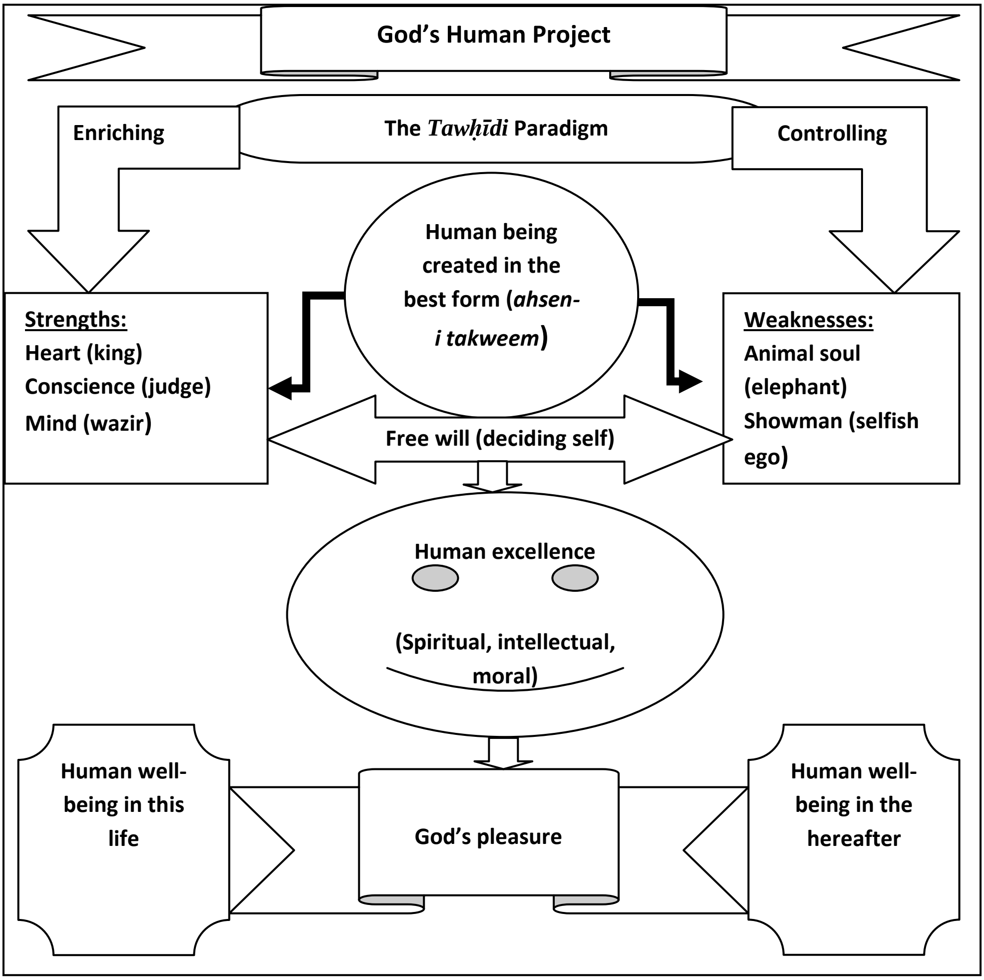
9. God's Human Project

From the Qur'ānic perspective, human being is a (perhaps the) major project of God. The Islamic worldview is built upon this project. The Qur'ān provides detail information about the initiation of the project and its expected outcome. "Remember (when) your Lord said to the angels: "I am setting on the earth a vicegerent. " The angels asked: "Will you set therein one who will cause disorder and corruption on it and shed blood…. He said: "Surely I know what you do not know" (The Qur'ān, 2:30). In another verse, the Qur'ān states that human beings were created in the best form (*ahsan-i taqwim*): "Surely We have created human of the best stature, as the perfect pattern of creation" (95:5). This refers to the potential in human beings. Indeed, the Qur'ān clearly indicates that human beings are potentially superior to all creatures, even angels. Therefore, when Adam was created the angels were asked to "prostrate before Adam! They all prostrated, but Iblis Satan did not; he refused, and grew arrogant, and displayed himself as an unbeliever." (The Qur'ān, 2:34) The superiority of Adam was not coming from wealth, pleasure, fame etc. It was coming from his ability of learning the truth about God in comprehensive manner. "(Having brought him into existence,) God taught Adam the names, all of them. Then (in order to clarify the supremacy of humankind and the wisdom in their being created and made vicegerent on the earth), He presented them (the things and beings, whose names had been taught to Adam, with their names) to the angels, and said, "Now tell Me the names of these, if you are truthful (in your praising, worshipping, and sanctifying Me as My being God and Lord deserves)." (The Qur'ān, 2:31) The angels acknowledged that they could not gain knowledge as much as human could. The Qur'ān (95:5) also warns about the failure of not using the great potential given to human being by saying that he will be "reduced him to the lowest of the low." The only way out from such failure is be among " those who believe and do good, righteous deeds" (The Qur'ān, 95:6).

From Islamic perspective, the ultimate purpose of life is to excel in virtuous and sincere deeds in order to fulfill his mission of vicegerent and earn God's pleasure. This means that human beings should be guided in terms of how to live a good life and fulfill his Divine mission. However, the guidance does not come from the secular mind; it comes from the mind enlightened by the Divine revelation. As seen in the chart below, the God's human project will succeed if we enrich our heart, conscience, and mind, and control our weaknesses namely animal soul, selfish and oppressive ego through the teaching of *Tawḥīdi* paradigm. Nursi defines the *Tawḥīdi* paradigm on five pillars: *tawḥīd* (oneness of God), *nubuvvah* (prophethood), hereafter (*ākhirah*), *ʿadālah* (justice) and obedience to God

(ʿ*ibādah*). The last one is not just praying, it is living whole according to the Divine guidance. God's human project is built upon these pillars. They help human beings to control their negative sides and disclose their positive sides to fulfill their missions as vicegerent and to reach to the highest of high going even beyond angels. If we fulfill our mission by following our nature, we will excel and reach to the highest of high. If we fail to do so, we will fall to the lowest of low. For that reason, the Qur'ān praises the Prophet Muhammed in terms of his character: "You are surely of a sublime character, and do act by a sublime pattern of conduct." (The Qur'ān, 68:4)

Chart-2
God's Human Project



The success of the project is not measured by material outcome. It is majored by spiritual, moral, and intellectual outcome. Ghazali outlines the outcome of good and bad life as follows: "Beware that your acts and deeds will create in you're a corresponding trend of character which will make you or mar you. Indeed nothing but the good emerges out of the good. Vice versa, if you are obedient to the swine of desire, you will have similar habits of profanity, shamelessness, avarice, flattery, dirtiness and that of being happy over the wickedness of the others. However if you succeed in suppressing the swine; getting the better of him, you will be crowned with the qualities of contentment, grace, wisdom, piety and selflessness etc."(Ghazali 2001, p.14)

Ghazali gives the example of a person who aims to go to *Kabah* by camel. Of course, the person has to take care of the camel to certain extent in order to complete his journey successfully. However, if he acts as if he is main job is to serve the camel, he will perish on his way without reaching the destination. The relationship between body and soul is like that of a rider and camel. The rider aims to go to *Kabah* (Ghazali 2001, p.78). He will take care of his camel to realize his goal. If he spends all of his time serving the camel, but making no progress, he would be considered foolish. In other place, Ghazali again refers to kingdom metaphor to explain the purpose of life: "Allah thus gave man the heart and its kingdom to reign over. He provide him with the army--- the force to do so, also the wherewithal to ride, in order to make him rise to the higher grounds of grandeur."(Ghazali 2001, p.9)

For that matter life is not fun even though there is room for fun in life. Rather, life is a test. "We have surely made whatever is on the earth as an ornament for it (appealing to humanity), so that We may try them (by demonstrating it to themselves) which of them is best in conduct. Yet, We surely reduce whatever is on it to a barren dust-heap (and will do so when the term of trial ends). " (Qur'ān, 18:7-8) Therefore, material possessions cannot be the goal in life; they can only be a means of accomplishing the ultimate goal of disclosing our potential. For a believer "the present, worldly life is nothing but a play and pastime, and better is the abode of the Hereafter for those who keep from disobedience to God in reverence for Him and piety…" (Qur'ān, 6:32) The purpose of life is to pursue God's pleasure by fulfilling our mission as desired and designed rather than pursuing self-pleasure. However, from the Islamic perspective, well-being in this life and in the hereafter will be realized as byproduct of God's pleasure. Ghazali points out the hapless pursuit of happiness in sensual pleasure as follows: "some people think that they have been made to eat, drink and fulfill their urge for the other sex. People of this kind whither away all their life in such hapless pursuits." (Ghazali 2001, p.17)

10. Redefining Islamic Economics

Islamic economics has been a key subject matter among diverse pool of Muslim scholars such as commentators of the Qur'ān, jurists, historians, and social, political, and moral philosophers. In last few decades, discussions on Islamic economics have intensified. Muslim economists have been discussing the need for Islamic economics as a new discipline. Even though there is a great consensus among scholars that Islamic worldview differs from its secular counterpart, "the debate on 'nature' of and 'need' for Islamic economics and finance as an alternative paradigm is not settled yet".(Iqbal, Syed Ali & Muljawan 2007, p.4) Despite significant progress in the discussion, there is still argument even on the very definition of Islamic economics.

Four groups of people write on Islamic economics. First group of scholars are those who attempt to present Islamic economic system as an alternative system to capitalism and/or socialism. They are in favor of radical changes rather gradual modification of the existing system. The second group acknowledges that Islamic economics should be distinct system, but they do not think that Muslim scholars are ready to present such comprehensive alternative system. Therefore, they are in favor of gradual reformation of the conventional economics. Hasan argues that Islamic economists make mistakes by comparing the ideals of Islamic system with the realities of capitalist system, not its ideals (Hasan 2011). Therefore, he considers their writings being a sort of apple-orange comparisons. He calls for a step-by-step approach to Islamizing economics rather than comprehensive approach (Hasan 1998).

The third group does not see any difference between Islamic and capitalist economic system. They think that "the revealed word of God in the Qur'ān itself embodies rational economic principles that are quite in line with the modern assumptions of neoclassical economic theory. As a form of universally applicable theory about human beings' economic behavior, economic theory necessarily is in accord with and confirms the source of universal knowledge, the Qur'ān: homo-Islamicus and homo-economicus are one and the same."[10] For instance, Zubair Hasan (1992) claims that the basis features of the capitalistic system were evolving during the era of Muslim Spain in Europe before even it emerged in England. In

[10] Maurer, Bill (2005), Mutual Life, Limited, Islamic Banking, Alternative Currencies, Lateral Reason, Princeton University Press, p.36

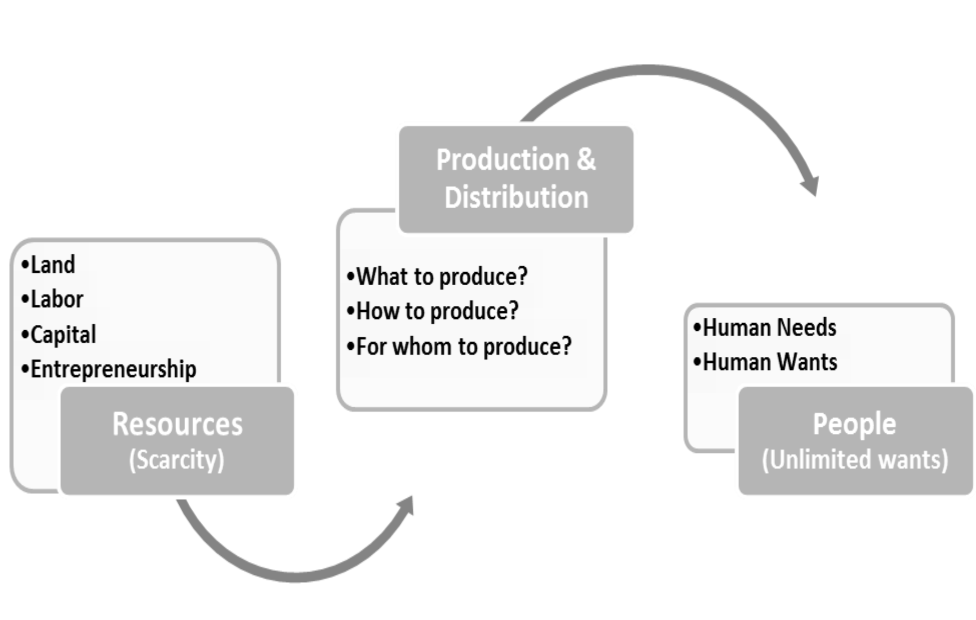
my view, this judgment is due to equating free market system with capitalism. Indeed, it is possible to claim that the Prophet of Islam himself was functioning within a capitalist economic system if we see private property and free enterprise as the defining features of capitalism.

The fourth group consists of critics of Islamic economics who do not see any potential for Islamic economics to be a distinct model. For instance, Timur argues that Islamic economics is not a genuine answer to the world's economic problem, but invented device to "Islamic civilization against foreign cultural influences" (Kuran 1995, p.156). In my view, Timur and other skeptics of Islamic economics do not understand the distinctive features of Islamic worldview. They see the efforts for Islamic economics as capitalism minus interest plus *zakāh* or socialism minus state control plus God. They do not think Islamic economics could be defined as something unique. In this section, I would like to discuss the definitions of Islamic economics suggested by leading scholars of the first two groups mentioned above. Then, I will present my own definition based on the Islamic worldview outlined in this paper.

11. Conventional Economics

Marshall, in his famous book Principles of Economics published in 1890, defines economics as follows: "Political Economy or Economics is a study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely connected with the attainment and with the use of the material requisites of wellbeing. Thus it is on the one side a study of wealth; and on the other, and more important side, a part of the study of man." It means that the main subject matter of economics, irrespective of whether it is capitalist or Islamic, is the allocation of scarce resources to produce and distribute goods and services in order to fulfill the needs and wants of human beings. Thus, need and want fulfillment of human beings are at the final end of economic activities. However, the challenge arises from the scarcity of resources versus unlimited wants of human beings. Economists are supposed to help finding the answers to three core questions: what, how and for whom to produce? Even conventional economics is divided over how to answer the questions above. The positive economics deals with those questions without taking any norms into consideration while the normative economics tries to find out universally desired answers. In other words, the positive economics aims efficiency in production and distribution while the normative economics consider value judgments above efficiency.

Chart-3
Defining Economics



Due to the scarcity of resources and unlimited nature of human wants, the core questions are same for every kind of economics, capitalist, socialist or Islamic. However, the answers to those questions depend on worldviews. In general, we could talk about two main worldviews: 1) materialist and secular 2) spiritual and religious. The materialist and secular worldview rejects the spiritual realm of human being and the universe. There is nothing beyond material world. The life is strictly limited to this world. There is no room for belief in the hereafter. For that matter, the primary concern of materialist people are the acquisition of material goods and the enjoyment of physical satisfactions, and as a consequent rejection of or indifference to the spiritual, aesthetic, or ethical things (Stuart 1989, p.19). This is same for socialist economic system as well. Despite disagreement between the two, in reality capitalist and socialist systems are two twins who prefer different means to the same ends. In other words, both capitalism and socialism see human pleasure as the final ends. The disagreement is about how to produce goods and services for human pleasure and who to please among human beings. The well-being is defined in a purely materialist and hedonist sense. While free market capitalism envisions the fulfillment of social interests within the free pursuit of self interests, socialism gives priority to social interests. Both capitalism and socialism aim for "worldly paradise" through material well-being of people. The disagreement is in the tools they suggest for the final end.

12. Islamic Economics

Even though Islamic economics overlaps with conventional economics in terms of dealing with scarce resources in order to fulfill the needs and wants of human beings, it differs significantly in the way it answers to the core economic questions and define human needs and well-being. While conventional economics which emerged within the materialist worldview is solely based on human reason, Islamic economics is based on human reason and the Divine guidance (Khan 1989).

Islam recognizes spiritual, moral, and social needs of human beings in addition to material needs. In Islamic economics, human well-being is not defined from hedonic perspective; it is rather defined from a spiritual, moral, and social perspective. Even though Islamic economics is for free market in general, it does provide certain filters to avoid the madness and unfairness of the market. Thus, the answer to "what to produce" is determined by the comprehensive understanding of human nature and needs, not by self-interest. Self-pleasure is not the final end, it is the byproduct of God's pleasure. Since the Islamic economic system relies on different moral, social, and spiritual principles which determine the answers to the core economic questions, it could be defined as distinct economic paradigm.[11]

There are many competing definitions of Islamic economics. I would like to discuss several of them here. Hasannuzzaman is one of the first person who attempts to come up with a comprehensive definition: "Islamic economics is the knowledge and application of injunctions and rules of the Sharīʿah that prevent injustice in the acquisition and disposal of material resources in order to provide satisfaction to human beings and enable them to perform their obligations to Allah and the society." (emphasis added) (Hasanuzzaman 1984, p.52) This definition is quite vague. It does not specify which rules and knowledge are relevant to Islamic economics. Islamic economics is defined mainly on the concept of justice. It is not clear whether the author would consider capitalism or socialism as acceptable economic system if they are modified to prevent injustice.

[11] Asutay (2007) argues that Islamic economics needs to differ from conventional economics in the following aspects in order to be a distinct economic system: "Framework paradigm (with ontological and epistemological sources) in terms of point of reference; Value system; Foundational axioms; Operational principles/mechanism; Specific Methodology; Functional institutions."

For Mannan, the defining feature of Islamic economics is its values: “Islamic economics is a social science which studies the economic problems of a people imbued with the values of Islam.” (Mannan 1987, p.18). However, he does not elaborate on the relevant values and how their involvement will create Islamic economics as a distinct field. For Khurshid Ahmad, Islamic economics is “a systematic effort to try to understand the economic problem and man’s behavior in relation to that problem from an Islamic perspective.” (emphasis added) (Ahmad 1992, p.19). Again, the definition does not provide any hint on how Islamic perspective requires Islamic economics to be distinct. Likewise, the following definitions portray Islamic economics as something shaped by Muslim scholars within Islamic perspective, but do not say how it differs in terms of answering the core questions: “the Muslim thinkers’ response to the economic challenges of their times. In this endeavor they were aided by the Qur’ān and the *Sunnah* as well as by reason and experience.” (emphasis added) ((Siddiqi 1992, p.69). “Islamic economics is the representative Muslim’s behavior in a typical Muslim society”. (emphasis added) (Naqvi 1994, p.176).

For Khan, the distinctive feature of Islamic economics is well-being through cooperation and participation; however, he does not elaborate the implication of his definition the nature of Islamic economic system: “Islamic economics aims at the study of human *falāḥ* [well-being] achieved by organizing the resources of the earth on the basis of cooperation and participation.” (emphasis added) (Khan 1994, p.33). Although Hasan expands the preceding definition by highlighting the multiplicity of wants and scarcity of resources, he does not go further enough to outline the distinctive nature of Islamic economic system: “Islamic economics is the subject that studies human behavior in relation to multiplicity of wants and scarcity of resources with alternative uses so as to maximize *falāḥ* that is the well-being both in the present world and the hereafter. (emphasis added)” (Hasan 2011, p.21).

Umar Chapra comes with the most comprehensive definition: “The primary function of Islamic economics, like that of any other body of knowledge, should be the realization of human well-being through the actualization of the *maqāṣid*. Within this perspective Islamic economics may be defined as that branch of knowledge which helps realize human well-being through an allocation and distribution of scarce resources that is in conformity with Islamic teachings without unduly curbing individual freedom or creating continued macroeconomic and ecological imbalances.” (emphasis added) (Chapra 1996, p.30)

To me the distinctive features of Islamic economics come from the Islamic worldview, particularly its ontological, epistemological, and teleological differences from the materialist worldview. Therefore, it is important to highlight multi-dimensional well-being goals and morally guided market mechanism in definition: "Islamic economics foresees an economic system based on the Islamic worldview aiming to realize spiritual, moral, intellectual, social, and material well-beings of individuals in this life and the hereafter through allocation and distribution of scarce resources in a morally guided market system." Thus, the answers to the core questions could be as follows: what to produce? Produce goods and services which help human beings to excel spiritually, intellectually, morally, and socially. What to produce? Produce the basic goods and services for everyone, but others for those who could afford. Accumulate spiritual, moral, and social capital in addition to physical and financial capital. How to produce? Produce through efficient and fair market mechanism.

13. Concluding Remarks

The paper attempts to make a strong case for Islamic economics as an alternative paradigm to deal with the crises of capitalism. It draws the western worldview in which free market capitalism emerged and flourished. Then, it redefines Islamic economics based on distinctive worldview of Islam particularly from anthropological, epistemological, and teleological perspectives.

Even though free market capitalism has been very successful in the use of scarce resources, the paper strongly argues that the ultimate outcome of capitalism is not progress toward human excellence, rather it is regress toward animality. This is why the system has failed to bring authentic happiness. Indeed, the more progress it makes, the more it takes us away from such happiness. This reminds us the Seneca's opening words in De Vita Beata:

"To live happily, my brother Gallio, is the desire of all men, but their minds are blinded to a clear vision of just what it is that makes life happy; and so far from its being easy to attain the happy life, the more eagerly a man strives to reach it, the farther he recedes from it if he has made a mistake on the road; for when it leads in the opposite direction, his very speed will increase the distance that separates him."

It is important to note that despite few decade works, we are still at the beginning of a long path to go in order to present Islamic economics as a viable paradigm. There are many tasks ahead. First, we need to go beyond the existing paradigm and create our own concepts and models whenever it is necessary.

Second, we need to begin from microeconomics. As Yalcintas(1986, p.38) pointed out over two decades ago “construction of microeconomic theory under the Islamic constraints might be the most challenging task for Islamic economics.” We need to establish “a separate theory of consumer behavior and a separate theory of firm in the context of Islamic economics.”(Ahmad 1986) This should not be just the relabeling the existing microeconomics literature. As Chapra suggests, it should reflect “the radical differences in the worldviews of Islamic and conventional economics.”(Chapra 1996, p.50) Third, we need examine the existing empirical and theoretical studies to gather evidence for new concepts and models of Islamic economics. Fourth, we need conduct experimental and empirical studies to gather data and test economic assumptions and models from Islamic perspective. Most of existing papers on Islamic studies do not offer any scientifically acceptable evidence for their arguments. Therefore, they are more rhetorical, rather than scientific. The famous motto attributed to Lord Kevin puts measurement as the yardstick for scientific knowledge: “When you can measure what you are speaking about, and express it in numbers, you know something about it; but when you cannot measure it, when you cannot express it in numbers, your knowledge is of a meager and unsatisfactory kind; it may be the beginning of knowledge, but you have scarcely in your thoughts advanced to the state of Science, whatever the matter may be.”12 We now have more measurement tools to gather qualitative data in order to test concepts, assumptions, and models from the Islamic economics.

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[12] The shorter version of this motto is posted on the wall of the Social Science Research Building at the University of Chicago.

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Why is Growth of Islamic Microfinance Lower than its Conventional Counterparts in Indonesia?

DIAN MASYITA•

HABIB AHMED♣

Abstract

The aim of this paper is to examine the demand factors for microfinance services in Indonesia consisting of the understandings, perceptions and preferences of 581 micro finance institutions (MFIs) clients of four MFIs—two Islamic (BMT and BPRS) and two conventional (BRI and BPR).

The results show that MFIs clients' preferences are driven by economic (low interest rates, low collateral and size of loan) and non-economic factors (such as quality of services variables; easiness, speed, nearness, payment method and loan officers' profile). The results also indicate that BRI, a conventional MFI, is ranked the most competitive according to these factors, followed by BPRS (Islamic rural banks), BPR (conventional rural banks) and BMT (Baitul Maal wa Tamwil).

The survey also identifies the gaps in which Islamic MFIs should fulfill in enhancing their roles to reduce unemployment and poverty.

Key words: conventional MFI, Islamic MFIs, client's understanding, perceptions, preferences

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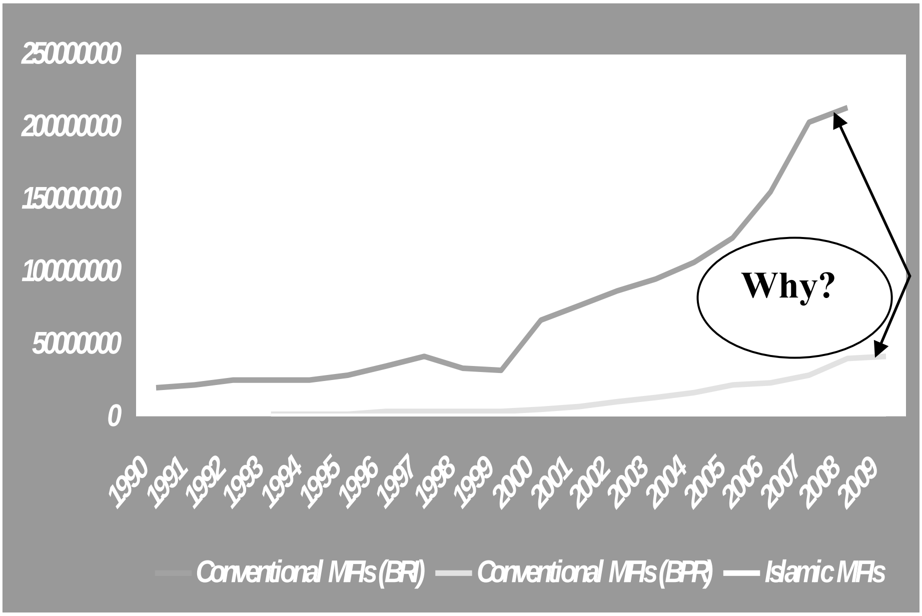
1. Background

Indonesia is the fourth largest country in the world in terms of population with 237.5 million people, with 88% of them being Muslims, making it the largest Muslim population country (based on 2010 Indonesian census). However, Indonesia also has other religions including Protestants, Roman Catholics, Hindus and Buddhists. Indonesian economy is dominated by micro, small, medium enterprises (MSME's) which together constitute 99% of the total business. Micro enterprises themselves dominate 98.85% of total business absorbing 90.98% of the total labor force and contributing 57.12% to GDP in 2010 (Indonesia Bureau Statistics, 2011). These figures show that micro-businesses play a strategic role in Indonesia economy. The Indonesian banking institutions are categorized into commercial and rural banks. In Feb 2011, there were 122 commercial banks and 1822 rural banks. Of the rural banks, the ones that are Islamic are only 151 with 291 total bank offices.

Indonesia has a diversity of both conventional and Islamic microfinance models. While conventional finance has existed for a long time, Islamic finance commenced in Indonesia relatively recently since 1990. As figure 1 shows, the growth of Islamic MFIs, however, has been sluggish and far behind the conventional MFIs. This research attempts to identify the client's understanding, perceptions and preferences toward MFI's products and institutions in order to understand why Islamic MFI grew slowly in Indonesia compared to conventional MFIs.

Figure-1
Gap between Conventional MFIs and Islamic MFIs



(Sources of data: Siebel's research, Bank of Indonesia's report, author's data processed from different resources)

While microfinance can be an instrument for poverty alleviation (Ahmed, 2004, 2007; Chapra, 2000, 2008: Kahf, 1999: Masyita, 2005, 2007) in reality it has not been used to its full potential. However, there is no single microfinance model or method that should be promoted. Every microfinance programme needs to be tailored specifically to meet complex local realities prevalent within each country or even different regions within a country. The needs of micro entrepreneurs, the complexity and nature of ventures to be financed are also the other reasons for doing this (Khan, 2008).

In this study, we report results from a survey of MFIs' clients conducted in Bandung, Indonesia. The population of the city and regency of Bandung is around 3.178 million. The study includes four MFIs, two conventional and two Islamic. The conventional and Islamic MFIs considered in the article include three non-governmental institutions BPR, BPRS, BMT and a governmental micro-banking institution BRI. The rest of the article proceeds as follows: In the section 2, the literature review on demand side issues of the microfinance sector is outlined. In the section 3, an overview of the poor and microfinance in Indonesia and some factors affecting it are presented. In the section 4, the research methodology, summary statistics of the data and analyses are provided. Section 5 reports the results from the survey. Section 6 concludes the paper and provides some recommendations.

2. Demand Side of Microfinance Sector

Contemporary microfinance evolved after developmental policies of the 1950s and 1960s failed to eradicate poverty. Not only did government rural credit schemes fail to reach small farmers (Hulme & Mosley, 1996) and the formal banking sector not fulfill the financial needs of low-income households there was concerted efforts to diminish the role of the state in economic development by cutting welfare spending such as basic healthcare and education (Fernando, 2006). In Muslim countries such as Indonesia, Bangladesh, Pakistan, many people do not deal with conventional interest-based financing due to their religious convictions. Thus, there is a need to establish Islamic microfinance institutions to include these people and fulfill their aspirations of *interest free* finance.

There are some economic problems for MFIs including asymmetric information, economic viability, low rate of return on investments (RoI), debt trap, high drop-out rate and non-graduation from poverty (Ahmed, 2002). As microfinance institutions deal with the poorer sections of the population who require small amounts of financing, the costs of delivery of the services become very high constraining their growth. As the size of the loan for micro enterprise is small, the administering cost of a per-unit of loan is high (Ahmed, 2007: 7; Obaidullah & Khan, 2008: 24). Furthermore, as clients of microfinance institutions do not have any track record, they are riskier than traditional financing portfolio. Therefore interest rates on microfinance are pegged relatively higher, since they entail higher risks, administrative charges and monitoring costs.

However, as asserted by Obaidullah & Khan (2008: 24) “easy to access, timeliness and flexibility are more important factors for micro entrepreneurs than interest rates”. Robinson (2009: 45), however, contradicts this when she states that “what matters to microfinance clients is the access and cost of financial services”. Ahmed (2007) maintains that microfinance institutions may find it difficult to attract deposits in the way that commercial banks do. As MFIs grow, however, the savings of beneficiaries accumulate, which can then be recycled in financing micro enterprises. Whatever the type of institution providing the finance, these institutions have to address the fundamental problems related to their operations and sustainability. To ensure income/revenue, these institutions have to mitigate the credit risk by ensuring that micro entrepreneurs repay the principal with returns in the absence of physical collateral and reduce the moral hazard problem. To be viable, the costs of operations have to be kept at a minimum (Ahmed, 2007).

There are some non-financial factors that have a significant impact on developing MFIs such as insufficient supervisory teams, low paid salary for officers, moral hazard problem, culture and specific behaviours. Sufficient supervisory and monitoring team compared with the number of clients is very important to increase the repayment rate. Wages paid to field level employees can affect their incentive to work and affect recovery rates (Ahmed, 2007: 7).

Some characteristics of micro entrepreneurs such as illiteracy, lack of collateral, the small size of the loan, the higher administering cost of loans (assessment, processing and monitoring) which make it impossible for traditional financial institutions to offer credit to micro enterprises (Ahmed, 2002; Khan, 2008). From the clients' point of view, the key words are "security, convenience, liquidity, confidentiality, access to credit, good service, and returns" (Robinson, 2009: 59) .

3. The Poor and Microfinance in Indonesia

This section first provides an overview of the poor in Indonesia and then discusses the nature of microfinance sector in the country. The results from the Bank Indonesia household survey in 2008 shown in Table 1 summarize the key economic variables for the household sector in the country.

Table 1 shows Indonesian households' assets can be divided into fixed assets 76.81%, non-financial assets 15.57% and financial assets 7.62%. Indonesian households' debt is mostly from banks constituting 78%, non-bank 12% and others 10% with the debt servicing ratio of banks being 72.11% and non-banks 33.08%. The purposes for which the households' take loan are business 24%, cars/motor 16%, property 14%, consumption 13%, education 8%, health 3% and others 4%. Moreover, households' repayment capacity ranges from 6.31% to 28.62%, with debt to assets ratio standing at 3.78% and debt to net worth ratio at 4.03%. These numbers show that there is a significant opportunity for MFIs to grow in the country.

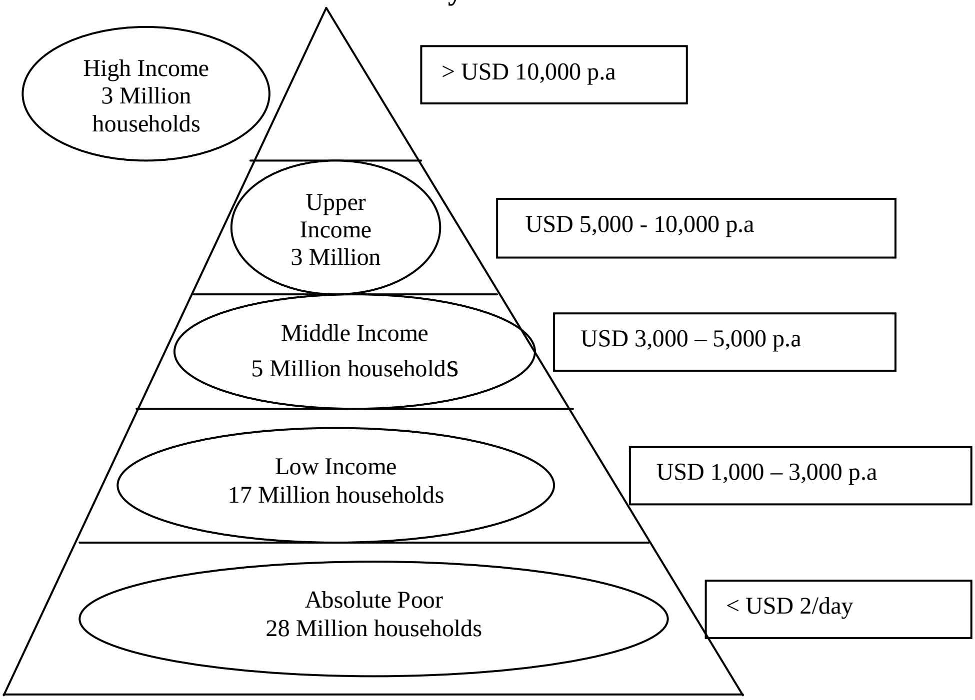
Table-1
Indonesian Household Survey

Assets		Liabilities	
Fixed Assets	76.81%	Debt from bank	78%
Non Financial Assets	15.57%	Debt non bank	12%
Financial Assets	7.62%	Debt other	10%
Total 100%		Total 100%	
Ratios			
Debt services ratio bank			72.11%
Debt services ratio non bank			33.08%
Repayment capacity range			6.31% - 28.62%
Debt to assets			3.78%
Debt to net worth			4.03%
Loan's Purposes			
Business	24%	Consumption	13%
Car/motor	16%	Education	8%
property	14%	Health	3%
others	22%		
Total		100%	

Source: Based on Bank Indonesia household survey in 2008

Indonesia's large population of 237 million people is housed in 56 million households. Figure 2 shows the spread of the households in different income groups. Middle to high income households with average yearly income range from USD5,000 - USD10,000 are the target highly competitive market of traditional retail banking by both local and foreign banks. The new target markets for microfinance/micro banking are low-income and the extreme poor households with average yearly income less than USD3,000. While the former group can be approached by commercial organizations with profit-oriented motives, the latter can be approached by organizations with social motives that are subsidized by either the government or NGOs.

Figure-2
The Income Pyramid for Indonesia



Source: Asian Banker 2004 (data as of Dec 2003)

Microfinance institutions are financial intermediaries which have core businesses in financing, capital accumulation, risk mitigation, payment and remittance systems and also provide funds to people at the lowest strata of the society. Compared to the ‘financial system’ approach identified by (Robinson, 2009), in which the MFIs operate with profit motives, the ‘social approach’ focuses welfare but have to depend on subsidies. Indonesia is dominated by ‘financial system’ approach whereby most Indonesian MFIs are motivated by profit rather than social amelioration. Thus Indonesia’s MFIs do not serve all the people in the bottom of pyramid (i.e low income earners, micro entrepreneurs and poor inhabitants). They mostly serve the non-poor and rarely serve the core poor.

Microfinance markets are interesting in terms of profit and scale. According to CGAP’s presentation ‘Making sense of Microcredit Interest Rate’, the yield on gross portfolio by scale of operation for large MFIs is 37%, medium MFIs 42.5% and small MFIs 42.8%. Four main types of financial institutions are engaged in the microfinance sector (Jansson, Rosales, & Westley, 2004):

(1) Commercial banks and other financial institutions opting for a strategy of 'downscaling'[1],
(2) Commercial banks and non-bank financial institutions specialized exclusively in microfinance,
(3) Cooperatives, and
(4) NGOs.

Fierce competition exists between microfinance providers in Indonesia where different institutions such as BPR, BPRS, BMT and also other large banks with their micro-banking division such as BRI (Bank Rakyat Indonesia), Andara, Mandiri, Mega, Mayapada, BTPN (local banks) and Citibank, Danamon, HSBC (foreign banks) and other commercial banks operate. This makes the cost of funds very competitive for micro-entrepreneurs. The MFIs include in this study include BRI which is type 1 institution in the above types; BPR (Bank Perkreditan Rakyat/rural bank) and BPRS (Bank Perkreditan Rakyat Syariah/Islamic rural bank) can be categorized as type 2 institutions; and BMT (*Baitul Maal wa Tamwil*) will be a type 3 Islamic Cooperative. Note that BRI, a state-owned commercial bank is fully supported by the Indonesian government and is a dominant player in the microfinance sector. It is noteworthy that BRI was recognized as a global microfinance institution giant in the Microfinance Summit 2005. There are two strategies employed by big banks in developing micro-banking. The first is to directly sell the products to the micro clients and the second to provide the services indirectly to the clients through other MFIs.

3.1. Types of Microfinance in Indonesia

Indonesia has a long history of providing finance in the rural areas with the first rural bank established in 1895. In 1910, there were over 13,000 rural banks. Bank Rakyat Indonesia (BRI), a state owned bank, was established in 1984 and BPR (Badan Perkreditan Rakyat/rural bank) was established in 1988. During the Asian financial crisis many large companies collapsed leaving a considerable amount of debt in the banking sectors. According to a 2005 report by the Asian Foundation, SMEs have been an important *engine of growth* for the Indonesian economy since 1997 (Musnidar & Tambunan, 2007). Since that time, banking sectors have put more of their investment portfolio into MSMEs and some of them became actively involved in microfinance through a linkage programme initiated by Bank Indonesia. This encouraged the big commercial banks to enlarge their lending to

[1] This type favours the creation of an internal unit specialized in microfinance sectors to reach a niche target. This unit is not the main activity of the banks.

MSMEs. Commercial banks took this opportunity by opening micro-service units in early 2003 which was also considered unfair to BPRs due to their scale of operations. However, the potential of the micro-credit market is still large[2]. It is not only banking sectors that have enthusiastically embraced the microfinance market, the Pegadaian (pawnshops with special privileges regulated by law) have also aggressively taken part as a state-owned company to provide these services. Pegadaian's (pawnshops) customers are obliged to pay a predetermined fee for safe-keeping the collateralized goods physically in the premises of Pegadaian by the employees.

According to Ismawan and Budiantoro (2005), Indonesian approaches to microfinance can be categorized into four kinds: savings-led microfinance, credit-led microfinance, micro-banking and linkage model. In savings-led microfinance, membership and active participation are pivotal. These organizations include self-help groups (SHGs), Credit Union (CU), and *Koperasi Simpan Pinjam*/*KSP* (savings and credit cooperative). Financial mobilization is based on membership and the capacity of the poor to contribute to savings. In credit-led microfinance, the key financial resource is not from savings mobilization of the members or poor but from other sources. BRI (People's Bank of Indonesia) and BPR (rural banks) are examples of micro-banking designed to provide micro-finance services.

The central bank, Bank Indonesia mandated to regulate and promote the development of banking in the country by Act 10 of 1998 and Act 23 of 1999. The linkage model, initiated by Bank Indonesia, is the starting point for collaborative ventures between commercial banks and BPRs since 2000. Both institutions have different natures that can be linked for mutual benefit: commercial banks have large amounts of capital and BPRs have experience dealing with micro-entrepreneurs. BPRs that lack funds but have more access to the poor can get access to financial support while commercial banks, which have more funds, can increase their number of clients (outreach). Supported by Bank Indonesia, this collaboration is widely well-known as *Pola Hubungan Bank dan Kelompok Swadaya Masyarakat/ PHBK* (Bank-Self-Help Groups Linkage) in 1988.

Akin to other commercial banking, Bank Indonesia as a regulator also applies a prudent microfinance institution for MFIs under its supervisory (BRI, BPR and BPRS only), the other hand, BMT is supervised under Ministry of Cooperative. One of the regulatory requirements for MFIs is to maintain non-performing loan

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[2] Adapted from a local newspaper, Suara Merdeka, in a polemic debate according the commercial penetration into the BPR market in the middle of 2004

(NPL) to at most 5% overall. This policy is very useful in protecting MFIs from potential bankruptcy and ensuring their future sustainability.

The Directorate of Sharīʿah Banking, Bank Indonesia implements a comprehensive linkage model for Islamic microfinance. This linkage model foresees three types of intervention: "for-profit financial assistance, not-for-profit financial assistance and technical assistance for developing micro-enterprises. Islamic commercial banks get for-profit financial assistance for either their own division or jointly with the rural banks (BPRS) and/or BMTs" (Obaidullah, 2008: 79-80). Non-profit-financial assistance is provided by Islamic commercial banks in the form of *zakāh, infāq, ṣadaqah* and *waqf*. These funds are utilized to fulfil the basic consumption needs of the poor and to provide both training for unskilled micro-entrepreneurs and start-up capital for micro-entrepreneurs. Bank Indonesia provides technical assistance funds to various business development services providers and consultants in collaboration with universities. During 2006-2007, Bank Indonesia collaborated with Lembaga Manajemen Fakultas Ekonomi/LMFE (Management Studies Centres), University of Padjadjaran Bandung to conduct a pilot project involving Sharīʿah linkage for Islamic microfinance institutions in West Java and Yogyakarta Provinces. LMFE conducted this research and also provided support (spiritual, technical and managerial) for micro-entrepreneurs who obtained financing from Islamic rural banks (Masyita, *et al.*, 2011).

3.1.1. Conventional microfinance institutions

As indicated, two institutions providing conventional micro-financing, BRI and BPR are included in this study. A brief description of these organizations is given below.

3.1.2. Bank Rakyat Indonesia (BRI) microbanking

BRI, one the best known MFI in the world, is a state-owned bank and has had the best credit rating since 2008. As one of the largest MFIs in the world (Microcredit Year, 2005) in terms of the loan provisions and serving lower-income people, Bank BRI provides various services such as loans, savings products, insurance, and money transfer services/remittances. BRI can be categorized as a commercial bank which operates in the market doing massive volume of business by serving hundred million Indonesians who live in the rural areas. Loans are limited to USD 500 (IDR 5 Million) per client and given for a maximum tenor of 2 years. BRI provides individual-liability loans that are also non collateralized for the lower-income clients. Instead, BRI utilizes pre-existing relationship within communities by using the testimony of a respected community figure as social collateral on the borrower's loan are some reasons of BRI's success ingredients (Robinson 1992; 1994). This has enabled BRI to achieve the high repayment performance than schemes with social networks among borrowers.

Bank Rakyat Indonesia (BRI) has been successful due to various factors. Use of testimony and guarantee of community figures appears to have proven successful in Indonesia compared to group-lending schemes. According to Don Johnston cited in (Morduch, 2009: 18), "The main clients of BRI are petty traders or owners of small enterprises like restaurants and tailor shop, typically making high margin, quick turnaround investment who have capabilities to pay real interest rate". Furthermore, "BRI's scheme had developed product that have enabled it to work profitably with low-income households and it is more convenient for bank clients" (Arun, Hulme, Matin, & Rutherford, 2009: 11). As a profit making enterprise, BRI's efficiency is also achieved through transfer prices in subsidized programs, whereby "the internal prices used by institutions to value capital and determine relative performance at branch levels"(Morduch, 2009: 27). Bank BRI Units savings products are based on principles of trust, security, convenience, liquidity, privacy, linkages with loans and returns (*Microfinance Industry Reports - Indonesia*, 2009: 11). Robinson (2009) asserts that sustainability in the long-term requires a financial approach and BRI have showed that it can reach the active poor clients.

3.1.3. BPR (Badan Perkreditan Rakyat)/ Rural credit banks

During the nineteenth century Dutch colonial rule in Indonesia, rural credit banks were established as Lumbung Desa, Bank Desa, Bank Tani, and Bank Dagang Desa. The main objective of these banks was to help workers not to fall into the debt trap of high interest rates from moneylenders. During the post-independence period, some types of small financial institutions were established in the rural areas such as Bank Pasar (Market banks), Bank Karya Produksi Desa (BKPD). In the early 1970s, Lembaga Dana Kredit Pedesaan (rural credit fund institutions) were established by the local governments. Subsidized credit has been provided to SMEs since the 1970s. The credit programmes are called small investment credit (*Kredit Investasi Kecil,* KIK) and permanent working capital credit (*Kredit Modal Kerja Permanen, KMKP)*. In 1988, the President of the Republic of Indonesia decreed Paket Kebijakan (Policy package) October 1988 (PAKTO 1988) through President's decision no.38 which further gave momentum to establishing rural credit banks.

The Directorate of Economics and Monetary Statistics of Bank Indonesia Jakarta divides rural banks into three sub-groups namely: (a) BPR non-rural, i.e. new BPRs, petty traders/village banks, BKPD, and employee banks, (b) BPR rural, i.e. village banks, *paddy banks*, and (c) LDKP. The key success of rural financial intermediation systems in Indonesia comes from the design of their organization. If the commercial banks can be owned state companies and the private sector, most of the BPR's owners are private individuals. The first BPR (Badan Perkreditan Rakyat) established in 1988 with minimum capital requirements were IDR 50 million or equivalent to USD 29,000. Since then, there have been three major types of BPR: newly established institutions, converted BPR and conversions from other MFIs.

BPR is a financial intermediary for lower-income people and the poor that being regulated and supervised by the central bank. The target markets of BPR are mostly rural and suburban people who are not served by large commercial banks. BPR is characterized by easy access and simple administrative procedures for the villagers. Mostly, BPRs are located close to markets and focus on people's unique needs of particular areas. As a supervisor of BPR, Bank Indonesia has facilitated linkages between commercial banks and BPR.

From 2001 to July 2006, 249 BPRs were closed and the remaining 306 BPRs were merged into 26 BPRs (post-merger); 95% of merged BPRs were owned by the local government. Nevertheless, during the crisis, the proportion of bankrupt BPRs was lower than the proportion of bankrupt commercial banks. A challenge for BPR is the government policy encouraging larger private and owned-state companies to use a part of their profit to finance SMEs. Therefore, through their Corporate Social Responsibility/CSR's program, private and state-owned corporations prefer lending directly to MSMEs, instead of using existing BPRs. To gain political advantage and be "good neighbors", large corporations provide credit to SMEs at low interest rates (6% interest rate flat). For example, the biggest companies in Indonesia, Telkom, Pertamina, Krakatau Steel, Indonesia Harbor and other stated-owned companies disbursed revolving soft loans at 6% p.a. to SMEs. At the same period, BPRs provide credit with an interest rate of 30% per annum. As the result, it is quite difficult for BPR to compete with the big state-owned corporations in term of interest rate of credit in the particular areas in Indonesia.

3.1.4. Islamic microfinance institutions

Given Bank Indonesia's mandated to regulate and promote the development of banking, it is actively involved in promoting Islamic banking and Islamic microfinance institutions. There are three types of Islamic banking institutions in Indonesia; fully-fledged Islamic commercial banks, Islamic banking units of commercial banks and Islamic rural banks (BPRS). On the liability side of rural banks, clients deposit in *muḍārabah* accounts on profit-loss sharing basis. On the asset side, the bank invests in various assets using different sale, lease and equity modes of financing. Islamic MFI finances only real transactions with the underlying assets and any debt created is backed by collateral. To minimize risks, usually the well-performing existing clients are financed. Evidence, however, shows that the development of Islamic microfinance has not been smooth and the reality is different from the expectation.

The Islamic MFIs considered in this paper are briefly discussed next.

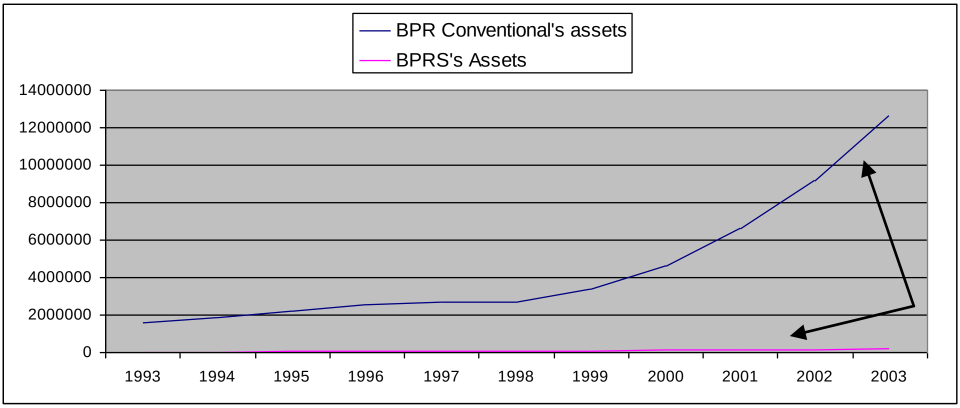
3.1.5. Bank Pembiayaan Rakyat Syariah (BPRS)/Islamic rural bank

Bank Pembiayaan Rakyat Syariah (BPRS) is regulated by National Act No.7/1992, amended by National Act No.10/1998 (*Peraturan Bank Indonesia tentang Badan Perkreditan Rakyat*, 2004: 3). BPRS are supervised by the central bank, Bank of Indonesia. "BPRS were first licensed in 1991, after a technical team based on decision of *ʿUlamāʾ* on the prohibition of *ribā* was formed and steps were taken to established Islamic commercial and rural banks" (Seibel & Agung, 2005: 15). Thus, Islamic rural banks (BPRS) came into existence in 1991, two years after conventional rural banks (BPR) first started in 1989.

According to Seibel and Agung (2005), there is no significant effect on to the preferences of Indonesian Muslims towards Islamic banking after the issuance of *fatwa* from the Indonesian *ʿUlamāʾ* Council (MUI) on the prohibition of *ribā* according. The historical data shows that the growth of Islamic rural banks has been far behind the conventional ones in a country with 88% Muslim population.

Specifically, Seibel and Agung (2005) show that conventional rural banks have grown more than 20 times faster than Islamic rural banks on a yearly basis. After a promising start in the early 1990s, the development of Islamic micro-banks has almost come to a standstill. An initial period of growth until 1996 when their number reached a total of 71, their growth almost stagnated during and after the financial crisis, reaching 78 by 1998 and a mere 84 by 2003 (out of a total of 2,134 rural banks).

Figure-3
Differences between BPR (conventional) and BPRS (Islamic) Assets



3.1.6. Baitul Maal wa Tamwil (BMT)

Fast growing microfinance institutions are those that gain support politically and are socio-religiously accepted. One of these institutions *Baitul Maal wa Tamwil* (BMT) serves the grassroots segment, majority of who are Muslims, by implementing Sharīʿah compliant financing. Beyond the reach of Bank Indonesia, BMTs are cooperatives and have grown rapidly in the aftermath of the banking crisis, reaching more than 3,000 units in 2010. The development of Islamic banking has been complemented by that of Islamic financial cooperatives, or BMT. The first Islamic cooperative, Ridho Gusti, was established in 1990 in Bandung. The first Islamic cooperative was established in 1990. Rapid expansion started after 1996, as a result of promotion by Center for Micro Enterprise Incubation (PINBUK), a non-government organization, and continued throughout the financial crisis, but stagnated after 1999 at around 3,000 and then declined to less than 2,900 as of 2003 (out of a total of some 40,000 microfinance cooperatives) (Seibel, 2008: 90)Seibel & Agung, 2005: 19).

Seibel & Agung (2005) found that "BMT (*Baitul Maal wa Tamwil),* comprising about 95% of Islamic cooperatives, affiliated to Nadhatul *ʿUlamā'* (NU), which is, with almost 40 million members, the largest Islamic mass organization in Indonesia". They further said that NU does not play an active role in guiding and supervising BMTs, which are under the guidance of PINBUK. It should be noted that statistics on BMT usually include the BTM (unless otherwise stated). "BTM *Baitul Tamwil Muhamadiyah*, comprising about 5% of Islamic cooperatives, guided since 1999 by Muhamadiyah, which is the second-largest

Islamic mass organization in Indonesia with some 25 million members. BTM are informally supervised by PPEM" (Seibel & Agung, 2005: 13). The Ministry of Cooperatives does not register cooperatives as Islamic or conventional and provides no information or special assistance to Islamic cooperatives. In sum, the outreach of Islamic cooperatives was negligible, and then, their overall performances were poor. Issues related to BMT include lack of regulation, supervision and reliable reporting, large majority of Islamic cooperatives are dormant or technically bankrupt, the savings of the depositors are at great risk (Seibel, 2008).

4. Research Methodology

To study the relative understandings, perceptions and preferences of conventional and Islamic MFI's clients, a survey on 28 BPRs, 17 BPRS, 64 BRI Units and 8 BMTs in Bandung was conducted in 2010. However, Bandung is one of hundreds of cities in Indonesia and cannot represent the characteristics of the country in general. However, almost all ethnic groups in Indonesia can be found in Bandung. People who live in Bandung are multi-cultural with varying educational backgrounds. Bandung has the highest density of population in Indonesia. More than one thousand micro, small and medium enterprises underpin Bandung as a tourist destination and an education city in Indonesia.

The aim of this study is to investigate the gap in the growth between conventional and Islamic MFIs based on understanding, perceptions and preferences the clients of these institutions. The objectives of this study are (1) to identify the profile of MFI's clients, (2) to explore MFI's clients' understanding, (3) to explore MFI's clients' perceptions, (4) to explore the preferences of MFI's client, and (5) to identify the reasons behind choosing a MFI. As the MFIs clients are dispersed in a large area in Bandung, multi-stage cluster sampling was used. One of the researchers along with four surveyors divided the area into six zones, and interviewed 110 randomly selected MFIs clients at each area. In this research, probability sampling designs are preferred because such designs give each MFI's client chance of being selected. The list of the MFI's clients was given by MFI officers to the researcher. Based on those data, the interviewers selected them randomly. In the field, this technique is hard to apply due to many reasons such as respondent's reluctance to be interviewed, the difficulty to arrange a meeting time, and use of more money and time. In the beginning, the respondents are chosen randomly based on the list and after one month the surveyors visited the respondents in the traditional markets which is spread across the city. Most traders in traditional markets are MFI's clients. Another place where it is quite easy to find

MFI's clients is government institutions. From 650 questionnaires distributed, 603 MFIs clients responded from which only 581 questionnaires were deemed appropriate and complete to be processed statistically.

5. Results

5.1. Profile of Microfinance Clients

As shown in table 2, the proportion of male (56%) is greater than female (44%) for the whole sample. However, results from BRI shows otherwise with female numbers being much more than men.

Table 2
Gender of MFIs

		Gender of MFI's Client		
	MFI	Female	Male	Total
MFI's Clients	BMT	43	64	107
	BPR	43	100	143
	BPRS	53	70	123
	BRI	115	93	208
Total		254 (44%)	327 (56%)	581

The majority of MFI clients' ages range was between 30 and 41 years old (56.5%), followed by clients aged between 42 and 52 years old (28.5%), younger clients with ages up to 30 years old (13%) and only 2% of the sample were aged over 53 years old (see Table 3).

Table-3
Age of MFI's Clients

		Age of MFI's Client				
	MFI	< 30	30 – 41	42 – 52	53+	Total
MFI's Clients	BMT	15	64	26	2	107
	BPR	29	85	27	2	143
	BPRS	18	68	34	3	123
	BRI	14	110	78	6	208
Total		76 (13%)	327 (56.5%)	165 (28.5%)	13 (2%)	581

Data shows that MFIs tend to give loans/financing to younger clients. It is reasonable to finance clients in the productive age group more than other age group. However, the clients of the microfinance sector are expected to be riskier compared to the banking sector as they are involved in micro business and lack collateral. However, it is different with BRI which has a higher percentage of clients in the group 42-52 years old.

Table-4
Jobs of MFI's Clients

		Job of MFI's Client			
		Government Employee	Others	Private	Total
MFI's Clients	BMT	7	46	54	107
	BPR	11	66	66	143
	BPRS	5	56	62	123
	BRI	85	84	39	208
Total		108 (19%)	252 (43%)	221 (38%)	581

Table 4 shows that the majority of clients in the sample (43%) work in the informal sector as petty traders, micro entrepreneurs and peasants jobs followed by private companies (38%) and the government sector (19%). It is clear that BMT, BPR and BPRS do not choose government employees as their target market and they deal mainly with private and informal sectors. These MFIs are active in the high-risk market but with potential higher returns. Interviews with the clients reveal that to get loan/financing from these MFIs, the clients have to deposit a key document such as education certificate, estate ownership document, car/motor ownership certificate, employment status document or other valuable documents as collateral. Without putting one of these collaterals, it is impossible to get a loan.

BRI can give a client a lower interest rate as long as the government or company offices have prior mutual understanding or an agreement with the BRI. BRI requires a guarantee from a government or company treasurer that every month their salary would contribute towards the loan payment directly. This can be done by BRI as it is a state bank, which puts it at an advantage to overcome the fierce competition among MFIs in Indonesia. Thus, BRI's largest target market the government employees have particular characteristics: a fixed income, the lowest risk and lower monitoring costs.

Table-5
Duration of MFI’s Loan

		Duration of MFI's Loan (year)					
	MFI	< 1	1-2	2-3	3-4	4-5	> 5
MFI's Clients	BMT	59	17	14	7	9	1
	BPR	115	17	4	0	4	3
	BPRS	51	42	25	1	1	3
	BRI	65	30	34	10	50	19
Total		290 (50%)	106 (18.25%)	77 (13.25%)	17 (3%)	64 (11%)	26 (4.5%)

Table 5 shows that the majority of loans had durations of less than one year (50%), followed by duration of 1-2 years (18.25%), 2-3 years (13.25%), 3-4 years (3%), 4-5 years (11%) and more than 5 years (4.5%) respectively. The short-term loan is the dominant type of financing for BMT and BPR. Short-term loans/financing implies that the clients use the loan for emergency or consumption needs. It is unlikely that they would be able to build a robust business in a year or less that can yield high profits. BPRS and BRI spread their loan/financing in terms of duration. Note that the duration of loans can also affect the cost of financing.

Table-6
Size of MFI’s Loan (million IDR)

		Size of MFI’s Loan (million IDR)									
	MFI	<1	1-3	3-5	5-10	10-20	20-30	30-40	40-50	50-100	>100
MFI’s clients	BMT	10	40	12	18	6	9	6	5	1	0
	BPR	1	69	44	14	6	2	1	3	3	3
	BPRS	0	29	27	22	15	9	4	5	12	0
	BRI	17	35	14	12	19	41	17	29	24	3
Total		28 (5%)	173 (29.5%)	97 (16.5%)	66 (11%)	46 (8%)	61 (10%)	28 (5%)	42 (7%)	40 (7%)	6 (1%)

There are various sizes of loan of MFI’s clients. The majority of loans (29.5%) were between IDR 1 million (USD 100) – IDR 3 million (USD 300) and the least (only 1%) were in more than IDR 100 million (US D10,000) category. BMT focuses its financing between IDR 1 and 3 million (USD100 - USD300), BPR in the IDR 1 and 5 million (USD100 - USD500) range, and BPRS’s financing ranges between IDR 1 and 10 million (USD100 - USD1,000). The loans provided by BRI covers a long range of less than IDR 1 million to more than IDR 100 million (<USD100 to > USD10,000). A staff of BRI indicated in an interview that it is not constrained by funds and lends to clients as long as they fulfill all the prerequisites and pass the screening application process. The BRI units can request additional funds from the headquarters if there are potential customers. This is another advantage of BRI compared to other MFIs.

Table-7
Frequency of Loan

	BPR	BPRS	BMT	BRI	Total
Once	120	75	52	90	337 (58.11%)
Twice	9	17	22	46	94 (16.21%)
Three times	6	12	16	28	62 (10.68%)
Four times	4	13	13	29	59 (10.17%)
More than four times	3	6	4	15	28 (4.83%)
Total	142	123	107	208	580 (100%)

Table 7 shows that only 4.83% of MFI clients in the sample received loans more than four times and 10% of clients received loan four times. The majority of the client (58%) received financing once, 16.21% received loans twice and 10.68% received loan three times. Most of the first-time clients got their loans from BPR, followed by BRI, BPRS and BMT. It is interesting to note that only a small number of clients get their second round of financing from MFIs in general and BPR and BPRS in particular. It seems that after evaluating the first loan cycle, only a small number of clients who qualified to get the second loan. This is confirmed by the loan officers who said that it was very difficult to get good clients who had sustainable small or micro businesses. The loan officers claimed that although most of the MFI's clients indicate that the purpose of financing is to use it for working capital or buying fixed assets to support their business (see also Figure 4), many use the money for consumption or emergency needs. In the above is true then BPR appears to have the highest risk clients followed by BPRS as the drop from the first and second loans are the highest for them. BRI shows a relatively stable pattern retaining the most clients in subsequent periods.

When MFI's clients are asked about the purpose of their loan/financing, see Figure 4 shows that 50% of them responded it to be for working capital and fixed assets, 23 % of client stated for working capital only and 14% of client stated to buy fixed assets. A minority (13%) of the clients indicate that they used the loan for consumption purposes. Again, when the researcher interviewed the clients about the real use of the loan/financing, most of them said that they needed it for emergency (such as to cover hospital costs for family member, pay admission fees for school, pay off other debt, etc.) and consumption (such as down payment for a motorcycle, a new TV, hand phone, etc.). They wrote 'working capital or fixed assets' on the application form so that they could get the financing as soon as possible.

Figure-4
Purpose of MFI's Loan

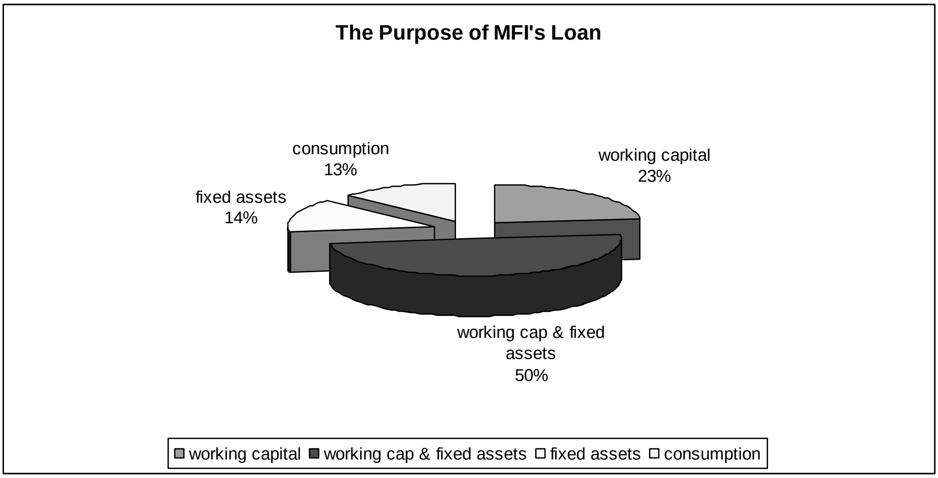


Table-8
Average Interest Rate/Cost of Fund

	MFI	Monthly Average Rate
MFI's interest rate	BMT	1.68%
	BPR	2.73%
	BPRS	2.02%
	BRI	1.46%

Table 8 above demonstrates the average monthly interest rate/mark-up/rate of return charged by MFIs. Note that rates not only vary from one MFI to another in Bandung and also among clients in a single MFI as well. This figure was obtained based from the answers of MFI clients from the survey. As the client job profiles show in Table 4, BPR, BPRS and BMT compete with each other to attract new potential clients from a similar background. The level of competitiveness among MFIs in Bandung particularly BPRs, BPRS, BMTs and other cooperatives to attract clients is high but they still cannot compete with BRI's low interest rates. As indicated, BRI is a state bank fully supported by the Indonesian government with many cross subsidy programs has a relatively less risky client base and, as such, can charge a lower interest rate. Note that while Islamic MFIs, BPRS and BMT's have similar clients to the conventional MFI BPR, the rates they charge is quite moderate compared to the latter.

5.2. Clients' Understanding Towards Islamic Microfinance Products

The survey included questions about the clients' understanding of Islamic microfinance products. In general, the majority of MFI clients did not understand financing modes and the concept of Islamic banking or microfinance products as can be seen in Table 9 below.

Table-9
Understanding of Islamic Banking Products

		Understanding about *Murābaḥah* concept		
		No	Yes	Total
MFI's Clients	BMT	53	54	107
	BPR	139	4	143
	BPRS	54	69	123
	BRI	179	29	208
Total		425 (73.15%)	156 (26.85%)	581
		Understanding about *Muḍārabah* concept		
		No	Yes	Total
MFI's Clients	BMT	55	52	107
	BPR	140	3	143
	BPRS	87	36	123
	BRI	187	21	208
Total		469 (80.72%)	112 (19.28%)	581
		Understanding about *Mushārakah* concept		
		No	Yes	Total
MFI's name	BMT	61	46	107
	BPR	143	0	143
	BPRS	98	25	123
	BRI	197	11	208
Total		499 (85.88%)	82 (14.12%)	581
		Understanding about *Ijārah* concept		
		No	Yes	Total
MFI's Clients	BMT	75	32	107
	BPR	143	0	143
	BPRS	88	35	123
	BRI	194	14	208
Total		500 (86%)	81 (14%)	581

The results on understanding to different Islamic finance products in Table 9 show a low level knowledge on most of the Islamic financial instruments. Of the modes, *murābaḥah* is the most familiar to MFI clients. Nonetheless, it was only understood by 26.85% of the respondents. As expected, the clients of Islamic MFIs appear to understand the concept better than the conventional ones. Specifically, both Islamic MFIs (BPRS and BMT) have an almost equal number of clients who understood and who did not. However, the clients of two conventional MFIs (BPR and BRI) show that an overwhelming majority did not understand *murābaḥah* Knowledge about other modes of financing is even worse. A total of 80.72 % of respondents did not understand the *muḍārabah* concept. Only clients of BMT show an almost equal balance between respondents who understood and who did not. Akin to two Islamic banking products above, *mushārakah* showed the same pattern with the previous products. BMT demonstrated slightly different numbers between clients who understood and who did not. Similar results are found for *ijārah* products with only a small number (14%) of clients who understood the concept.

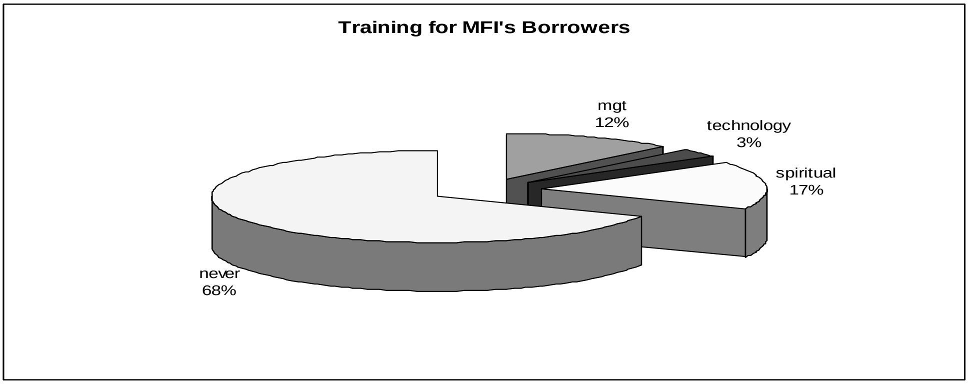
Lack of understanding about Islamic microfinance products can be partly understood by considering the training sessions that the clients had received. This is shown in Table 10.

Table-10
Training per MFI's Type

		Training	No Training	
MFI's Clients	BMT	60	47	107
	BPR	13	130	143
	BPRS	42	81	123
	BRI	66	142	208
Total		181 (31.15%)	400 (68.85%)	581

The survey shows that the majority of the clients in the sample did not receive training during the loan periods (68.85%). Table 10 shows that only 31.15% of MFI clients received training sessions and only a small number of them from BRI, BPR and BPRS received these sessions. However, the majority of BMT's clients received training (56%). For those who received training, only 17% clients received spiritual training, 12% and 3% received management and technological training respectively (see Figure 5 below).

Figure-5
Training for MFI's Clients



There was no specific training on the introduction of microfinance products provided by Islamic MFIs. This probably explains the overall lack of understanding on Islamic products among the clients of MFIs.

5.3. Clients' Perception to their Relative Interest Paid

Table 8 above showed the monthly average interest rate/mark-up/return rate that clients of different MFIs pay. The table indicates that BRI on average had the lowest interest rate, respectively followed by BPRS, BMT and BPR. Interestingly, when clients were asked about their perceptions about the interest rate/rate of return they pay compared to other MFIs, 48.4% clients felt that the rate of his/her MFI was equal to other MFIs, and only 5.3% said that his/her rate was higher than others (see Table 11 below).

Table-11
Perception of Relative Interest Rate Paid per Different MFI

		Perception of Relative interest rate compared to other MFI's			
		lower	equal	higher	Total
MFI's Clients	BMT	72	29	6	107
	BPR	28	101	14	143
	BPRS	45	73	5	123
	BRI	124	78	6	208
Total		269 (46.3%)	281 (48.4%)	31 (5.3%)	581

Table 11 shows that even though BPR had the highest interest/profit rate (as shown in Table 8), majority of its clients perceived the interest rate to be equal to other MFIs. Akin to BPR, BPRS clients demonstrated the same perception but actually the fact was quite higher than BRI. Surprisingly, most BMT clients perceived that BMT's rate was lower than other MFIs (67.3%). Whereas in the reality, BMT's rate were quite high compared to BRI and BPRS. The majority of BRI's clients said that BRI's rate was reasonable and relatively lower than other which was in line with the results in Table 8.

5.4. Clients Preferences for Conventional or Islamic MFI

Table 12 shows that 54.4% of respondents preferred an Islamic MFI to a conventional MFI (45.6%). When asked about the reasons behind this, most clients answered that using Islamic products as Muslims was harmonious with their belief and gave them peace and confidence. It is interesting to see a significant number of people using conventional MFIs also indicate their preference for Islamic finance. Despite this, they use conventional MFIs due to practicality and economic factors. Reasons of choosing different MFIs are discussed in the next section (Table 13).

Table-12
Preferences of MFI's Clients

		Prefer Islamic MFI		
		No	Yes	Total
MFI's Clients	BMT	1 (1%)	106 (99%)	107
	BPR	116 (81.1%)	27 (18.9%)	143
	BPRS	35 (28.5%)	88 (71.5%)	123
	BRI	113 (54.3%)	95 (45.6%)	208
Total		265 (45.6%)	316 (54.4%)	581

It was reasonable if 99% of BMT's (Islamic MFI) clients preferred to choose Islamic MFI and also made sense if 81.1% of BPR (conventional MFI) clients preferred conventional MFI. However, the fact that there were 28.5% of BPRS and 1% of BMT (both Islamic MFIs) clients who preferred conventional MFI seems puzzling. This is also the case for 45.6% of BRI and 18.9% of BPR clients who preferred Islamic MFIs rather than conventional MFIs, but using these MFIs although they were aware that these were conventional MFIs. Moreover, the proportion of BRI clients who preferred Islamic MFI and those who preferred conventional was almost equal. These findings of preferring one thing and choosing another appear to indicate inconsistent behavior. The next sub-section attempts to answer some of the reasons for this.

5.5. The Reason of Clients in Choosing a MFI

In order to understand the reasons behind their decision to choose a MFI, the clients were asked to rank the MFIs based on economic and non-economic factors. Based on the literature on microfinance and the preliminary research in the fieldwork, there are five non-economic factors mainly related to services. These include location (nearness), easiness, speed/promptness, profile of loan officers (LO) and payment method. The three economic factors are identified as low collateral, size of loan, and low interest/cost of fund. They were also asked to rank these factors according to their priorities.

Table-13
Reasons in choosing a MFI

Ranking of Clients' Reasons to Choose a MFI								
Services					Economy/Finance			Ranking /Priority
Nearness	Easiness	Speed	Loan Officer	Payment Method	Loan Size	Low Collateral	Low Interest	
66	(1) 316	63	7	10	15	15	108	1
117	132	(2) 173	9	8	16	26	109	2
96	72	151	20	12	21	32	(3) 178	3
(4) 140	29	138	22	46	39	83	83	4
33	6	27	31	54	99	(5) 268	57	5
26	9	14	71	111	(6) 241	82	19	6
27	10	10	109	(7) 280	73	48	17	7
76	7	5	(8) 312	60	77	27	10	8
Total 581	581	581	581	581	581	581	581	

Table 13 above shows that easiness in processes was the first priority for 316 out of 581 clients when selecting a MFI, followed by speed/promptness (fast) of the application process, low interest rate, nearness, low collateral, size of loan, payment methods and profile of loan officer which came second, third and up to eight respectively. The low interest rate/mark-up margin rate became the third priority for clients after easiness and speed/fast in the application process. Some non-economic factors, mostly related to services, such as ease, speed in the process and nearness to the market were prioritized high by clients compared to economic factors such as low interest, low collateral and size of loan. In many interviews, the surveyor got the impression that rational choice in terms of management issues and economic factors were the main reasons for selecting an MFI and religious reasons came subsequently.

The findings present some interesting implications in understanding the behavior of Indonesian Muslim clients towards economic transactions and spiritual aspects. Where when respondents were asked about their preferences towards their choice for Islamic products or conventional, the majority preferred Islamic MFIs. However, in reality their economic choices appear to be based on the economic and non-economic factors which become dominant in clients' decision to choose a MFI.

5.5.1. MFI's Clients Rankings

Respondents were also asked to rank MFIs based on the services and economy/finance categories. MFIs in Bandung face fierce competition because clients have opportunities to choose a MFI that suits his/her needs. Therefore, the majority of them are well acquainted with the reputations of other MFIs and their operations. The clients are able to compare between the different MFIs before deciding on choosing a particular MFI.

Table-14
Ranking of MFIs based on MFI's Clients Perspectives

	BPR	BPRS	BMT	BRI
Sharīʿah compliant	4	2	1	3
Easy	2	3	4	1
Application process	3	2	4	1
Low Interest	4	2	3	1
Speed/Fast	2	1	4	3
Low Collateral	4	3	2	1
Payment Methods	3	2	4	1
Loan's Officers	3	2	4	1
Preference	3	2	4	1
Overall	3	2	4	1

Table 14 shows the rating for each MFI from 581 respondents' perspectives. The results reveal that the clients rank BMT highest for Sharīʿah compliance and BPRS for speed/fastness in process application. For all other categories BRI gets the highest rank. Specifically, BRI was well known to have good services related to easiness, good process of application, low interest rates, low collateral, appropriate payment methods, excellent relationship with loan officer categories. Given these features, BRI was also ranked highest in the overall category and can be considered as the most preferable MFI.

6. Conclusions

Based on information gathered from a survey of four MFIs in Indonesia, it can be concluded that BRI, a conventional MFI, is preferred by the clients most. The empirical data clearly show that disparity in the growth of BRI, BPR, BPRS and BMT can be explained partly by many economic and non-economic factors. Although most of clients were Muslims and indicate preference for Islamic MFIs, in reality their choices of MFI were based on economic (low interest rates, low collateral and size of loan) and non-economic factors (such as quality of services variables; easiness, speed/fast, nearness, payment method and loan officers' profile).

There appears to inconsistency in the behavior whereas conventional MFI's clients preferred an Islamic MFI and Islamic MFI's clients preferred a conventional MFI. Dealing with these issues is not an easy task. Their unconscious (or conscious) loyalty is towards the moral/ethical teachings of Islam and the economic reality seem to conflict with each other. Prohibition of *ribā* has not made any significant impact on some of the clients' behavior yet. The findings in this paper imply that in order to attract clients to use Islamic microfinance the Islamic MFIs have to provide the same level and quality of products and services as the conventional ones.

BRI as a state-owned bank has a robust structure, special privilege from government, long experience, cheaper source of funds and scale of economies makes it a strong institution and the primary source of loan for clients. Moreover, the MFIs include in this study inevitably must also compete with large commercial banks which have widely opened micro-banking units to reach micro-entrepreneurs and also other forms of non-bank financial institutions such as pegadaian/rahn/pawnshop, SHG (self-help group), Credit Union (CU), and *Koperasi Simpan Pinjam*/*KSP* (savings and credit cooperative) which have operated in surrounding residential areas. As long as the existing banking regulations do not change to level the playing field, it will be difficult for BPR, BPRS, and BMT to compete and grow significantly in the future.

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State of Liquidity Management in Islamic Financial Institutions

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Abstract

Liquidity position and liquidity risk of Islamic financial institutions has been changing over time. Using three measures of liquidity this paper analyses the state of liquidity and the risk management practices of Islamic banks across countries and regions and compares them with conventional banks. It calls for creating new instruments and infrastructure for liquidity risk management and proposes fresh approaches to manage this risk.

1. Introduction

While liquidity surplus is considered a drag on competitiveness, shortage of liquidity is said to be assassin of banks. Episodes of failure of many conventional banks from the past and the present as well as the cases of financial distress faced by Islamic financial institutions provide the testimony to this claim. Therefore, banks and more so their regulators are keen to keep a vigil on liquidity position of banks and manage this risk. Due to profit sharing nature of Islamic banks, in theory at least, they are likely to be more stable. However, we observe that liquidity risks have played a role in bringing financial distress to Islamic banks as well, and some of them were forced to close.[1] Many different types of risks such as credit risk, operational risk etc., culminate in the form of liquidity problem for individual banks and the banking sector as a whole, therefore it, sometimes, becomes difficult to analyze this risk in isolation. The recent financial crisis has forcefully

1 An example is the closure of Ihlas Finans in Turkey in 2001 in the wake of liquidity crisis that had affected the entire banking sector of the country. Conventional banks faced greater problems than Islamic banks during that crisis.
During the Global Financial Crisis of 2007-2009 many conventional banks experienced distress, insolvency and some major ones closed down. Islamic banks in general survived, however, those relying predominantly on wholesale funding such as Islamic investment banks also faced problems.

highlighted the importance of liquidity risk and its management at micro and systemic levels.

The purpose of this paper is to present and explain the dynamic evolution of liquidity and liquidity risk in Islamic banking institutions and show its current status. This is done through analyzing liquidity ratios, deployment ratios and maturity mismatch over a long time horizon that includes period before and after the global financial crisis. The paper further discusses the sources of liquidity risk for Islamic financial institutions in comparison with conventional banks and summarizes liquidity management practices currently used in Islamic financial services industry. It shows how the structure of Islamic banking industry is changing over the time which necessitates greater efforts to liquidity management by the banks themselves and by the regulatory bodies. Some proposals floated at the international level and some rules proposed in Basel III for liquidity risk management are also summarized and evaluated in the appendix.

1.1. Definitions of Liquidity and Liquidity Risk

Liquidity of an asset is its ease of convertibility into cash or a cash equivalent asset. Liquidity risk arises from the difficulty of selling an asset quickly without incurring large losses. For a banking and financial firm "liquidity risk includes both the risk of being unable to fund [its] portfolio of assets at appropriate maturities and rates and the risk of being unable to liquidate a position in a timely manner at reasonable prices."[2] Sometimes it is defined in terms of maturity mismatch between assets and liabilities while at others it is defined in terms of asynchronous timing of cash inflows and cash outflows from the business.[3] The bank regulatory literature defines it as "risk to a bank's earnings and capital arising from its inability to timely meet obligations when they come due without incurring unacceptable losses."[4]

The liquidity risk can also be defined in terms of likelihood of illiquid positions. As defined by Nikolaou (2009): "Risk relates to the probability of having a realization of a random variable different to the realization preferred by the economic agent. In our context the economic agent would have a preference over liquidity. In that sense, the probability of not being liquid would suggest that there is liquidity risk. The higher the probability, the higher the liquidity risk. When the

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2 J.P. Morgan Chase (2000). The text [its] in square brackets is inserted by the author in place of name of the company JP Morgan Chase.
3 See Merill Lynch (2000).
4 Office of the Comptroller (2000).

probability equals unity (i.e. the possibility becomes a certainty) liquidity risk reaches a maximum and illiquidity materializes. In that sense, there is an inverse relationship between liquidity and liquidity risk, given that the higher the liquidity risk, the higher the probability of becoming illiquid, and therefore, the lower the liquidity."[5]

1.2. Sources of Liquidity Risk

Liquidity risk emanates from the nature of banking business, from the macro factors that are exogenous to the bank, as well as from the financing and operational policies that are internal to the banking firm. In case of Islamic banks the nature of Sharīʿah-compatible contracts are an additional source of liquidity risk, particularly if the conventional financial infrastructure is maintained.

Banks provide maturity transformation. Taking deposits that are callable on demand or that on average have shorter maturity than the average maturity of the financing contracts they sell. While maturity transformation provides liquidity insurance to the depositors, which is valued by them, it exposes banks to liquidity risk themselves. Since banks specialize in maturity transformation, they pool deposits and take care to match the level and time profile of their cash inflows and outflows in order to address the liquidity risk they face.

However, maturity mismatch at a given time is not the only source of liquidity risk. The risk of this kind can arrive from many directions and its pinch depends on various factors. In a nutshell its sources (i) on assets side depend on the degree of inability of bank to convert its assets into cash without loss at time of need, i.e. how deep and efficient are the markets of the assets they hold, and (ii) on liabilities side it emanates from unanticipated recall of deposits. Using the categorization in Jameson (2001) and adding a few more we can break them into following behavioural and exogenous sources:

1. Incorrect judgment or complacent attitude of the bank towards timing of its cash in- and out-flows.
2. Unanticipated change in the cost of capital or availability of funding.
3. Abnormal behaviour of financial markets under stress.
4. Range of assumptions used in predicting cash flows.
5. Risk activation by secondary sources such as:

5 Nikolaou (2009), p. 15-16.

i. Business strategy failure
ii. Corporate governance failure
iii. Modelling assumptions
iv. Merger and acquisition policy

6. Breakdown in payments and settlement system
7. Macroeconomic imbalances

We can add to this list the 8.“contractual form”, 9.“ Sharīʿah restriction on sale of debt”, and 10. “financial infrastructure deficiency” as additional sources of liquidity risk in the case of Islamic banks.

1.3. Sources of Liquidity Risk Special to Islamic Banks – Contractual Forms, Restriction on Sale of Debt, and Absence of Appropriate Infrastructure[6]

The various contractual forms available to Islamic banks can be partitioned into three categories: (1) Sharing contracts such as *muḍārabah* and *mushārakah*, (2) trade based contracts such as *murābaḥah, salam,* and *istiṣnāʿ* and (3) service based contracts such as *ijārah.* Each of these categories of contracts has various kinds of risk implications including the liquidity risk dimension. The liquidity risk in these contracts can arise directly from the nature of the contract and also indirectly due to realization of other kinds of risks (such as credit risk and market risk) at some stage during the course of the contract. In the following we take each of these contract types and discuss the direct and indirect liquidity risk associated with it both on the asset side and liability side.

1. Profit Sharing Contracts such as *muḍārabah* and *mushārakah* does not pose an asset-liability mismatch problem for the bank if each deposit is invested in a specific project and depositors can only withdraw on maturity of the project in which their funds are invested.[7] While this eliminates liquidity risk to the banks it also wipes out the liquidity insurance possibility for the depositors. It also exposes the depositors to concentrated business risk. It then begs the question what is the role of bank as financial intermediary, why can’t an individual directly invest in a project of his choice? Economies of scale and scope of the bank in monitoring of the investment projects are left as the only rationale for investment through banks.

6 This section borrows heavily from my earlier paper Ali (2004).
7 This assumes that accounting period for calculating returns on deposits is same as the accounting period for profit calculation on the projects where funds are invested.

However, there is another rational too. Banks can also work as providers of pooled investment opportunity to their depositors whereby depositors share in the returns of an investment pool rather than take concentrated risks in one project. This value added to the depositors in the form of investment diversification can be another rationale for the existence of Islamic banks. This arrangement not only smoothes out the variability of returns to depositors but can also address their liquidity needs to some extent if the investment projects are of various maturity periods. In order to address the preferences of depositors for stable income stream and liquidity needs the bank would have to carefully select the projects that have non positive correlation of returns and whose revenue cycles are negatively synchronized with each other. In the normal circumstances the bank does not have any liquidity risk emerging from the liability side because no fixed returns are contractually committed to the depositors.

In the extreme event that the depositors want to recall their investments the sharing assets are sellable in the market. The liquidity risk for the banks comes into picture if these assets fetch a price lower than their fair market price. But this loss is shared between the depositors and the bank in proportion to their capital contributions. Thus the liquidity risk to the bank is reduced by this proportion.

Due to various reasons, *mushārakah* and *muḍārabah* modes form only a small proportion of the asset portfolio of Islamic banks in present times. Most of their assets are in trade based modes or *ijārah*. Therefore we now turn to assess the liquidity risks embedded in such instruments.

2. *Murābaḥah*: Abstracting away from the operational details, in *murābaḥah* contract a bank buys a commodity for a client and sells it to him on a markup price to be paid later. Since *murābaḥah* receivables are debt payable on maturity they cannot be sold at a price different from the face value in secondary market. This is a source of liquidity risk for the bank, particularly, if average maturities of deposits are shorter than average maturity of *murābaḥah* contracts or if the deposits are sensitive to market returns. We will call the liquidity risk due to non-re-sellable nature of *murābaḥah* 'primary liquidity risk' associated with this instrument.

There are other risks in *murābaḥah* that can also give rise to liquidity risk. Let us call them 'secondary liquidity risk' associated with this instrument. For example, in a *murābaḥah* contract the ordering client has the right to refuse acceptance of the delivery for various reasons.[8] If the client rejects and refuses to

8 Though a sale is a binding contract irrespective of whether it is spot or deferred *murābaḥah*. However, for a valid sale (spot or *murābaḥah*) the merchandise must be in the ownership of the seller

receive the commodity the bank is stuck with it until another buyer is found. Thus cancellation risk also gives rise to liquidity risk for the bank. Similarly, if the buyer is unable to pay the due amount on time, which is essentially a credit risk, it can also give rise to liquidity risk for the bank. It is also important to note that like any other sale contract there are operational risks in the procedure of carrying out *murābaḥah* contract. Likewise there are legal and litigation risks if some laws are violated or if a dispute occurs. This can also give rise to liquidity risk if the payment of price is stopped.

Some ways can be devised to reduce the secondary liquidity risk. For example, banks require the client to keep his business account with them. They often release funds in instalments which contribute towards maintaining the bank's assets protected and liquid funds at its disposal. Our main concern here is the primary liquidity risk of *murābaḥah* finance.

3. *Salam:* It is an advance payment commodity sales contract where the delivery of the commodity is deferred.[9] When a bank signs to purchase a commodity on *salam* and pays out the price, its receivable is the commodity due at a specified future date that is stipulated in the contract. In the time of cash needs the bank is unable to exit the *salam* contract by selling it to a third party before maturity because of Sharīʿah restriction of "do not sell what is not in your possession." Thus there cannot be a secondary market for trade in *salam* contracts. This is a source of primary or direct liquidity risk associated with this finance.

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at the time of sale. In a banking *murābaḥah* the bank does not have the merchandise in its inventory (or in its ownership) to begin with. The bank only buys it from a supplier just in time, on the specification of the merchandise, and on a promise from the end buyer of his intention to buy it from the bank. Then the bank offers it for sale to the end buyer. Since a promise to buy is not a binding contract (i.e., legally unenforceable) hence, there is always a risk that the final sale will not be affected. Therefore, there is a possibility that the bank will end up owning a commodity and it is not as liquid as cash.

Some scholars are of the view that the promise to buy made by the end buyer becomes a binding commitment (i.e., legally enforceable) once the bank has committed its resources and has incurred a cost as a result of this standing promise. In this case the likelihood of the bank ending up with unsold merchandise are low but not zero. For example, the merchandise may not exactly match the specification of the client therefore he has the right to rescind. However, to mitigate such risk the bank resorts to appoint the client (the final buyer) an agent of the bank to procure the merchandise according to the specifications and then sells it to him. (For more discussion see AAOIFI Accounting Standard No.2 and Sharīʿah Standard No. 8).

9 Jurists have identified specific conditions for validity of this contract which can be found elsewhere, for example see Usmani (1998).

Secondary or indirect liquidity risk arises in *salam* contract when some other risk associated with this contract materializes. For example, the credit risk with this contract is that the seller may not be able to deliver the commodity on the specified date. If it does happen, then the liquidity problem of the bank extends beyond the maturity date. Having not received the commodity it cannot sell it in the market to convert it into a liquid asset. Another example of indirect liquidity risk is if the commodity is delivered but the quality or quantity or some other attribute of the purchased commodity is below the required specifications causing a legal dispute. The litigation risk which was a risk factor before the delivery now becomes a liquidity risk.

A way to mitigate the primary liquidity risk (as well as to avoid the delivery) in *salam* contract is to use parallel *salam*. The idea is to write a separate offsetting *salam* contract.[10] But the second *salam* has to be (i) an independent contract not contingent on the performance of the first *salam* contract, and (ii) must be with a third party (i.e., not with the counter party in the first *salam* contract or its affiliates).[11] However, as long as the credit risk and the risk of dispute are there the secondary liquidity risk (or indirect liquidity risk) of *salam* still remains, and even increases now because of the two parallel contracts instead of one contract.

<u>4. *Istiṣnāʿ*</u>: It is a manufacture to order contract for yet to be manufactured good on payment of an advance price either in full or in instalments. The primary liquidity risk arises in the same way as in *salam* contract but to a lesser extent because it is permissible for the bank to provide funds in instalments or even to defer the whole amount to a future date thus maintaining its liquid assets. Whereas in *salam* full upfront payment is necessary.

The secondary liquidity risks of *istiṣnāʿ* are the same as for *salam* with two exceptions:

(i) As opposed to *salam*, an *istiṣnāʿ* contract can be cancelled unilaterally before the manufacturer starts manufacturing. Therefore it involves definition and verification of this event. This feature can contribute to lesser or greater liquidity risk to the bank depending upon how well the event is defined, the ease of verification by a third party such as a court, and how much funds have already been advanced by the bank.

10 See Khan (1992) and Khan (1995).

11 The first condition is in order to meet the sharīʿah requirements of: (a) prohibition of contingent sales, (b) prohibition of sale of a thing that is not in possession. The second condition is in order to meet the sharīʿah requirement of prohibition of *aeena* or buy-back arrangement.

(ii) Time bound delivery is not a must feature of *istiṣnāʿ* contract, however in current practice it is not left open ended otherwise it would have been hard to define an event of default. Thus secondary liquidity risk that is triggered by realization of credit risk is similar to that found in *salam*. The only difference being that some jurists (*fuqahāʿ*) allow penalty for lateness in delivery on the analogy of permissibility of such measure in *ijārah* contracts.[12] This can induce stronger incentives for timely delivery thus reducing the chances and the duration for which the contract remains open to liquidity risk after a default as compared to a *salam* contract.

5. *Ijārah*: In an *ijārah* contract the bank first owns an asset which it leases to its customer. Or the bank gets a tangible asset on lease from a third party and subleases it to the customer. Liquidity risk comes in an *ijārah* contract when the bank has to pay the price of the asset upfront to acquire the asset before it can lease it to its customer. The liquidity risk depends upon whether or not the asset is readily resell-able in the market. This risk is however less here than in *murābaḥah* contract because *murābaḥah* is not re-sellable and re-price-able. The liquidity risk in hire-purchase (*ijārah muntahi bi tamleek*) is even lower because the sale price is built into the rental instalments. However, the rentals cannot be drawn unless the asset is ready to provide usufruct to the lessee, therefore liquidity of this contract also depends on the time required to make the asset useable by the lessee after the agreement.

Above we have discussed the liquidity risk of each individual mode of finance. In reality the situation is more complicated as the overall liquidity risk depends on the proportion of each of these contracts in the bank's portfolio and the concentration and exposure to individual parties through them.

2. Current State of Liquidity

To analyze current state of liquidity we have utilized three commonly used measures of liquidity. Assuming a given probability distribution over unforeseen liquidity needs a reduced amount of liquidity, as measured by these ratios, increases the potential for getting into liquidity shortage situation hence the liquidity risk. The three ratios we utilize are: (1) Liquid Assets to Total Assets ratio, where the liquid assets are defined as cash and cash equivalents as well as deposits with other banks. The advantage of this ratio, often called liquidity ratio, is that it gives a quick picture of proportion of liquidity available within a bank as

12 Usmani (1998)

well as in the banking system as a whole when aggregated across banks. (2) Financing to Deposit ratio. This is the most commonly used ratio of liquidity risk. It captures the changing nature of financing demands and the bank's ability to gather the deposits. (3) Maturity Mismatch of Assets and Liabilities, particularly of short-term nature of less than 3 month period. This captures the liquidity risk generated by the maturity transformation role of the bank. There are other possible measures too, such as the ratio of stable deposits to total deposits or the ratio of profit sharing investment accounts (PSIA) to total deposits, but they are not used due to deficiencies in data.

In section-4, the paper also looks at the situation of change in probability distribution of unforeseen liquidity needs, again indirectly, by examining the change in the structure of funding. As some sources of bank funding are more volatile than others, a shift towards these sources of funding will result in increase in liquidity risk even with no change in the liquidity ratios. Thus the paper captures liquidity risk emanating both: (i) from changes in ratios at a given point in time and (ii) changes in probability distribution of liquidity stress, but does not attempt to quantity these probabilities.

The data on Islamic banks utilized for this study comes from Islamic Banks Information System (IBIS) provided by Islamic Research and Training Institute. We utilized data of 61 Islamic banks from 18 countries and cover the period from 2000 to 2009.[13] The appendix-1 gives the list of countries and number of banks from each country. The data on conventional banks was obtained from Bank Scope and the World Bank.

2.1. State of Liquidity in Islamic Banks (past, present and during the crisis)

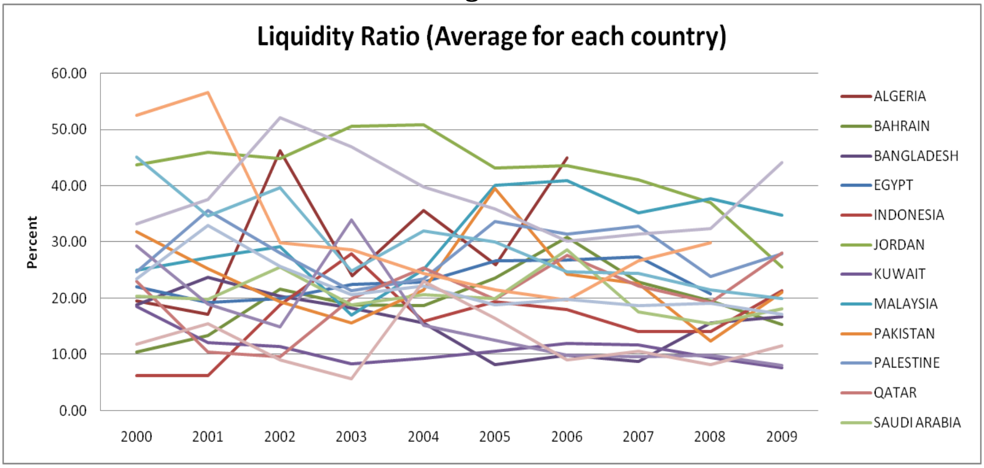
Liquidity Measure-1: The Liquid Assets to Total Assets Ratio

The Figure-1 shows liquidity ratio data for Islamic banking sector from 18 countries over a period from 2000 to 2009. This reflects averages of liquidity ratios of Islamic banks within each country for each year. In this sense Figure-1 represent the liquidity ratio of an average representative Islamic bank in each country. Higher the liquidity ratio, better is the ability of bank to manage liquidity risk. However, very high liquidity ratio indicates a drag on the earnings of the bank as more liquid assets generally bring in low or no returns not only to shareholders but

13 This means 61 x 10 = 610 data points. However, eliminating the missing values we still have 512 data points for analysis.

also to the *muḍārabah* based deposit holders. Thus there is a trade-off between higher liquidity and return.

Figure-1



Source: Author's calculations using IBIS data.

In general, the countries where Islamic banking is new or where new Islamic banks are coming into being very fast, we can expect to see erratic movements in the liquidity ratios. This is due to the fact that the newly established banks have most of their assets in liquid form in the beginning.

Among the GCC Countries, Kuwait had consistently low liquidity ratio throughout the period. UAE is the country where liquidity ratio dropped most and remained lowest during the global crisis. Among all countries, Jordan has the highest liquidity ratio consistently since 2004 followed by Malaysia. Whereas, the liquidity ratio in Sudan has been consistently showing a downward trend since 2004 but remained in the middle of the range of all countries in the sample.

The Figure-1 also shows that there is a great deal of variation in liquidity ratios across countries in each year. However, this figure does not give any information on variability of liquidity among Islamic banks within a country. This variation among Islamic banks within each country as measured by the standard deviation of liquidity ratios is high in Bahrain, Jordan, Malaysia, Pakistan, Saudi Arabia, and Yemen. The variability is found to be low in Bangladesh, Indonesia, Kuwait, Qatar, Sudan, Turkey, and UAE.[14] Both the inter- and intra-country variations in liquidity ratios point to a potential for creation of inter-bank market.

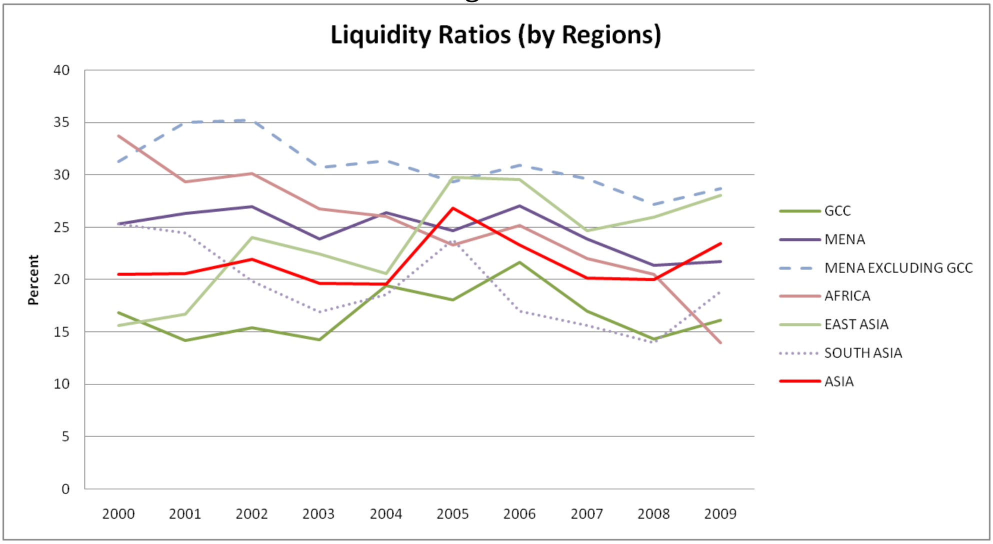
While Figure-1 gives a comprehensive picture to compare across countries. However, there is information overload in it precluding readers to see any discernable trend and understand the future direction. Clearer picture emerges when the same information is presented aggregated by regions. Figure-2 gives the liquidity ratio of average Islamic banks by regions.[15] It clearly shows that a downward trend in liquidity ratio had started in most regions even before the global financial crisis. After the crisis this trend further deepened. Only in 2009 after the crisis the liquidity ratio has started to improve. In the past Islamic banks were characterized to have high holding of liquid assets. This high liquidity was partially due to lack of avenues for short-term parking of excess liquidity and partially as a result of risk management strategy as Islamic banks do not have lender of last resort facility. However, the excess of liquidity is becoming a matter of past and possibilities of liquidity shortages are building up.

This regional comparison of ratios puts GCC and South East Asia regions on the lower side of liquidity consistently throughout the ten year period. However, in terms of absolute amounts (Dollar value) the liquid assets in these regions are multiple times higher than other regions as the assets of average Islamic banks in these two regions are much high.

14 To capture within country variation, the standard deviations of liquidity ratios among the Islamic banks within each country were calculated for each year. Countries where this standard deviation exceeded 20 within any of the past five years (2005 to 2009) were classified as high variability countries.

15 Average is taken over the liquidity ratios of all individual Islamic banks within a region. It is not total liquid assets in the region divided by total assets in the region.

Figure-2



Source: Author's calculations using IBIS data.

Table-1
Regional Liquidity Ratios

YEAR	GCC	MENA	MENA EXCLUDING GCC	AFRICA	EAST ASIA	SOUTH ASIA	ASIA
2000	16.86146	25.29871	31.32532	33.72185	15.65001	25.34142	20.49571
2001	14.2233	26.35404	35.01885	29.34263	16.74299	24.49688	20.61994
2002	15.4576	27.01252	35.26604	30.13395	24.00653	19.87588	21.94121
2003	14.31611	23.86979	30.69384	26.79788	26.72011	16.90559	21.81285
2004	19.42119	26.37737	31.34607	26.03993	20.58021	18.58992	19.58506
2005	18.07303	24.66476	29.37314	23.32841	29.77088	23.84733	26.80911
2006	21.64811	27.0544	30.91604	25.20829	29.52054	17.02539	23.27297
2007	16.99369	23.9035	29.66167	22.01624	24.70429	15.65787	20.18108
2008	14.36213	21.36174	27.19474	20.50475	25.9895	13.97454	19.98202
2009	16.15152	21.7299	28.70287	14.0055	28.04554	18.8833	23.46442

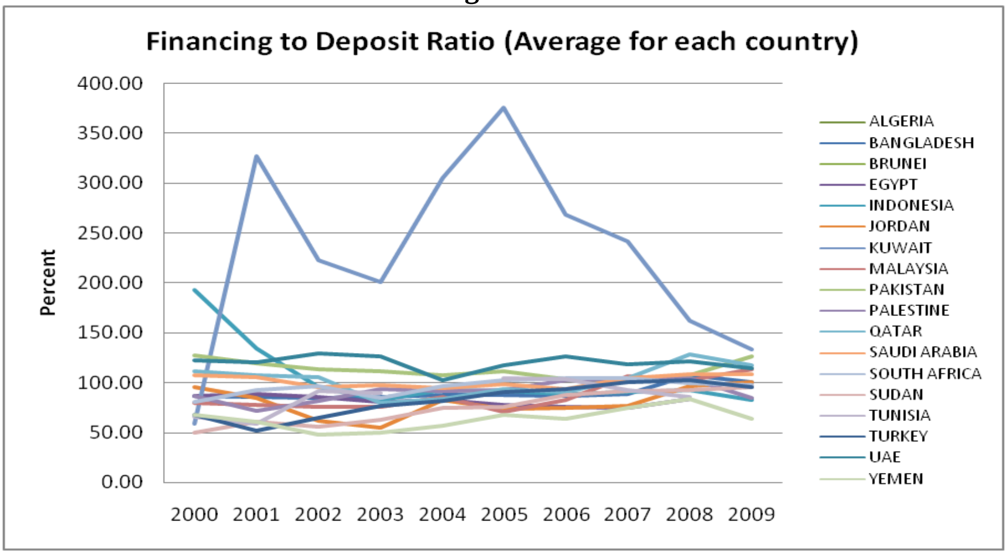
Source: Author's calculations based on IBIS data.

<u>Liquidity Measure-2: Financing to Deposit Ratio</u>

An important measure of liquidity risk is the Financing to Deposit Ratio. It captures the relationship between changing nature of demand for financing (be it in the form of *murābaḥah, istiṣnāʿ, ijārah* or partnership based modes) and the deposit gathering ability of banks to fund that demand. Higher the ratio, higher is the liquidity risk faced by the bank. Figure-3 shows the Financing to Deposit Ratio of average Islamic banks in individual countries. In this regard stable funding, which increases along with demand for financing, is an important factor in managing the liquidity risk. The Financing to Deposit Ratio has moved differently in many countries but in most countries this ratio peaked between 2006 and 2009. During this period the growth rate of financing was higher than the growth rate of deposits in many banks, however, deposits also increased. The exceptions are the investment banks which rely more on wholesale funding and little on retail deposits. As a result these banks faced sharp increase in Financing to Deposit Ratio (i.e., high liquidity risk) during the financial crisis. Islamic investment banks in Bahrain and Kuwait faced significant distress during 2009.

Table-2 gives the region wise average Financing to Deposit Ratios. The same is shown graphically in Figure-4. It clearly shows that this ratio was quite high in the GCC and MENA when compared to other regions. The very high ratio is due to inclusion of investment banks in our sample from these regions. Figure-5 shows the same ratio for other regions after excluding the GCC and MENA. It is evident from the data and its plot that the liquidity risk has moderately increased after the crisis in Asia, East-Asia, South-Asia, and Africa.

Figure-3



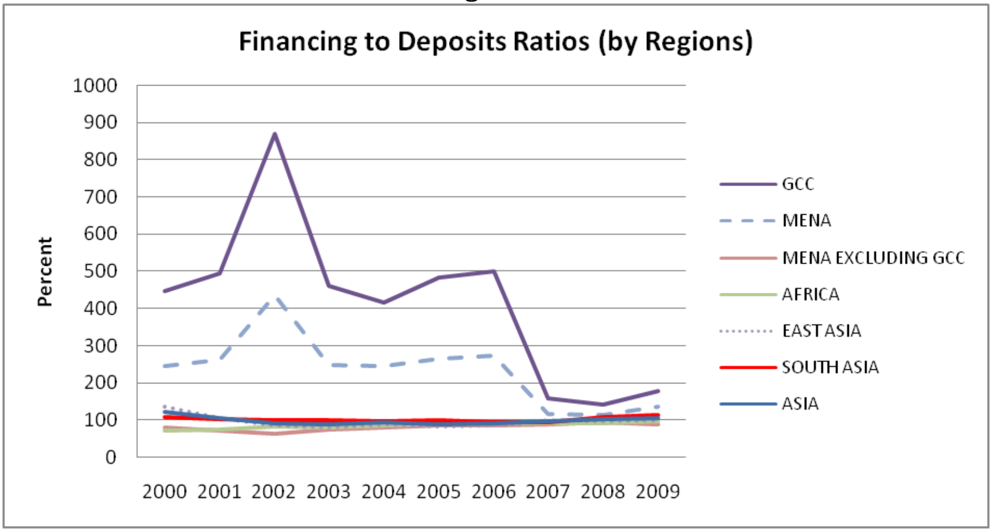
Source: Author's calculations using IBIS data.

Table-2
Financing To Deposit Ratios By Region

YEAR	GCC	MENA	MENA EXCLUDING GCC	AFRICA	EAST ASIA	SOUTH ASIA	ASIA
2000	445.19	245.07	78.31	70.51	136.60	107.07	121.83
2001	493.51	262.00	69.07	74.77	106.18	102.47	104.33
2002	870.20	434.80	61.68	82.02	85.43	98.87	92.15
2003	459.55	249.22	73.95	79.40	79.11	98.60	88.85
2004	414.63	246.71	78.80	84.19	88.99	97.29	93.14
2005	483.58	265.76	84.24	89.77	81.07	99.33	90.20
2006	501.15	274.55	85.73	93.15	85.72	95.20	90.46
2007	156.43	118.52	86.93	90.77	98.44	94.23	96.34
2008	140.66	114.59	92.85	90.21	97.68	107.38	102.53
2009	176.84	136.52	86.12	96.40	98.06	113.32	105.69

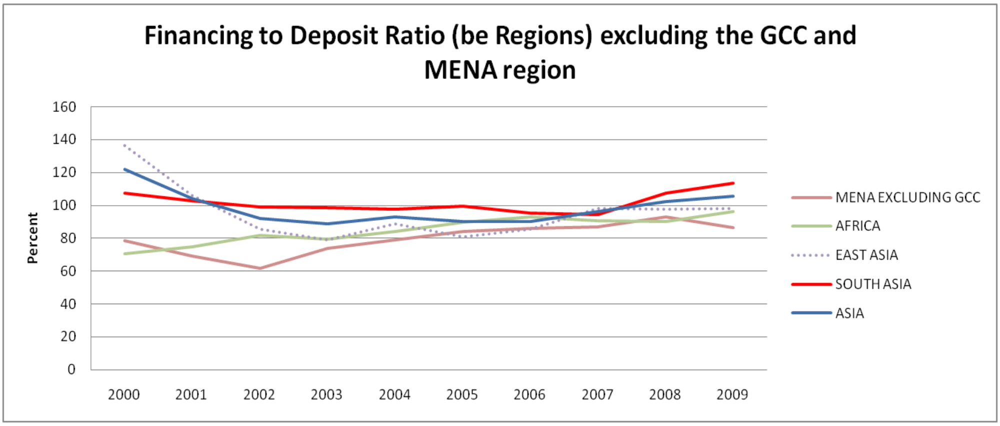
Source: Author’s calculations using IBIS data.

Figure-4



Source: Author’s calculations using IBIS data.

Figure-5
without GCC



Source: Author's calculations using IBIS data.

A growth in deposits equal to the growth in financing is not enough for managing liquidity risk. Stability and liquidity of deposits are also important which is not captured in the above measure. The stability and greater liquidity depends on the diversity of depositor base, on the contractual terms whether the deposits are profit sharing *muḍārabah* based accounts or fixed liability *murābaḥah* and *tawarruq* based deposits. It also depends on the maturity tenor of the deposits whether contractually determined or behaviourally set. Many Islamic banks have strong deposit base, but in some countries the demand for financing is even higher. If this rise in demand is due to economic growth and development of the country in which Islamic bank is operating then this is very healthy. However, if this happens due to financial arbitrage opportunities and speculation then in such environment as competition heats up banks start relying on wholesale funding and short-term funding to provide longer term financing and investment. This itself is a source of liquidity and other risks. The paper will provide some comments on these in a later section. The next section looks at the third measure of liquidity which is maturity gap in the asset and liabilities.

Liquidity Measure-3: Maturity Gap

The maturity gap tries to measure the congruence of maturity tenors of assets and liabilities of individual banks and, when aggregated, possibly for the banking sector. High positive or high negative gaps are sign of potential liquidity problems. For the purpose of analysis of short-term liquidity position of Islamic banks the focus here is on assets and liabilities gap of up to 3-month maturity. Using the data for individual banks maturity ladders of assets and liabilities have been constructed and maturity gap for those banks were calculated in 5 tiers: for up to 3 months, 3 to 6 months, 6 months to 1 year, 1 to 3 years, over 3 years, and unspecified maturity. This section analyses only the very short term maturity gap i.e. up to 3 months category.

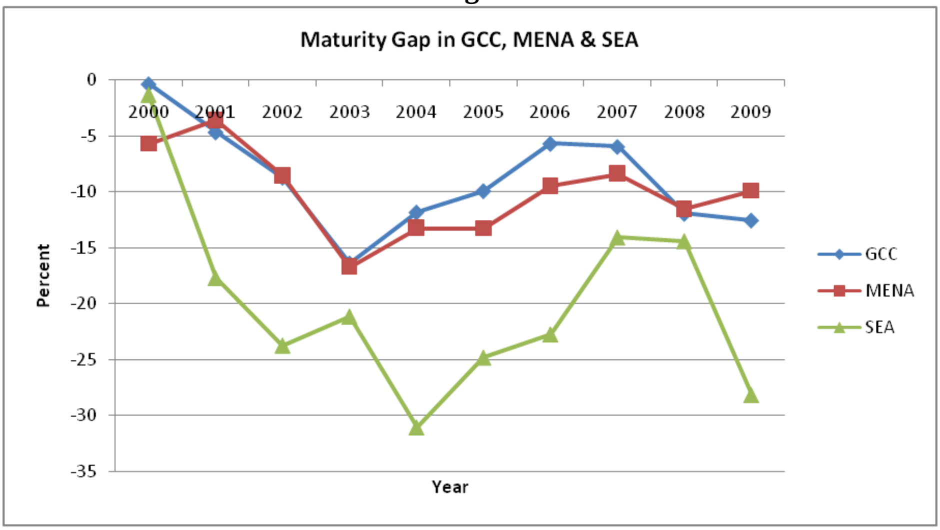
Figure-6 shows the average maturity gap of up to 3 months assets and liabilities of Islamic banks in three regions: The GCC, MENA, and South East Asia (SEA). It is obtained by averaging the respective maturity gap of individual Islamic banks in that region. The data is reported for the years 2000 to 2009.

The Figure-6 reveals that:

With a long history the average maturity gap of up to 3 months assets and liabilities for Islamic banks have been negative in all regions. Implying that on the average Islamic banks face lack of short-term assets as compared to the short-term funds they raise.

The SEA region has been consistently showing larger negative maturity gap for short-term assets and liabilities as compared to the MENA and GCC regions. This implies that the problem of short-term maturity mismatch is more severe in that region and hence the liquidity management issues.

Figure-6



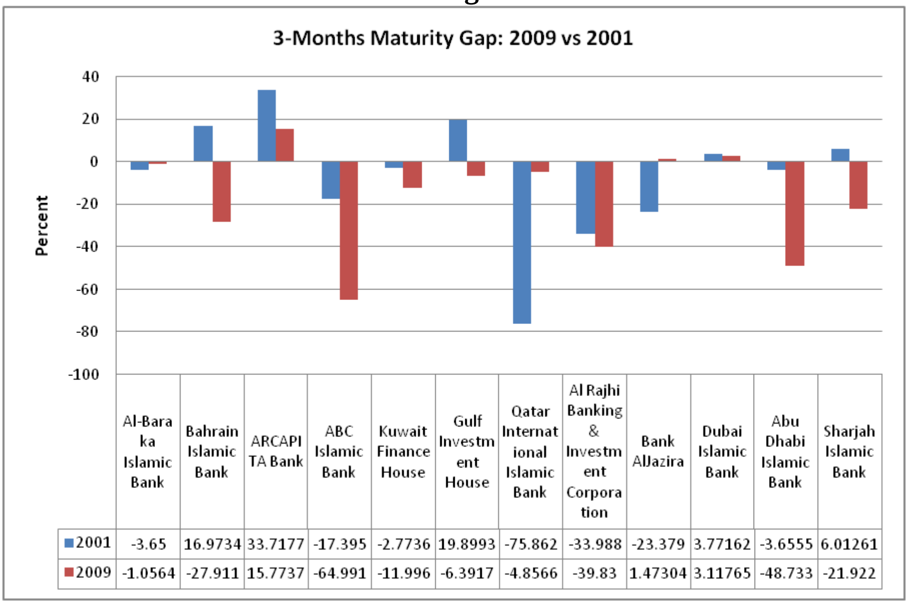
Source: Author's calculations using IBIS data.

The above are some preliminary observations which will require further investigation because the sources of asset liability mismatch can be many, including the asset and liability management policies of Islamic banks. Therefore a policy response at the level of banks and their regulators will crucially depend on those factors.

It can also be noted from Figure-6 that the short-term maturity mismatch in Islamic banking had been reducing in all regions from 2004 until the advent of the global financial crisis. The liquidity situation started to deteriorate in the GCC (2007) before the SEA region (2008). However, later in the year (2009) the short-term maturity mismatch deteriorated much significantly in the SEA region while it started to taper-off or improve in the GCC and MENA regions respectively.

It may also be noted that the structure of liquidity of Islamic banks have changed significantly over the years. From an era of liquidity surplus in the beginning of the decade Islamic banks are now in the era of liquidity shortages. Figure-7 compares the short-term maturity gap during 2001 versus that in 2009 of some Islamic banks. In general, the banks have moved from a position of positive gap to a negative one or from a negative gap to a more negative one.

Figure-7

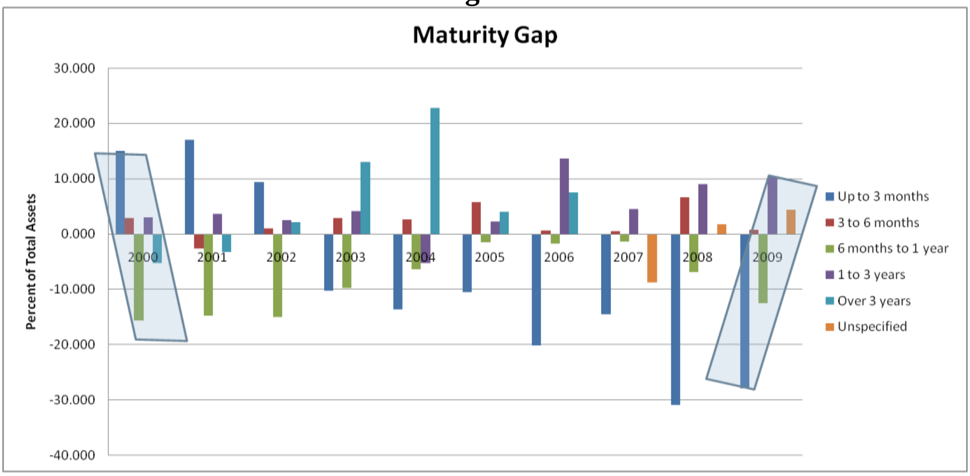


	Al-Baraka Islamic Bank	Bahrain Islamic Bank	ARCAPITA Bank	ABC Islamic Bank	Kuwait Finance House	Gulf Investment House	Qatar International Islamic Bank	Al Rajhi Banking & Investment Corporation	Bank AlJazira	Dubai Islamic Bank	Abu Dhabi Islamic Bank	Sharjah Islamic Bank
2001	-3.65	16.9734	33.7177	-17.395	-2.7736	19.8993	-75.862	-33.988	-23.379	3.77162	-3.6555	6.01261
2009	-1.0564	-27.911	15.7737	-64.991	-11.996	-6.3917	-4.8566	-39.83	1.47304	3.11765	-48.733	-21.922

Source: Author’s calculation using IBIS data.

The change in liquidity structure is not confined to 3-month gap only. Rather there has been a structural shift over the decade with Islamic banks relying more on short-term funding to fund long term assets, which indeed increases the risks faced by them. To show that the structural shift has taken place in the funding and financing operations of Islamic banks at all levels of maturities we took the example of one bank (name left anonymous) and plotted its maturity gap for all tenors of assets and liabilities from 2000 to 2009. This is shown in Figure-8. It can be seen from the figure that the structure of the maturity distribution has undergone considerable change during this period. In fact, it has now the reverse shape in 2009 compared to the year 2000. To facilitate the reader visually see the difference, two different shaped rhombuses are placed on the data for 2000 and 2009 in Figure-8.

Figure-8



Source: Author's calculations using IBIS data.

2.2. Liquidity Comparison with Conventional Banks

For a meaningful comparison of liquidity and liquidity risk of Islamic banks with that of conventional banks some control over the other very divergent factors between the two types of banks is necessary. For example, comparing Islamic banks with major international conventional banks operating at global level will not make sense because of sheer differences in their size, operations, markets, influence and regulatory environment. To control for these differences and yet keeping the comparison with well performing conventional banks, the following methodology was used. Three large banks (largeness defined in terms of assets), were selected from each of the seven countries where Islamic banks are actively operating. The seven selected countries are Bahrain, UAE, Saudi Arabia, Malaysia, Indonesia, Pakistan, and Turkey. Table-3 shows the average liquidity ratio of three largest conventional banks in each of these seven countries.

Table-3
Liquidity Ratio (percent) – Average of three large conventional banks in each country

Year	Bahrain	UAE	Saudi Arabia	Malaysia	Indonesia	Pakistan	Turkey	GCC Average	Asia Average
2006	0.99	6.25	6.26	14.63	2.27	n.a.	8.90	4.50	8.45
2007	1.14	17.70	10.46	17.66	2.62	10.03	8.84	9.77	10.10
2008	1.92	6.37	7.97	14.00	3.37	9.79	9.11	5.42	9.05

Source: Author's calculations using annual reports of conventional banks. In this table the GCC Average is average of Bahrain, UAE and Saudi Arabia. While in this table the Asia average is average of Malaysia, Indonesia and Pakistan. This definition is slightly different than that used in the text for GCC and Asia.

For the three years from 2006 to 2008 the range of liquidity ratio in conventional banks (average of three large banks) was between 4.5 percent to about 10 percent in the GCC region. In comparison to it, the liquidity ratio of average Islamic bank in the same region during that period varied from 14 to 21 percent.

Similarly, for the Asia region the liquidity ratio in conventional banks varied from 8.5 percent to 10 percent during 2006 to 2008. During the same period the liquidity ratio of Islamic banks varied from 20 percent to 23 percent.

This comparison clearly shows that Islamic banks in general are holding high proportion of liquid assets than conventional banks. Even during the financial crisis, which occurred during the above mentioned period of comparison (2006 to 2008), the liquidity of Islamic banks were more than twice the liquidity of conventional banks. This, among other factors, helped most Islamic banks to ride out of the crisis.

The liquidity risk as measured by the Loans to Deposit Ratio in case of conventional banks can be compared with Financing to Deposits Ratio in case of Islamic banks. Using the same approach as above we find that Islamic banks have a high deployment ratio than conventional banks. During 2006 and 2008 the ratio of loans to deposits of conventional banks ranged from 88 percent to 97 percent in the GCC region (see Table-4), while for Islamic banks the financing to deposits ratio was a whooping 140 percent to 156 percent. This implies that Islamic banks in the region were using non-depository sources of funds. This may be partially the banks' own capital and partially borrowing from wholesale market possibly through commodity *murābaḥah*, *ṣukūk* and private placements. Inclusion of some large Islamic investment banks from the GCC region in our sample can also account for this high ratio as Investment banks do not rely much on retail deposit base.[16]

Comparing the Islamic banks with conventional banks in Asia region for the period 2006 to 2008 again shows that Islamic banks do not leave deposits idle. The financing to deposit ratio of average Islamic bank varied from 90 percent to 96 percent in comparison with 69 percent to 70 percent loans to deposit ratio of average conventional bank.[17]

Table-4
Loans to Deposits Ratio (percent) – Average of three large conventional banks in each country

Year	Bahrain	UAE	Saudi Arabia	Malaysia	Indonesia	Pakistan	Turkey	GCC Average	Asia Average
2006	95.32	99.39	70.61	85.42	51.87	72.03	61.38	88.44	69.77
2007	106.02	104.97	70.31	76.50	52.45	68.13	65.62	93.76	65.69
2008	100.36	114.76	75.90	78.67	54.39	74.00	68.79	97.01	69.02

Source: Author's calculations using annual reports of conventional banks. In this table the GCC Average is average of Bahrain, UAE and Saudi Arabia. While in this table the Asia average is average of Malaysia, Indonesia and Pakistan. This definition is slightly different than that used in the text for GCC and Asia.

Given the high utilization ratio of deposits, the less developed state of liquidity management instruments and infrastructure, and non-sellable nature of debt Islamic banks are exposing themselves to higher liquidity risk unless they rely on profit

16 Financing to deposit ratio has been historically higher in the GCC region even for conventional banking sector compared to the other regions of the world. This may be due to existence of some very wealthy families and individuals who invest directly in the capital of the bank rather than opening a deposit account. Why this is historically the case can form an interesting research question for future research. Compared to the pre-crisis period, this ratio substantially declined during the crisis from its historical values for both conventional and Islamic banking sector, but remained higher than other regions (see Table-2 and Table-4).

17 This difference is not because of any difference in Capital Adequacy Ratio (CAR) but due to the fact that Islamic banks can pay to their depositors only from their earnings (a share of profit). In order to pay a share that is competitive enough to the rates available in the market Islamic banks have to ensure efficient deployment and quick turnover of the available funds.

sharing investment accounts (PSIA) and genuinely use risk sharing in their financing as well as funding operations.

3. Liquidity Management Practices

3.1. Liquidity Management in Conventional Banks

Liquidity management has always been important for banking. However, in the growing and profitable market of money lending business the liquidity risk often becomes a secondary concern for the managers of banks. Aggressive expansion of lending operations that became possible through securitization of loan portfolios helped the banks to further ignore liquidity risk and expand the asset portfolio even on thin capital base. The financial crisis that followed has taught many important lessons to the banks, their regulators and the society in general. Importance of liquidity risk management is one of these lessons that forced the banks to reconsider their practices. Ernst & Young conducted a survey of 62 large banks in 2010 on behalf of International Institute of Finance and found:[18]

- 92 percent of banks have made changes to their approaches to managing liquidity risk
- Liquidity risk management has become single most important area for banks
- Primary challenges to liquidity management identified by the survey are:
  - Systems 87%
  - Data Quality and Consistency 81%
  - Regulatory Uncertainty 69%
- Banks report that their "risk appetite" is now linked to business decisions.

The global financial crisis has also placed liquidity risk control high in the agenda of regulators. In this regard various proposals have been discussed in the literature to monitor and control this risk for financial stability. Basel Committee on Banking Supervision (BCBS) has come up with new recommendations for liquidity risk management in BASEL-III. Key among them are two quantitative measures (i) Liquidity Coverage Ratio and (ii) Net Stable Funding Ratio. The first one is to ensure that the banks have enough liquid assets to cover for 30 days of net cash out flows. The second one is to encourage more medium- to long-term funding. The details of these measures of BASEL-III and other proposals are given

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18 Ernst & Young (2010).

in Apendix-1. The liquidity management tools available to conventional banks and the regulatory support infrastructure available to them including the lender of last resort facility are well known. Instead of dwelling into these well known aspects the paper moves in the next section to liquidity management practices in Islamic banks.

3.2. Liquidity Management in Islamic Banks

Liquidity stress is not unknown to fully fledged Islamic banks, subsidiaries of conventional banks as well as to Islamic banking divisions and Islamic investment banks. During the recent crisis all these types have faced liquidity shortages of varying degrees and varying durations. The severity of liquidity crunch in some jurisdictions was so high that central banks offered special facilities or provided temporary blanket guarantees for all accounts, including to Islamic banks.[19] In other jurisdictions they only provided no more than lip service to Islamic banks.

Generally, the risk management, including the liquidity risk management is carried out at the group level rather than individual divisions' level. This means, in case of Islamic banking subsidiary of a conventional bank or Islamic banking window of a conventional bank the liquidity risk management is performed using conventional hedging instruments and techniques. Such banks do not feel the difficulty that fully fledged Islamic banks face when they try to exercise liquidity risk management within the bounds of Sharīʿah in the existing environment. Thus the mixing of liquidity risk management activities of Islamic and conventional lines of business in the former group of banks creates negative externalities for Islamic banks and for the Islamic financial system.

Islamic banks are using both asset side liquidity management and liabilities side liquidity management strategies. Inter-bank placements based on *murābaḥah* and commodity *murābaḥah* are most common instruments. In addition to these, Islamic banks have instituted (i) Investment risk reserves and (ii) Profit Equalization reserves that help smooth out the payments to the depositors, hence avoid deposit shifting and control liquidity risk. However, there are arguments for and against this practice.

Within the Islamic banks the responsibility of monitoring the liquidity does not necessarily reside with one section but several departments are involved. However,

19 An analysis of Sharīʿah legitimacy of such guarantees would be interesting question in itself but this is beyond the scope of the present paper.

increasingly the Chief Risk Officer is getting responsible for liquidity risk management in many banks. The other departments having liquidity risk management responsibilities may include asset-liability-management units, and treasury department.

Various opinion surveys indicate that the Islamic banks do not think that regulators' are less inclined to support them in liquidity risk management. Rather, they consider the unavailability of Islamic money market instruments or the less developed state of such money markets as the major constraint for their liquidity management. This is followed by the constraints imposed by the legal environment and unavailability of Lender of Last Resort facility to them.

Securitization of own assets is so far relatively less among Islamic banks. Only few large banks have issued *ṣukūk* to securitize their own assets for liquidity management. Islamic banks are usually coming in as arranger and facilitator in issuance of *ṣukūk* of other entities and hold these certificates for liquidity management purposes.

4. Issues in Liquidity Management of Islamic Banks

The above analysis has shown that the liquidity structure of Islamic banks have been changing towards lesser level of liquid assets and increasing maturity gap in the short-term assets and liabilities. These changes have implications for increased liquidity risk faced by Islamic banks. These developments call for a review of liquidity management practices and policies at all levels; i.e., by the individual banks, their regulators, and financial sector policy makers. The situation also calls for creating appropriate instruments, mechanisms, and institutions for efficient liquidity management appropriate for Islamic finance philosophy. The recent global financial crisis has also provided an experience of abrupt liquidity shortages to Islamic banks and the difficulties encountered due to unavailability of suitable infrastructure for providing liquidity to them. Below we highlight some challenges in liquidity management faced by Islamic banks and comment on some proposed solutions with a view to provide future direction.

4.1. Issues in Liquidity Management Instruments and Infrastructure

<u>Inter-bank market</u>

Islamic inter-bank markets based on *muḍārabah* placement of funds or on the basis of *wakālah* (agency contract) exist but they are less developed. The previous sections have shown that liquidity ratios across countries vary considerably (see Figure-1). Thus there is a potential to create cross-border inter-bank placement market to manage liquidity. However, such market has so far not emerged because there exists restrictions on cross boarder movement of capital in many countries and the costs of such transactions are high due to various reasons including the exchange rate risks.

Domestic inter-bank market among Islamic banks exists only in those countries where multiple Islamic banks exist and the variance of liquidity across these banks is high. However, in many countries Islamic banks are very few and this situation does not allow the possibility of inter-bank placements among them. Moreover, during any event of macro economic significance the liquidity positions of Islamic banks start moving in correlated manner, as experienced during the global financial crisis, then this market virtually disappears. These are some limitations and constraints on the development of active domestic inter-bank markets.

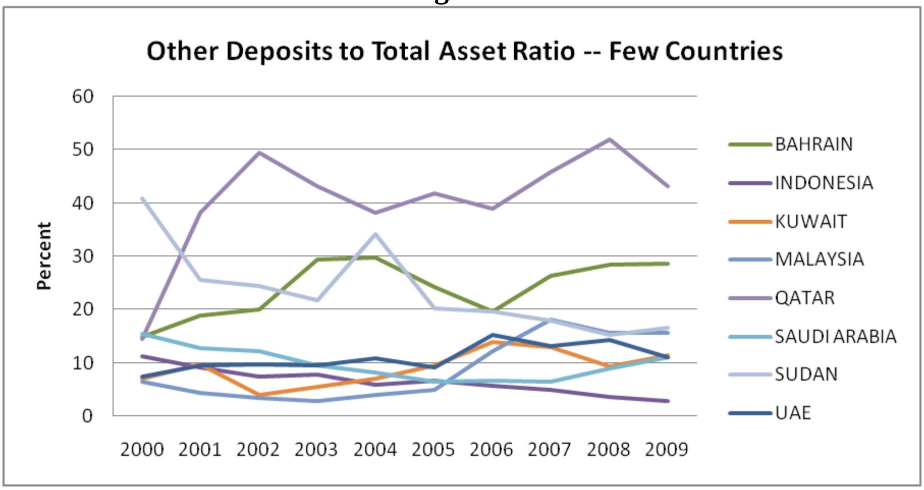
<u>Commodity *murābaḥah*</u>

Another solution that has been used, for quite some time now, is the use of commodity *murābaḥah* to manage short-term liquidity. Such transactions are carried out by large Islamic banks through international metals and commodities markets. In some countries such markets have become also locally available. A liquidity surplus bank can use commodity *murābaḥah* to buy metal from one party in the international commodity market by making spot payment and sell it to another party on deferred payment basis with a marked-up price. Similarly, temporary liquidity shortage can be made up by buying the commodity on deferred payment basis on mark-up, and selling it in the spot market at going price to get cash. There are Sharīʿah as well as public policy issues in using such methods on system-wide level. Commodity *murābaḥah* does not tie the mark-up to economic value addition as commodity bought and sold is neither intended for consumption nor for further production by the transacting parties. When practiced on large scale, it breaks the much needed link between the financial and the real economic sectors.

However, the use of commodity *murābaḥah* has now transcended from its use for short-term management of small liquidity gaps to become a funding source or an instrument to raise funds for the banks. This situation not only creates a dichotomy between the real and financial sectors but also increases the systemic risk in Islamic banking sector. The matter therefore calls for a regulatory intervention.

Data on *murābaḥah* on the liabilities side of the Islamic banks are not available for all banks in the sample. However, it is possible to create its good proxy by calculating the size of 'deposits due to other creditors' which include deposits due to banks and other financial institutions that are mostly murābaḥah and fixed obligation deposits.[20] The Table-5 shows the ratio of 'deposits due to other creditors' to 'total assets' for average Islamic banks in different regions. The same is represented in Figure-9 for some selected countries. This ratio has been rising until 2008 and in many countries it constitutes a substantial portion of total assets (from 15 to 30 percent). This development calls for regulatory intervention. Commodity *murābaḥah* should not be used as fund raising source, but only as liquidity management tool. This also implies only moderate use of commodity *murābaḥah*. The regulators should specify upper limit for its use. Benchmarking for this purpose can be done using bank level data in each jurisdiction and at the global level.

Figure-9



20 In this paper 'deposits due to other customers' is obtained by using the accounting identity: Assets – Equity – Customer Deposits = Deposits due to Other Customers.

Table-5
Deposits Due to Other Creditors as Proportion of Total Assets (Percent)

COUNTRY AVERAGES	BAHRAIN	INDONESIA	KUWAIT	MALAYSIA	QATAR	SAUDI ARABIA	SUDAN	UAE
2000	14.90313	11.30308	7.111149	6.442273	14.40714	15.53766	40.78868	7.504963
2001	18.90095	9.167814	9.791766	4.357644	38.16655	12.90474	25.46221	9.625743
2002	20.1303	7.466366	4.004657	3.369744	49.30553	12.32315	24.49502	9.864709
2003	29.4711	7.842027	5.457043	2.786637	43.17153	9.471009	21.7	9.622013
2004	29.8591	5.952651	7.061392	3.923051	38.08775	8.273096	34.08317	10.84074
2005	24.31076	6.586518	9.612413	4.882895	41.81519	6.457849	20.17907	9.119679
2006	19.70334	5.727467	13.95198	12.30084	38.85201	6.720875	19.61846	15.27284
2007	26.36012	4.885499	12.92624	18.20989	45.82013	6.51784	17.87812	13.26485
2008	28.54338	3.570015	9.288876	15.68579	51.88143	8.937748	15.25784	14.31009
2009	28.63433	2.790146	11.5045	15.61897	43.08906	11.18634	16.60054	11.16435

Source: Author's calculations based on IBIS data.

Ṣukūk

There is also a dearth of market based Sharīʿah compliant instruments for liquidity management of Islamic banks. This dearth is both in terms of number of instruments and available volume. This is not new but has been a long standing situation in Islamic banking. However, some countries have experimented with creation of various capital market and shorter-term products. These efforts so far have shown limited success. For example, the Government Investment Certificates of Sudan and *salam* based *ṣukūk* Bahrain. In the former case the limited number of assets available for securitization was the issue, while in the later case the issuance of *ṣukūk* was not for any direct economic activity and that the instrument was not tradable in the secondary market. Pakistan, Indonesia and Turkey have also introduced *ṣukūk* for liquidity management in domestic markets, however they are still small in number and volume. All these experiences should be carefully evaluated to come up with better and sound instruments for liquidity management.

It is generally believed that availability of *ṣukūk* markets can help in liquidity management. However, the shortage of short-term *ṣukūk* and insufficient volume of *ṣukūk* in the market are also considered as main hindrances in liquidity management. It is thought that issuance of *ṣukūk* in larger volume and in many tenors will result in the creation of an Islamic benchmark rate which can serve as an alternate to LIBOR for pricing of fixed return assets and inter-bank financing. However, the issuance of more *ṣukūk* will not necessarily create a new '*ṣukūk* yield curve' if the *ṣukūk* pricing remains tied to LIBOR. In this case the benchmark created will not be an alternate but only another reflection of LIBOR. To make true '*ṣukūk* yield curve' it is important to increase the number of *project specific sovereign ṣukūk*, issue them against diversified economic projects, and price them according to the economic realities of those projects and economic sectors. A benchmark created on the basis of such *ṣukūk* will then reflect the real economy's rate of return.

The use of project specific *ṣukūk* as instruments of liquidity management is indeed superior to the use of commodity *murābaḥah* for this purpose because project specific *ṣukūk* are more tied to underlying economic activity than commodity *murābaḥah*.

4.2. Issues in Regulatory Framework for Liquidity Risk Management

Proper guidelines need to be developed on liquidity management for Islamic banks. These guidelines can be 'principles based' in the first stage in order to encourage and develop a liquidity risk management culture. However, sooner concrete measures from national level regulators will also be needed supported by quantitative measures of liquidity risk and their enforcement.

Liquidity risk is generated from various sources and different risks culminate to it. Therefore, an approach for overall risk management is needed to contain the liquidity risk. However, the primary focus of the regulatory efforts for liquidity risk management is to create and meet certain liquidity ratios, which takes the focus of bank mangers away from the real issue to just meeting those ratio requirements. Ideal regulatory measures should not only look at risk in holistic manner but should also account for banks' specific characteristics as well as more generalized ratios and measures for liquidity risk management geared towards systemic stability. The principles of Islamic finance such as prohibition of interest and avoidance of *gharar;* rules of trade such as prohibition of sale without ownership, and emphasis on linking finance and returns with real economy not only control the undue credit expansion and debt accumulation but also bring liquidity and liquidity risk management to the attention of financial institutions.

Further research is needed to find the drivers of liquidity risk in Islamic banking sector and how different it is from conventional banking sector. For example, whether, equity base, asset size, the proportion of *murābaḥah* in total assets or liabilities and the size of deposits have any relation with liquidity risk. To what extent existence of regulatory rules for liquidity risk management contribute to reduction in liquidity risk? Can a system-wide index of liquidity risk for Islamic banking be created? All these form important questions for research.

4.3. Importance of Principles of Islamic Finance in Liquidity Risk Management

At this juncture it is also important to emphasise the role of Islamic principles of finance and trade. These principles such as prohibition of interest, avoidance of *gharar;* the other simple principles such as ‘do not sell that you do not own’, prohibition of trade of debts etc, make risk management, including the liquidity risk management, endogenous to the system. Then only little support is needed from external regulations to discipline the violators.

4.4. Out of the Box Thinking

Out of the box thinking is needed to come up with solutions. Researchers and policy makers need not confine their thinking within the present model of commercial banking and the set-up of the existing financial sector. Alternative financial institutional structure can be envisaged in which banks create a series of deposit pools instead of a common pool. Each deposit pool is for different maturity and duration and used for investments accordingly. Such arrangement minimizes liquidity risk for the banks, and provides better justice or fair treatment to the depositors whose money the banks use. One such proposal is eluded to in Tahir (2006). Another possibility is to create interbank placement arrangement through Unrestricted *Wakālah* on segregated asset pools. The concept of fund placement through *Wakālah* arrangement has already come into practice. The advantage of *Wakālah* over commodity *murābaḥah* is that it does not necessitate sale and re-purchase. IIFM is working on standardized documentation of Unrestricted *Wakālah* contracts (see Alvi 2011).

5. Conclusions

The business model of Islamic banking is changing over the time and moving in a direction where it is acquiring more liquidity risk. The three measures of liquidity risk used in this paper point to this conclusion. A number of factors including competition with conventional banks can be cited as the reason for this situation. However, such investigation can form the agenda for another research.

Better approach to risk management is not to treat only the symptoms but to acquire understanding of the underlying causes where the corrections are needed. This requires risk management of banks across their business lines, since liquidity risk may be emanating from some fundamental causes which if corrected will alleviate the problem.

Think and work for systemic changes that will facilitate implementation of Islamic principles of finance. Many problems of liquidity risk will be address through this approach. Still proper management of liquidity risk and regulatory oversight will remain important. In this regard the regulations should look at liquidity risk in combination with capital regulations and aggregate debt of the economy and of the financial sector. These aspects are altogether missing in the current regulatory thinking.

There were some good proposals put forward by academia and regulators in the aftermath of the global financial crisis. These were much closer to the principles of Islamic economics and finance. However, those proposals were not given their due weight in the reform efforts taken up by the Basel Committee and international forums like G-20. The approach taken is to tweak and fine tune the existing framework which is politically easy but does not address the fundamental problems which remain at the heart of the crisis. Islamic finance practitioners, researchers and regulators have to shoulder this responsibility to make a change in the global financial system.

Appendix-1

Basel III on Liquidity Risk

The financial crisis highlighted the lack of sound liquidity risk management at financial institutions and the need to address systemic liquidity risk—the risk that multiple institutions may face simultaneous difficulties in rolling over their short-term debts or in obtaining new short-term funding through widespread dislocations of money and capital markets. IMF Global Financial Stability Report (GSFR) 2011 takes the view that liquidity risk can materialize in two basic forms:

- Market liquidity risk, which is the risk that a firm will not be able to sell an asset quickly without materially affecting its price;[21] and
- Funding liquidity risk, which is the risk that a firm will not be able to meet expected cash flow requirements (future and current) by raising funds on short notice.

Under Basel III, individual banks will have to maintain higher and better quality liquid assets and to better manage their liquidity risk. However, because they target only individual banks, the Basel III liquidity rules can play only a limited role in addressing systemic liquidity risk concerns. Larger liquidity buffers at each bank should lower the risk that multiple institutions will simultaneously face liquidity shortfalls; but the Basel III rules do not address the additional risk of such simultaneous shortfalls arising out of the interconnectedness of various institutions across a host of financial markets.

Basel III establishes two liquidity standards—a liquidity coverage ratio (LCR) and a net stable funding ratio (NSFR) to be introduced after an observation period and further refinements. Principles for liquidity risk management existed before the crisis, but these rules represent the first time that quantitative standards for liquidity risk have been set at a global level.[22]

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21 Market liquidity can also be defined as the difference between the transaction price and the fundamental value of a security (Brunnermeier and Pedersen, 2009)

22 The latest version of the framework was published in December 2010. An observation period will precede official implementation of the ratios as a minimum standard. In both cases, any revisions to the factors will be finalized one and a half years before their implementation, which will be on 1 January 2015 for the LCR and 1 January 2018 for the NSFR

The LCR aims to improve a bank's ability to withstand a month-long period of liquidity stress as severe as that seen in the 2007-08 financial crisis. The LCR is defined as the "stock of high-quality liquid assets" divided by a measure of a bank's "net cash outflows over a 30-day time period". The resulting ratio should be at least 100 percent.

The NSFR aims to encourage more medium and long-term funding of the assets and activities of the bank, including off-balance sheet exposures as well as capital market activities, and thereby reduce the extent of maturity mismatch at the bank. In theory, this would lower a bank's probability of liquidity runs and associated default. The ratio is defined as a bank's available stable funding (ASF) divided by its required stable funding (RSF) and must be greater than 100 percent.

Proposed Measurement Methods of Systemic Liquidity Risk

Three measurement methods, which are complementary to the Basel III liquidity standards, are proposed and expected to accomplish two goals: (1) measure the extent to which an institution contributes to systemic liquidity risk; and (2) use this to indirectly price the liquidity assistance that an institution would receive from a central bank. Proper pricing of this assistance would help lower the scale of liquidity support warranted by a central bank in times of stress.

The methods are (1) a systemic liquidity risk index (SLRI), that is, a market-based index of systemic liquidity based on violations of common arbitrage relationships; (2) a systemic risk-adjusted liquidity (SRL) model, based on a combination of balance sheet and market data and on options pricing concepts of a financial institution, to calculate the joint probability of simultaneous liquidity shortfalls and the marginal contribution of a financial institution to systemic liquidity risk; and (3) a macro stress –testing model to gauge the effects of an adverse macroeconomic or financial environment on the solvency of multiple institutions and in turn on systemic liquidity risk. Details of the proposed methodologies are depicted in the table below.

Main Features of the Proposed Methodologies

Features	Systemic Liquidity Risk Index (SLRI)	Systemic Risk-adjusted Liquidity (SRL) Model	Stress-testing (ST) Systemic Liquidity Risk
Indication of systemic liquidity risk	Sharp declines in the SLRI.	Joint probability that firms will experience a funding shortfall simultaneously (i.e., all risk-adjusted net stable funding ratios (NSFRs) fall below 1 at the same time).	Probability that a given number of banks end stress test with negative net cash flow.
Dimension	Time-series and cross-sectional	Time-series and cross-sectional	Time-series and cross-sectional
Macroprudential tools	Insurance premia used to assess institutions for their exposure to systemic liquidity risk.	Price-based macroprudential insurance premia and/or capital surcharge—used for costing contribution of an institution to systemic liquidity risk.	Capital surcharge used to minimize the probability of triggering a liquidity run for a bank.
Modeling technique	Exploits breakdowns of arbitrage relations, signaling market participant's difficulties in obtaining liquidity. Uses principal components analysis.	Uses advanced option pricing to convert an accounting measure of liquidity risk (NSFR) into a risk-adjusted measure of liquidity risk at market prices, and, thus, is forward-looking by definition.	Derives banks' net cash flows as the result of a stress test. Uses Monte Carlo simulation, network analysis, valuation equations for bank positions, and assumptions about a bank creditors' funding withdrawal response to solvency concerns.
Stochastic or deterministic assessment of liquidity risk	Stochastic, based on bank's equity volatility associated with the SLRI.	Stochastic, based on the exposure to funding shocks, which takes into account the joint asset-liability dynamics in response to changes in market rates.	Stochastic , based on banks' probability of default and bank creditors' response to solvency concerns.
Market/Transaction based	Market-based.	Market-based.	On- and off-balance-sheet-transaction based.
Treatment of funding and market liquidity risks	Indirectly. The SLRI is used to measure heightened market and funding liquidity risks.	Market and funding risks are embedded in equity prices, funding rates, and in their volatility.	Explicit modeling of funding and market liquidity risks using behavior observed during the recent crisis.
Treatment of solvency-liquidity feedbacks	Attempts to isolate counterparty risk to create a clean measure of liquidity risk.	There is no explicit treatment of the impact of solvency risk on liquidity risk. However, the derived risk-adjusted NSFR embeds a recognition that banks are vulnerable to solvency risks.	Integrates solvency and liquidity risks explicitly as well as second round feedback between them.
Treatment of channels of systemic risk	Not modeled directly.	Estimates the non-linear, non-parametric dependence structure between sample firms so linkages are endogenous to the model and change dynamically.	Captures institutions' common sources of asset deterioration—including price spirals driven by asset fire sales, network effects, and contagion.
Ease of computation	Econometrically simple and easy to compute.	Econometrically complex and time consuming.	Econometrically complex and time consuming.
Data requirements	Based on publicly available market data. Can be applied to any institution and system with publicly traded securities. No use of supervisory data.	Minimal use of supervisory data. Approach relies on pre-defined prudential specification of liquidity risk (e.g., NSFR) to assess the impact of maturity mismatches but can be directly linked to non-diversifiable liquidity risk, such as the SLRI.	Can be applied to any institution/system, even those that are not publicly traded. Requires detailed supervisory data, including data to assess underlying credit risks of institution assets.

Source: IMF Global Financial Stability Report (2011)

Appendix - 2

Data Description

Data for Islamic Banks is obtained from "Islamic Banks Information System" (IBIS) provided by Islamic Research and Training Institute. The IBIS is available on-line at www.ibisonline.net

We used data from 61 Islamic Banks from 18 countries for the period 2000 to 2009. However, due to missing values in some years for some banks or because of new banks coming into existence in some countries the sample has to be adjusted accordingly. Hence it is unbalanced dynamic sample. Following table shows the distribution of our sample coverage by showing actual number of Islamic banks covered in each country by each year. In total 524 data points were used for analysis.

Description of Data: Number of Islamic Banks Covered by Country and Year

Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Total Data Points
Algeria	1	1	1	1	1	1	1	1	1	1	10
Bahrain	7	8	9	8	9	11	12	11	11	10	96
Bangladesh	2	2	2	2	2	2	2	2	2	2	20
Egypt	2	2	2	2	2	2	2	2	2	2	20
Indonesia	2	2	2	2	2	2	2	2	2	2	20
Jordan	2	2	2	2	2	2	2	2	2	2	20
Kuwait	2	2	2	2	2	2	2	2	2	2	20
Malaysia	3	3	3	3	3	4	3	3	3	3	31
Pakistan	2	2	2	1	3	3	3	4	4	3	27
Palestine	1	1	1	1	1	1	1	1	1	1	10
Qatar	3	3	3	3	3	3	3	3	3	3	30
Saudi Arabia	2	2	2	2	2	2	2	2	2	2	20
South Africa	1	1	1	1	1	1	1	1	1	1	10
Sudan	5	8	8	10	6	9	10	9	9	7	81
Tunisia	1	1	1	1	1	1	1	1	1	1	10
Turkey	3	3	3	3	3	4	4	4	4	4	35
UAE	3	3	3	3	4	4	4	5	5	5	39
Yemen	2	2	3	3	3	3	2	3	2	2	25
Total Banks	44	48	50	50	50	57	57	58	57	53	524

The full set of data was not available for all variables, as there can be missing observations. When this occurred the sample is adjusted suitably.

The variables used for this study include: total assets, liquid assets, cash & cash equivalents, total financing, total deposits, maturity of assets, maturity of liabilities.

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RESOLUTIONS OF OIC *FIQH* ACADEMY

Islamic Economic Studies
Vol. 21, No. 1, June 2013

Resolution of OIC Fiqh Academy
(related to Islamic Economic and Finance)

بسم الله الرحمن الرحيم

Resolution No.186 (1/ 20) on: Rules of Insolvency and Bankruptcy in Islamic Sharīʿah and Contemporary Systems

The Council of the International Islamic Fiqh Academy (IIFA) meeting in its 20th Session in Oran (People's Democratic Republic of Algeria), from 26 Shawwal to 2 Dhul Qadah 1433H (13-18 September, 2012).

Having regard to the researches received from the Academy on the above subject, and having listened to the discussions on the subject,

DECIDES the following:

First: Definition of Insolvency and Insolvent Debtor

1. Taking into account the text of paragraph 7 of the Academy's Decision No. 64(2/7 concerning the type of insolvency that requires respite, insolvency is defined as a temporary circumstance that befalls a person making him incapable of meeting his financial obligations and paying his debts. The insolvent is a person who fits this description.

2. Bankruptcy criterion: lack of sufficient funds to settle debts. A bankrupt person is one who fits this description.

Second: The Main Differences between Insolvency and Bankruptcy According to Islamic Jurists

1. Insolvency may or may not be preceded by a condition of solvency, whereas Bankruptcy cannot happen except when it has been preceded by a condition of solvency.

2. A bankrupt person could be restrained, whereas as the insolvent may be given respite if he can prove his insolvency based on Sharīʿah tenets: Allah's decreed that, "If the debtor is in straitened circumstances, then grant him respite till a time of ease" (Surat al-Baqarah, verse 280).
3. A Judge may not order the detention of an insolvent person if insolvency is established, whereas a bankrupt person may be detained for acts of fraudulence and forgery or negligence, and nonfeasance.
4. Insolvency can result from debt or legitimate expenditure, unlike bankruptcy which can only come from debt.

Third: **Rules of Bankruptcy in Islamic Jurisprudence**

1. Prevent the bankrupt from disposing of his assets to the detriment of creditors, such as giving out donations, financial tradeoffs, admission of debt after declaration of bankruptcy. A ruling preventing the bankrupt from acts of disposition of assets and termination of such a ruling shall be in accordance with the decision of a competent judge.
2. The bankrupt may be prevented from travelling if that could cause an apparent harm to the rights of creditors.
3. Expiration of deferred debt deadlines given to the bankrupt.
4. A competent judge may order the disposal of the bankrupt's assets in a manner that is beneficial to the creditors and the debtor by sharing the value. If new assets emerge for the debtor, the creditors have the right to demand payment of the remainder of their debts.
5. The creditor reserves the right to recover his asset, if found unaltered among the assets of the bankrupt if he was not paid for it.

Fourth: Imposition of Fine on Procrastinating Solvent Debtor

The Academy re-affirms what was stated in its earlier Decision No. 51(2/6), item 3, concerning selling by installments, forbidding imposition of a fine on a procrastinating solvent debtor, but such a debtor may be charged with payment of judicial expenses.

Fifth:

The Academy is of the view that the following issues concerning insolvency be deferred to the next session:

1. Juristic issues concerning the protection of Islamic financial institutions including the question of debt insurance and obligation to pay pledged donations.
2. Rules on actions of the bankrupt during the uncertainty period.
3. Rules on the bankruptcy of companies and financial institutions in the light of contemporary systems.
4. Issues pertaining to insolvency (civil), where the term insolvency in some ordinances covers both bankruptcy and insolvency in Islamic jurisprudence.

بسم الله الرحمن الرحيم

Resolution No.187 (2/ 20) on:
Cooperative Insurance: Sharīʿah Rules and Regulations

The Council of the International Islamic Fiqh Academy, meeting in its 20th Session in Oran (People's Democratic Republic of Algeria), from 26 Shawwal to 2 Dhul Qadah 1433H (13-18 September, 2012);

Having considered the researches received from the Academy on the subject: "Cooperative Insurance: Sharīʿah Rules and Regulations" during this session and the previous sessions; and

Having listened to the recommendations adopted by the Conference on "Cooperative Insurance: Dimensions, Perspectives, and the Position of the Islamic Sharīʿah" held in Amman (Hashemite Kingdom of Jordan), from 26-28 Rabi' al-Thani 1431H (11-13 April, 2010) in collaboration with the International Islamic Fiqh Academy, the Islamic Educational, Scientific and Cultural Organization, the University of Jordan, and the Islamic Research and Training Institute (member of the Islamic Development Bank Group); and having listened to the debates on the issue,

DECIDES the following:

First: Reaffirms its resolution No. 9/2 that the fixed premium insurance contract applied by commercial insurance companies is an exchange contract which involves significant risk (*gharar*) invalidating the contract and is therefore forbidden according to the Sharīʿah.

The alternative, which is compatible with the rules of transactions in Islam, is cooperative Insurance based on donation and cooperation.

Second: Given the problems that emerged during a number of applications within Islamic insurance companies, as well as statutory and regulatory obstacles encountered in this process, there is a need for a comprehensive conception about cooperative insurance,

The Academy recommends the following:

- Mandates the Secretariat of the Academy to constitute a committee of Islamic jurists and experts in cooperation with the relevant research centers in order to arrive at a comprehensive draft rules and regulations for cooperative insurance. Such a draft should include Sharīʿah -compatible models allowing flexibility in practical implementation. This should include rules and regulations based on Sharīʿah which stipulate the basic principles of cooperative insurance such as:

1. The concept and nature of cooperative insurance from the perspective of the Islamic Sharīʿah
2. Comparison between cooperative insurance and commercial insurance:
   (a) Comparison between Sharīʿah -compatible cooperative insurance and international principles of cooperation.
   (b) Comparison between Sharīʿah -compatible cooperative insurance and the principles of commercial insurance.
3. Relationships between parties to cooperative insurance and their descriptions, especially description of relationships between subscribers to the insurance pool, and the relationship between the pool and those entrusted with its management.
4. Compensation rules for the manager of the pool and its estimation criteria.
5. Rules on insurance surplus and deficit
6. Sharīʿah regulations on subscription to, and withdrawal from, the cooperative insurance pool
7. The Sharīʿah rules on liquidation of a cooperative insurance pool
8. Rules and regulations on re-insurance
9. The principle of participation in profit and loss
10. Principle of substitution and related matters
11. Principle of insurance deduction and related matters.

Third : The proposed draft to be agreed upon by the Committee shall be submitted to the next session of the Academy in order to prepare a draft resolution in the light of what was stated in paragraph 2 above.

Allah Knows Best

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EVENTS AND REPORTS

Islamic Economic Studies
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Risk Management Meeting on Islamic Banking
December 10, 2012, IDB Headquarter, Jeddah

IRTI hosted a joint consultative meeting on Risk Management in collaboration with GARP (Global Association of Risk Professionals), a leader in global financial risk testing and certification programs. Other IDB Group departments such as IFPDC (Islamic Financial Product Development Center) and GRMD (Group Risk Management Department) collaborated in the event held at the IDB Headquarters.

The event mainly sought to achieve four objectives: (i) to identify issues considered important to market players, regulators, stakeholders, Sharīʿah scholars and researchers; (ii) to identify risk management and measurement tools applicable to Islamic financial institutions in accordance with Sharīʿah principles; (iii) to serve as a basis for further policy and technical discussions with stakeholders of the Islamic financial industry, and (iv) to provide a market review as a basis to determine a priority for the development of risk management framework. The participants also discussed prioritizing the development of practice driven risk management standards which will allow for more rapid implementation of the general principles enunciated by the Islamic Financial Services Board (IFSB), the international standard setting body that promotes and enhances the soundness and stability of the Islamic financial services industry.

Given the background of GARP in risk management and the rich background of IDB in Islamic finance, the two institutions are expected to come up with a road map on how to address Islamic finance-related risk management issues. Since 2011, IRTI and GARP have been discussing a joint pilot project to map and measure risks in Islamic financial products to develop practice driven learning material for risk professionals.

"This joint effort will be fruitful for the industry as a whole", explained Dr. Ahmed Jachi, Chairman, Islamic Finance at GARP adding; "Islamic banks performed in a better way than conventional banks in terms of the effects of the global economic crisis. However, at the end of the day, there are risks whether you are Islamic or Conventional. If Islamic banks address these issues more properly, they may be in a better position than the Conventional banks."

Dr. Azmi Omar, Director General, IRTI, on the occasion emphasized the need to come up with an integrated set of principles and best practices for managing risks in Islamic banking and to disseminate it at a global level.

To begin with, IRTI and GARP are to initiate a pilot project on risk mapping measurement and mitigation of *Murābaḥah* instrument. The scope could be extended to other instruments after the successful conclusion of the pilot project. The participants at the meeting further expressed willingness, with no binding commitment, to help in the project by sharing information, providing advice and insight for the successful completion of the pilot project.

The event was attended by 30 delegates from 13 entities including the World Bank and the International Monetary Fund (IMF); regulators from State Bank of Pakistan, Bank Indonesia, Central Bank of Kuwait and Bank Negara Malaysia, Bank Muamalat Indonesia, Bahrain Islamic Bank, Jordan Islamic Bank, Saudi Economic and development Company (SEDCO) Holding, the National Commercial Bank (NCB), representatives from IDB Group entities and Path Solutions (a leading software provider for the financial services industry with special focus on Islamic banking).

(Summarized by Salman Syed Ali, Hylmun Izhar and Ahmad Jachi)

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Expert Group Meeting on the
Financial Sector Assessment Program for Islamic Finance (*i*FSAP)
December 11, 2012, IDB Headquarter, Jeddah

IRTI-IDB has been working on developing a template for Islamic financial sector assessment program (*i*FSAP). The target is to develop supplementary templates that are consistent with Islamic finance requirements and that can help the World Bank – International Monetary Fund in the financial sector assessment program (FSAP) that they routinely carry out for their member countries. An initial study was undertaken in 2008-9 to identify the gaps and needs in the current FSAP if it is applied to Islamic financial sector. Based on that, a second study was started in 2010-11 in consultation with institutions such as IFSB, AAOIFI, World Bank, IMF and financial authorities (central banks, capital market authorities, insurance supervisors, and governments) to define the position of Islamic financial sector within the global finance and come up with some draft templates for assessment of this sector's stability and development needs. A working draft of this study has been completed and shared with others in the Expert Group Meeting on *i*FASP held on December 11, 2012 in IDB Headquarters.

The full day Meeting was attended by representatives of the IFSB, AAOIFI, IIFM, World Bank, IMF, Central Bank of Bahrain, and financial sector experts from within and outside the IDB. The focus of discussion was the above mentioned study to comment and share expert opinions for its further refinement.

The present study identifies potential differences and similarities of the regulatory frameworks of the conventional and Islamic systems. It offers a method for global integration of the Islamic financial industry into the international market and shows how the Islamic financial industry can contribute to economic development and financial stability. It also provides some analytical grounds for governments that wish to develop Islamic finance within its jurisdictions, whilst maintaining its financial soundness and operational efficiency.

The study explores two major areas: potential observance of international best practices set out in the regulatory standards and the prudential measures allowing the supervisors to always maintain financial soundness. In the area of regulatory standards, the study focuses on the compilation process of the main documents on the international regulatory standards issued by the conventional bodies and the international standard setter for Islamic finance. This compilation process is aimed at identifying the existing gaps that should be filled by the Islamic regulatory setting bodies so that it could serve as reference points for financial supervisors. The regulatory framework covers the banking industry, capital market, insurance, social sector, accounting standards and other aspects relating to the infra-structural development.

The project's objectives are:

1- A compilation of the international regulatory standards as the reference point for regulatory observance. This include the compilation of the conventional and Islamic regulatory standards.

2- Identification of potential adoption of the existing framework and the needs for the development of the Islamic regulatory framework at both micro and macro levels.

3- Setting up templates to complement the current FSAP framework, particularly when it comes to the assessment of the Islamic financial industry.

(Summarized by Dadang Muljawan and Salman Syed Ali)

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Lecture on
The Reform of UK Financial Regulations
December 10, 2012, IDB Headquarter, Jeddah
Delivered by Prof. Maximillian J.B. Hall
(Professor of Banking and Financial Regulation in the Economics Department at Loughborough University)

Background of the Lecture

Taking advantage of the presence of Prof. Maximillian J.B. Hall in Jeddah for his participation in the Expert Group Meeting on Financial Sector Assessment Program, IRTI invited him to give a lecture on “The Reform of UK Financial Regulations”. The objective of the lecture was to provide updated information about the current trends in the development of regulatory environment of the international financial markets. Historically, UK has been a trend setter for other jurisdictions in financial development and regulation. The participants of the lecture were made aware of how the UK financial authorities reacted to the financial crisis and took precautionary actions in anticipation of the potential adverse financial situation.

Summary of the Lecture

Some important points that can be noted from the lecture are the following.

1. Introduction of the new Banking Act in February 2009 has created a new ‘special resolution regime’ in the UK. It has handed a new financial stability mandate to the Bank of England and strengthened the ‘Memorandum of Understanding’ under which the Tripartite Authorities operate. The financial reform debate has since intensified.
2. A major catalyst for this was publication of the ‘Turner Review’ which was followed by publication of the Labour Government’s and the Conservative Party’s White Papers on financial reform.
3. The Bank of England and the FSA also contributed, at various points in time, to the debate as they “battled for turf” under the new world order.
4. A new coalition government was elected in 2010 and the Conservative Party’s previously-espoused views were more or less adopted in their entirety in the new government’s White Paper on financial reform. Moreover, the new Chancellor of the Exchequer, in his Mansion House

speech of 15 June 2011, committed the government to accepting the main findings of the Independent Commission on Banking (a body it set up), three months in advance of publication of its final report.

5. A comparison of all the protagonists' views reveals a remarkable degree of unanimity on how regulatory and supervisory policies ought to be developed to prevent a recurrence of the type of financial crisis recently experienced around the globe.
6. Perhaps unsurprisingly, however, given their differing vested interests, there is little agreement on how the domestic financial architecture ought to be re-fashioned to facilitate delivery of the proposed package of reforms.
7. At the end of the day, however, it will be down to ordinary people – regulators, central bankers, supervisors, auditors, compliance officers, board members, etc. – to deliver what society expects from reform, whatever the design of policy and the form of the institutional architecture and financial infrastructure put in place to facilitate it.

(Summarized by Dadang Muljawan)

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ANNOTATED LIST OF IRTI'S RECENT PUBLICATIONS

Credit Risk Transfer

Author: Abd Elrahman Elzahi Saaid Ali

Published by
Islamic Research and Training Institute (IRTI)
A Member of Islamic Development Bank Group (IDB)

This study investigates the impact of credit risk transfer on Islamic banks' lending behavior and financial stability. The recent financial crisis has further increased the interest to investigate techniques of credit risk management by banks in general and Islamic banks in particular. The behavior of credit risk transfer of the commercial banks has been studied in the framework of conventional banks but little attention has been paid to the behavior of credit risk transfer of the Islamic banks. Therefore, the study intends to fill this gap. Data were collected from 60 Islamic banks and analyzed in panel-pooled framework to investigate the behavioral impact of the credit risk transfer.

Most of the estimated variables such as the Islamic banks total lending to asset ratio (TL/A), equity capital to assets ratio (CAP/A), liquidity to assets ratio (LIQ/A), profitability ratio (ROA), and credit risk transfer (CRI) proxy by dummy variables, Gross Domestic Product (GDP) and the exchange rate (EXR) were significant either at 1% level or 5% level, with the expected signs.

The research finds that Islamic banks with low capital might adjust their lending by reducing their assets up to the required level rather than raising it. This is due to the cost of acquiring additional capital. Likewise, Islamic banks reduce their lending portfolio when they fall short in the liquidity level. However, this might shrink their volume of lending.

The study attempts to capture the impact of credit risk transfer on the lending behavior of the Islamic banks through a proxy of dummy variables, which were found to be positively related. Credit risk transfer and banks' lending behavior shows that Islamic banks behave in risk averse manner when some sorts of credit risk management techniques are used. These results are consistent with previous findings regarding conventional banks, which behaved more aggressively in granting more loans when they used advance risk management techniques. Hence, this study concludes that there is no significant difference in the behavior of credit risk transfer of the Islamic banks and their conventional counter parts when modern risk management techniques of credit risk transfer are used. Since, Islamic banks were using less modern credit risk transfer techniques at the time when the financial crisis hit the entire globe; therefore, they remained relatively stable during the recent financial crisis.

Lessons learned:

1. Using more risk management techniques might lead to more credit risk as the banks become less risk averse in lending.
2. Banks whether conventional or Islamic need to pay more attention and behave more rationally when they are using modern risk instruments to manage their credit risk.
3. Islamic banks were resilient and relatively stable during the recent financial crisis because they were not using modern credit risk management instruments like financial derivatives, which were part of the causes of the crisis.
4. Islamic banks need to be very selective when they choose one or the other techniques for credit risk management to mitigate their risk.
5. To avoid the risk of financial instability, banks regulators are advised to monitor Islamic banks more closely when they try to select and use modern risk management instruments.

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ABSTRACTS OF ARTICLES PUBLISHED IN *DIRASAT IQTISADIAH ISLAMIAH* IN VOL. 19 No. 1

إنجاح الصيغ الإسلامية في التمويل الأصغر:
مع الإشارة إلي تجربة بنك الأسرة (السودان)

عصام محمد علي الليثي[1]

مستخلص البحث

(Published in Dirasat Iqtisadiah Islmiah Vol. 19 No.1)

يعتبر الكثير من العلماء والمنظرين في مجال التمويل الإسلامي Islamic Finance أن التمويل الأصغر من أفضل السبل لتحقيق الغايات الأساسية للتمويل الإسلامي المتمثلة في إعادة توزيع الثروة والفرص Wealth and Opportunity Redistribution، لا سيما أنه يلبي احتياجات الشرائح الفقيرة من السكان الذين هم خارج نطاق الحصول على الخدمات المالية الرسمية كما أنه يعمل على إدراجهم ضمن المستفيدين من هذا القطاع الهام والحيوي تحقيقا لما يعرف بمبدأ الشمولية المالية Financial Inclusiveness.

في المقابل، يري كثير من الممارسين Practitioner في مجال التمويل الأصغر أن التمويل الإسلامي حقق نجاحات متواضعة جدا في مجال التمويل الأصغر، خصوصا بالمقارنة مع نظيره التمويل الأصغر التقليدي Conventional Microfinance. ويلقون باللوم في هذا الجانب على الصيغ الإسلامية في التمويل الأصغر باعتبار أنها تمثل جوهر الاختلاف والخلاف بين التمويل الأصغر التقليدي والتمويل الأصغر الإسلامي. فهؤلاء يرون أن بعض هذه الصيغ تواجه العديد من المشكلات التي تحول دون إمكانية تطبيقها على أرضية الواقع، وبعضها الآخر ينطوي على تكاليف عالية تقلل من جدوى استخدامها في توصيل خدمات التمويل الأصغر للفئات المستهدفة. وعليه، فإن الهدف من هذه الورقة البحثية هو النظر في إمكانية الإجابة على التساؤلات التالية:

- هل تصلح الصيغ الإسلامية لتوصيل خدمات التمويل الأصغر؟
- ما هي مقومات نجاح صيغ التمويل الأصغر الإسلامية؟

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* أستاذ مشارك بقسم الاقتصاد - أكاديمية السودان للعلوم المصرفية والمالية.

- ما هي الضمانات التي يلزم توفرها لتوصيل خدمات تمويل أصغر إسلامية بصورة مستدامة؟

ستتم الإجابة عن هذه التساؤلات المثارة من خلال استعراض إحدى تجارب بنك الأسرة (السودان) وتحليلها في مجال توصيل خدمات التمويل الأصغر لشريحة الفقراء وفئاتها المختلفة، خاصة شريحة الخريجين. وسيكون تنظيم هذا البحث على النحو التالي: يخصص القسم الأول منه للمقدمة التي يسلط فيها الضوء على أوجه الشبه وأوجه الاختلاف بين التمويل الأصغر الإسلامي والتمويل الأصغر التقليدي. أما القسم الثاني من البحث فسوف يخصص للتعرف على مقاصد الصيغ الإسلامية وخيارات استخدامها في التمويل الأصغر والانتقادات الواردة عليها، في حين يتم في القسم الثالث من البحث عرض وتحليل تجربة بنك الأسرة، بينما سيفرد القسم الرابع للخلاصة ومناقشة نتائج البحث.

Success of Islamic Modes in Microfinance: The Experience of the Family Bank (Sudan)

Essam Mohamed Ali Laithi

Abstract

Many scholars and theorists in the field of Islamic Finance consider Microfinance as the best method to achieve the core goals of Islamic finance to realizing redistribution of wealth and opportunities. Microfinance meets the needs of poorer segments of the population who are outside the scope of access to official financial services. It also works to include these segments among the beneficiaries of this important and vital sector to achieve what is known as the principle of Financial Inclusiveness.

In contrast, many practitioners in the field of microfinance claim that Islamic finance has achieved very modest success in the Islamic microfinance, especially in comparison with the Conventional Microfinance. The reason in this aspect is the Islamic Modes of microfinance as it represents the essence of the difference and disagreement between conventional microfinance and Islamic Microfinance.

Practitioners believe that some of these Modes have obstacles that hinder the possibility to actually be applied on the floor, others involve high costs which reduce the feasibility of their use in the delivery of microfinance services to the target groups.

Accordingly, the objective of this paper is to consider the possibility of answering the following questions:

- *Are the Islamic Modes suitable to deliver microfinance services ?*
- *What are the elements of success of Islamic microfinance Modes ?*
- *What are the safeguards that are needed to deliver Islamic microfinance services in a sustainable manner ?*

All these raised questions would be answered through review and analysis of the experience of the Family Bank (Sudan) in delivery of microfinance services to the poor and its different segments, especially the segment of graduates.

This paper will be divided as follows: Section (1) is an introduction which sheds light on the similarities and differences between Islamic microfinance and conventional microfinance; Section (2) will be devoted to identify objectives of Islamic Modes, alternatives used in Microfinance and criticism; Section (3) displays and analyzes the experience of Family Bank; and Section (4) will consist of conclusion and resolutions.

إدارة المخاطر في الصيرفة الإسلامية في ظل معايير بازل

طهراوي أسماء•، وبن حبيب عبد الرزاق*

ملخص

(Published in Dirasat Iqtisadiah Islmiah Vol. 19 No.1)

شهدت العمليات المصرفية والمالية في السنوات الأخيرة العديد من التغيرات المهمة خاصة تلك المتعلقة بسياسات التحرير المالي كانت السبب الرئيسي في حدوث الأزمات المالية والبنكية. ومن هنا برزت ضرورة تطوير الآليات المتعلقة بتسيير المخاطر وإدارتها في كل المؤسسات البنكية والمالية وحتى الإسلامية.

حققت الخدمات المالية الاسلامية خلال السنوات الماضية نجاحــاً كبيراً ونمواً متميزاً، وسجلت حضوراً قوياً في أوساط القطاع المصــرفي والمالي، لكن على الرغم من نمو الصناعة المصرفية الإسلامية فإنها -شأنها في ذالك شأن الصناعة المصرفية التقليدية في

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العالم الإسلامي- تعاني العديد من المشكلات والتحديات المتعلقة بالمخاطر التي تتخلل صيغ التمويل والعمليات المصرفية الإسلامية وكيفية إدارتها، وبوجه خاص مخاطر الاستثمار وكيفية تطبيق مقترحات لجنة بازل الدولية، وبالتالي فهي مدعوة للاهتمام أكثر بنظام إدارة المخاطر والعمل على تطويرها.

ومن هنا تندرج هده الورقة البحثية في دراسة واقع المصرفية الإسلامية في ظل المعايير الاحترازية ومدى إمكانية تطبيقها للمعايير الجديدة. كما اهتمت هذه الدراسة باختبار أداء إدارة المخاطر في مجموعة البركة المصرفية وبيت التمويل الكويتي.

الكلمات المفتاحية: البنوك الإسلامية، إدارة المخاطر، اتفاقيات بازل، الأداء والكفاءة.

Risk Management in Islamic Banking under Basel Standards

Tehrawi Asmaa & Ben Habib Abdul Razzaq

(Published in Dirasat Iqtisadiah Islmiah Vol. 19 No.1)

Abstract

Banking and financial transactions have experienced in recent years a number of significant changes, especially those related to financial liberalization policies which were the main factor in financial and banking crises. Hence, the need arose to develop mechanisms for risk management in all banking and financial institutions including Islamic institutions.

Islamic financial services achieved over the past years a great success and significant growth, and registered a strong presence in banking and financial sector. Despite this growth, Islamic banking industry suffers, like traditional banking in the Muslim world, from many obstacles and challenges related to risks encountered in financial products and transactions management, particularly investment risks and how to implement the international proposals of Basel. Therefore, Islamic financial Industry is required to be more interested in developing risk management system.

The paper studied the status of Islamic banking in the light of prudential standards and the possibility of their application. The paper also examined the performance of risk management in Al Baraka Banking Group and Kuwait Finance House.

Keywords: Islamic banking, risk management, Basel, performance and efficiency.

CUMULATIVE INDEX OF PAPERS

CUMULATIVE INDEX OF PAPERS PUBLISHED IN PREVIOUS ISSUES OF *ISLAMIC ECONOMIC STUDIES*

PUBLICATIONS OF IRTI

LIST OF PUBLICATIONS OF THE ISLAMIC RESEARCH AND TRAINING INSTITUTE

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The seminar proceedings consist of papers dealing with theoretical and practical issues in Islamic banking.

☐ **ADVANCES IN ISLAMIC ECONOMICS AND FINANCE, (2007),** Vol. 1, pp. 532. **Price $ 20.0**
Munawar Iqbal, Salman Syed Ali and *Dadang Muljawan* (ed).,
Islamic economics and finance are probably the two fields that have provided important new ideas and applications in the recent past than any of the other social sciences. The present book provides current thinking and recent developments in these two fields. The academics and practitioners in economics and finance will find the book useful and stimulating.

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Salman Syed Ali (ed.),
This book brings together studies that analyze the issues in product innovation, regulation and current practices in the context of Islamic capital markets. It is done with a view to further develop these markets and shape them for enhancing their contribution in economic and social development. The book covers *ṣukūk*, derivative products and stocks in Part-I, market development issues in Part-II, and comparative development of these markets across various countries in Part-III.

☐ **ISLAMIC FINANCE FOR MICRO AND MEDIUM ENTERPRISES, (1432, 2011),** pp 264 **Price $ 30.0**
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This book is the outcome of First International Conference on “Inclusive Islamic Financial Sector Development: Enhancing Islamic Financial Services for Micro and Medium Sized Enterprises” organized by Islamic Research and Training Institute of the Islamic Development Bank and the Centre for Islamic Banking, Finance and Management of Universiti Brunei Darussalam. The papers included in this volume seek to deal with major issues of theoretical and practical significance and provide useful insights from experiences of real-life experiments in Sharīʿah -compliant MME finance.

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It is an attempt to present some economic dimensions of the major Islamic financing techniques in a comparative perspective.

☐ **CONTEMPORARY PRACTICES OF ISLAMIC FINANCING TECHNIQUES (1993),** pp.75 — **Price $ 5.0**
Ausaf Ahmad
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Sami Ibrahim al-Suwailem
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Abd Elrahman Elzahi Saaid Ali
The results of this research are expected to be valuable to the management of Islamic banks and to those who are engaged in the fields of Islamic banking and finance.

☐ **HANDBOOK OF ISLAMIC ECONOMICS, Vol. 1, Exploring the Essence of Islamic Economics, (1432, 2011),** pp.348 **Price $ 30.0**
Habib Ahmed & Muhammad Sirajul Hoque
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Nasim Shah Shirazi, Muhammad Zulkhibri Salman Syed Ali & SHAPE Financial Corp.
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Boualem Bendjilali and *Mohamed Alami (éd.)*
Actes de séminaire sur LA ZAKAT dont l’objectif est d’ ouvrir de nouvelles voies à la reflexion et de faire connaître les concepts, la méthodologie et les principes de base de la collecte et de la répartition de la Zakat.

☐ **DEVELOPPEMENT D'UN SYSTEME D'INSTRUMENTS FINANCIERS ISLAMIQUES (1995),** 328 pages — **Prix $ 10.0**
Mohamed Ariff and *M.A. Mannan* (éd.)
Actes de séminaire dont l'objectif principal était d'identifier les voies et moyens pour l'émission d'instruments financiers islamiques viables qui pourraient préparer le terrain à une mobilisation efficace des ressources financières dans les pays membres de la BID.

☐ **INTRODUCTION AUX TECHNIQUES ISLAMIQUES DE FINANCEMENT (1997),** 210 pages — **Prix $ 10.0**
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Ausaf Ahmed and *Kazim Awan*
Actes de séminaire dont l'objectif principal est de servir comme outil de base pour les étudiants et aux enseignants en économie islamique.

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Taher Memmi (éd.)
Actes d'un séminaire sur le développement durable qui présente, entre autres, la stratégie en cette matière de quelques pays membres de la BID.

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Taher Memmi (éd.)
Actes de séminaire sur la promotion et financement des micro-entreprises qui peuvent être utiles à tous ceux, décideurs, hommes et femmes du terrain, soucieux de faire de la micro-entreprise un outil efficace et durable de lutte contre la pauvreté.

☐ **LA ZAKAT ET LE WAQF : ASPECTS HISTORIQUES, JURIDIQUES, INSTITUTIONNELS ET ECONOMIQUES (1998),** 387 pages **Prix $ 10.0**
Boualem Bendjilali (éd.)
Actes de séminaire qui visent à faciliter l'accès des lecteurs francophones à la littérature sur l'économie islamique en général et la Zakat et le Waqf en particulier.

☐ **LES MODES DE FINANACEMENT ISLAMIQUES (1993)**, 48 pages **Prix $ 5.0**
Boualem Bendjlali (éd.)
Rapport d'un séminaire sur les modes de financement islamiques tenu en Mauritanie en 1413H (1992).

☐ **LES SCIENCES DE LA CHARI'A POUR LES ECONOMISTES: LES SOURCES DU FIQH, SES PRINCIPES ET SES THEORIES; LE FIQH DES TRANSACTIONS FINANCIERES ET DES SOCIETES; ET SON APPLICATION CONTEMPORAINE (2001),** 572 pages **Prix $ 15.0**
Boualem Bendjilali (éd.)
Actes de séminaire sur les sciences de la Chari'a pour les économistes dont l'objectif principal est de servir comme outil de base aux chercheurs, étudiants et enseignants en économie islamique sur les sources du *Fiqh.*

Recherches

☐ **LA COOPERATION ECONOMIQUE ENTRE LES PAYS DU MAGHREB (1985),** 138 pages **Prix $ 5.0**
Ridha Saadallah
Cet ouvrage traite de nombreux thèmes dont les ressources naturelles et humaines au Maghreb, le potentiel de coopération agricole et industrielle au Maghreb, etc.

☐ **PROFITS ET INTERETS BANCAIRES ENTRE L'ANALYSE ECONOMIQUE ET LA CHARI'A (1994),** 150 pages **Prix $ 5.0**
Abdelhamid El-Ghazali
Cet opuscule traite de l'intérêt bancaire face au profit en tant que mécanismes de gestion de l'activité économique. Une analyse de deux points de vue différents, celui de l'économie conventionnelle et celui de la Chari'a.

☐ **LA MOUDHARABA SELON LA CHARI'A ET SES APPLICATIONS CONTEMPORAINES (1994),** 83 pages **Prix $ 5.0**
Hassan El-Amin
Cette étude traite de nombreux aspects pratiques: légal, économique et bancaire.

☐ ***JOUALA* ET *ISTISNA,*** **Prix $ 5.0**
***Analyse juridique et économique* (1994) ,** 65 pages
Chaouki Ahmed Donia
L'intérêt de cette recherche réside dans le fait qu'elle aborde un nouveau domaine d'application des transactions économiques islamiques se basant sur deux contrats, à savoir "La Jouala et L'Istisna".

☐ **LA PROPRIETE FONCIERE EN ISLAM (1994) *(Enquête),*** 52 pages **Prix $ 5.0**
Mahmoud A. Guilaid
Le but de cette étude est d'examiner les questions les plus importantes concernant le droit de propriété foncière en Islam.

☐ **LES RELATIONS COMMERCIALES ENTRE LE CONSEIL DE COOPERATION DU GOLFE ET LA COMMUNAUTE EUROPEENNE (1995),** 152 pages, **Prix $ 5.0**
Du Passé Récent au Lendemain de 1992
Ridha Mohamed Saadallah
Cette étude procède à une analyse minutieuse des statistiques passées, des échanges commerciaux entre les pays du CCG et ceux de la Communauté Européenne en vue de dégager les tendances profondes et les caractéristiques structurelles du commerce Euro-Golfe.

☐ **ERADICATION DE LA PAUVRETE ET DEVELOPPMENT DANS UNE PERSPECTIVE ISLAMIQUE (1995),** 180 pages **Prix $ 5.0**
Abdelhamid Brahimi
Cette recherche, divisée en deux parties, traite dans la première des facteurs internes et externes de blocage et de l'impasse. La seconde est consacrée à la conception et à la mise en oeuvre de politiques économiques dans une perspective islamique.

☐ **JUGEMENT DU TRIBUNAL FEDERALISLAMIQUE DU PAKISTAN RELATIF A L'INTERET *(RIBĀ)* (1995),** 478 pages **Prix $ 15.0**
Ce document constitue un outil de travail et une référence indispensables à tous ceux, parmi les décideurs politiques et chercheurs dans les pays membres de la Banque, qui sont désireux de voir se développer l'alternative d'un système financier exempt d'intérêt.

Eminents Spécialistes

☐ **LES CONDITIONS MONETAIRES D'UNE ECONOMIE DE MARCHES DES ENSEIGNEMENTS DU PASSE AUX REFORMES DE DEMAIN (1993),** 64 pages **Prix $ 5.0**
Maurice Allais (Prix Nobel d'Economie - 1988)
L'auteur, dans son examen, critique du système monétaire international, appelle à des réformes tant économiques que morales.

☐ **JURISPRUDENCE DE LA *MASLAHA* ET SES APPLICATIONS CONTEMPORAINES (1995),** 92 pages — **Prix $ 5.0**
Hussein Hamed Hassan
L'étude, présente le point de vue islamique se rapportant à la question de l'intérêt publique, son lien avec la législation, ses conditions et ses dimensions juridiques; avec un certain nombre d'applications contemporaines.

☐ **JURISPRUDENCE DE LA NECESSITE (*FIQH* DE LA *DHARURA*) ET SON APPLICATION DANS LA VIE CONTEMPORAINE : PERSPECTIVE ET PORTEE (1996),** 259 pages — **Prix $ 10.0**
Abd al-Wahab I. Abu Sulayman
Cette recherche sur le *Fiqh de la Dharura* aborde le point de vue de la Chari'a islamique par rapport à la notion de *Dharura* (nécessité), ses conditions et ses perspectives juridiques.

☐ **COOPERATION ECONOMIQUE POUR UNE STABILITE REGIONALE (1996),** 37 pages — **Prix $ 5.0**
Bacharuddin Jusuf Habibie
Cet ouvrage porte sur l'importance coopération économique entre les pays en développement en général et entre les pays islamiques en particulier.

☐ **LE QIYAS ET SES APPLICATIONS CONTEMPORAINES (1996),** 139 pages — **Prix $ 5.0**
Mohamed Mokhtar Sellami
Uni conférence qui traite de l'une des sources de la jurisprudence, reconnue dans la science des fondements du droit sous le nom d'analogie (Qiyâs) et reconnue par l'ensemble des écoles juridiques comme preuve légale et méthode d'extraction des jugements.

Prix de la BID

☐ **LE SYSTEME BANCAIRE ISLAMIQUE : LE BILAN, (1996),** 65 pages — **Prix $ 5.0**
Ziauddin Ahmed
Le but de ce papier est d'examiner et d'évaluer la situation actuelle dans le domaine des banques islamiques aussi bien du point de vue théorique que pratique.

☐ **QU'EST-CE QUE L'ÉCONOMIE ISLAMIQUE? (1996),** 81 pages — **Prix $ 5.0**
Mohammad Umer Chapra
Conférence donnée par Dr. Chapra lauréat du Prix de l'économique islamique 1409H (1989) sur : l'économie conventionnelle et l'économie islamique.

☐ **EVOLUTION DES ACTIVITES BANCAIRES ISLAMIQUES: PROBLEMES ET PERSPECTIVES (1998),** 30 pages — **Prix $ 5.0**
Saleh Kamel
Conférence donnée par Cheikh Saleh Kamel lauréat du Prix de la BID en système bancaire islamique pour l'année 1416H (1995/96). Elle constitue une grande contribution à la compréhension de l'économie et du système bancaire islamiques et à leur évolution.

Traductions

☐ **VERS UN SYSTÈME MONÉTAIRE JUSTE, (1997),** 352 pages **Prix $ 10.0**

Mohammad Umer Chapra

Ce livre développe avec habilité la logique islamique de la prohibition du *Ribā*, et démontre avec rigueur la viabilité et la supériorité du système de financement basé sur la participation au capital.

Documents occasionnels

☐ **DEFIS AU SYSTEME BANCAIRE ISLAMIQUE, (1998),** 90 pages **Prix $ 5.0**

Munawar Iqbal, Ausaf Ahmad et Tariquallah Khan

Le but de ce document occasionnel est que les théoriciens et praticiens dans le domaine bancaire islamique doivent explorer les voies et moyens permettant au système bancaire islamique de soutenir son rythme de progrès au moment où il entre dans le 21ème siècle.

TRANSLITERATION TABLE

Arabic Consonants

- Initial, unexpressed medial and final:

ء	’	د	d	ض	ḍ	ك	k
ب	b	ذ	dh	ط	ṭ	ل	l
ت	t	ر	r	ظ	ẓ	م	m
ث	th	ز	z	ع	‘	ن	n
ج	j	س	s	غ	gh	هـ	h
ح	ḥ	ش	sh	ف	f	و	w
خ	kh	ص	ṣ	ق	q	ي	y

- Vowels, diphthongs, etc.

Short	ـَ	a	ـِ	i	وِ	u
Long	أ	ā	ي	ī	و	ū
Diphthongs	ؤ	aw	ئ	ay		

Notes To Contributors

1. The papers submitted to *IES* should make some noticeable contribution to Islamic economics, either theoretical or applied, or discuss an economic issue from an Islamic perspective.
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9. Articles: Al-Qari, Mohamed Ali (1993), "Towards an Islamic Stock Market", *Islamic Economic Studies*, Vol. 1, No. 1; Books: Khan, A. R. (1993), *Financial Intermediation*, New York: Springer Publishers. Page references to works referred to in the text should take the following form: Al-Qari (1993:17). Citations within the text should follow Harvard APA style.
10. The verses of the Qur'ān quoted should carry *surah* number and *ayah* number as (3:20).
11. Complete reference to the source of ahādith quoted should be given.
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Islamic Development Bank (IDB)

Establishment

The Islamic Development Bank is an international financial institution established in pursuance of the Declaration of Intent issued by the Conference of Finance Ministers of Muslim Countries held in Jeddah in Dhul Qa'dah 1393H (December, 1973). The inaugural Meeting of the Board of Governors took place in Rajab 1395H (July 1975) and the Bank was formally opened on 15 Shawwal 1395H (20 October, 1975).

Vision

By the year 1440H Hijrah, IDB shall have become a world-class development bank, inspired by Islamic principles that have helped significantly transform the landscape of comprehensive human development in the Muslim world and help restore its dignity.

Mission

The mission of IDB is to promote comprehensive human development, with a focus on the priority areas of alleviating poverty, improving health, promoting education, improving governance and prospering the people.

Membership

The present membership of the Bank consists of 56 countries. The basic condition for membership is that the prospective member country should be a member of the Organization of Islamic Cooperation (OIC), pay its contribution to the capital of the Bank and be willing to accept such terms and conditions as may be decided upon by the IDB Board of Governors.

Capital

As of the month of Rajab 1431H, the Authorized Capital of the Bank was ID 30 Billion, and the Issued Capital was ID 18 Billion, of which ID 17.474 Billion was subscribed with ID 4.031 Billion Paid-Up.

Group

At present the IDB Group is made up of Islamic Research and Training Institute (IRTI), International Islamic Trade Finance Corporation (ITFC), The Islamic Corporation for Insurance of Investments and Export Credit (ICIEC) and The Islamic Corporation for the Development of the Private Sector (ICD).

Headquarters and Regional Offices

The Bank's headquarters is in Jeddah in the Kingdom of Saudi Arabia. Four regional offices were opened in Rabat, Morocco (1994), Kuala Lumpur, Malaysia (1994), Almaty, Kazakhstan (1997) and Dakar, Senegal (2008).

Financial Year

The Bank's financial year is the lunar Hijra year.

Accounting Unit

The accounting unit of the IDB is the Islamic Dinar (ID), which is equivalent to one SDR – Special Drawing Right of the International Monetary Fund.

Languages

The official language of the Bank is Arabic, but English and French are also used as working languages.