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**ISLAMIC FINANCIAL INTERMEDIATION:
ECONOMIC AND PRUDENTIAL CONSIDERATIONS.**

Patrick Honohan

Development Research Group and Financial Sector Strategy and Policy Department

The World Bank

Abstract

This note reviews the functioning of Islamic financial intermediaries, seen as economic entities, and considers how their operations may be evaluated from a prudential point of view? It argues that Islamic finance has the potential to deliver most of the key economic functions, but cautions against a complacent view: the existing menu of Islamic financial instruments is more limited than is generally realized by observers who stress the convergent evolution of Islamic and conventional finance

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Islamic Financial Intermediation: Economic and Prudential Considerations.

Introduction

Many financial intermediaries around the world now operate intermediation subject to the requirements of Islamic jurisprudence.¹ As such, they neither charge interest (*riba*) nor do they receive it. Of course most of these intermediaries are run with the intent of commercial viability, and they generally think of themselves as establishing contracts with their clients that allow the intermediaries to cover operational costs and make a fair profit on their activities. Although some of their depositors are motivated by charitable goals, most deposits are placed with a view to the services or investment returns that they will yield.

Seen as economic entities, how do these intermediaries perform, and how should their operations be evaluated from a prudential point of view? This note argues that Islamic finance has the potential to deliver most of the key economic functions, but cautions against a complacent view: the existing menu of Islamic financial instruments is more limited than is generally realized by observers who stress the convergent evolution of Islamic and conventional finance. Prudential risks are as high for Islamic intermediaries as for others, and may be higher. Here too some observers have been too complacent, this time by exaggerating the differences between some Islamic instruments and their conventional counterparts.

What is Islamic Finance?

Islamic scholars have been most concerned to define carefully what is permissible in Islamic finance. This note does not pretend to advance that discussion, which requires theological expertise not available to the author. Instead, we take Islamic finance as it is observed and comment on how it performs the main functions of finance and what prudential issues it raises.

Underlying prohibitions

The prohibition on interest (*riba*) is not the only defining feature of Islamic finance. Also precluded are recklessness or unnecessary risk (*gharar*), gambling (*maysir*), and the exploitation of ignorance (*jahl*). Most important of all, financial support can only lawfully be provided in support of economic activities that are themselves lawful (*halal*); thus for example equity investment in a firm which profits from the production or sale of alcohol would be wrong (*haram*).

¹ Though the concepts and law relating to Islamic finance date to classical times, formal Islamic intermediation is relatively recent. A savings bank established in the Nile Delta in 1963 is pointed to as the first Islamic bank. After 1974 the number of Islamic intermediaries grew rapidly. By the late 1990s, estimates put the aggregate assets of Islamic banks worldwide at about \$200 billion. In addition, Islamic fund management is a growing niche in mutual funds, with total assets under management worldwide reportedly in the region of \$5 billion. Three countries, Iran, Pakistan and Sudan are said to have wholly Islamic systems, though Pakistan's compliance was thrown into doubt by a 1999 Supreme Court ruling (that will trigger some changes soon to be decided). Bahrain is considered the main center of offshore Islamic banking in the Middle East.

Here and throughout the note the correspondence between the Islamic concepts as expressed by Arabic words and the English counterpart is inevitably imperfect. We have sought to provide an English word that would most closely capture the relevant aspect of the Islamic concept in its financial sector context. Perhaps the most contentious word of all is *riba*. Though it is often translated as "usury", because of the negative connotation of that word, it is important to bear in mind that any rate of interest, however low, is *riba*: it is the nature of the transaction which is held to be wrong, and not just some idea of over-charging. Exploiting an arbitrage or price difference in trading money for money is the essence of *riba*.²

That is why some element—such as an underlying asset or business venture which is being financed—other than simply trading like for like, is almost invariably explicitly involved in a *riba*-free Islamic financial contract.

Finance without interest

Interest has long been a stumbling block for students of ethics, whether Islamic or not. Aristotle and Plato were hostile to interest, as were in succeeding centuries, both Hindu and Roman law-makers.³

Indeed, can anyone dispute that almsgiving or charity are more praiseworthy activities for the wealthy than seeking to profit by exploiting the desperation of the needy? Christian teachings along these lines predate Islam, and influenced church and secular law in Europe for centuries. It is worth remembering that the origins of such important financial instruments as the bill of exchange and the check lay in the search by Christian financiers in medieval and renaissance Europe for instruments that would equilibrate supply and demand for loanable funds without explicitly charging interest, which was then proscribed by the Roman church. Even in modern western economies, "usury laws" often place ceilings on the permissible rate of interest (and other laws and codes of conduct designed to protect vulnerable borrowers are often put in place).

But it is not only the needy that seek the temporary use of funds, and this insight has legitimized financial intermediation in Islamic as in other religious jurisprudence. In particular, Islam is not inherently hostile to the profitable financing of business enterprise.

As we will see, there is a wide spectrum between strict and liberal Islamic interpretations as to what types of financial instrument can be deemed free of *riba* and, as such, acceptable. Authorities often differ sharply. Even when a financial instrument has been synthesized from several different contracts each of which has long been sanctioned, the permissibility of the synthetic instrument can be questioned.⁴ For this reason, it is

² The old-fashioned English term "agio", still occasionally used in financial markets, may be the best one-word translation of *riba*.

³ For a brief review of what is a very extensive historical critique of interest and usury, see Visser and Macintyre (1998).

⁴ For example, a widely discussed paper by Kamali (1997, quoted in Ebrahim, 1999) has sought to legitimize futures as being a simple combination of a pre-paid forward purchase contract *bai-salam* and a deferred payment contract *murabaha*; Likewise a call option could be seen as the combination of a

difficult indeed to be dogmatic about what can and cannot be regarded as falling within Islamic finance. The essential problem is to decide what counts as a legitimate Islamic financial innovation, and what as mere circumvention (*heyal*) of the Islamic law.⁵

Insurance

This question of interpretation also arises acutely in the matter of insurance. Many Islamic scholars find the business of conventional insurance companies to be precluded by the prohibition of unnecessary risk (*gharar*). For non-Islamic observers, this is, if anything, more startling than the prohibition of interest. (The reasoning is based on the consideration that, for any single policy written by the insurance company, the company is taking on a sizable risk; for many scholars such a contract is forbidden, even though by pooling many together the risk is reduced or eliminated). However, a mutual assistance pool could be legitimate, and this is the basis for the many *taqafol* Islamic mutual insurance companies.⁶

The potential of Islamic finance

It is a reasonable conjecture that an Islamic instrument can be devised to meet each and every type of financing that is necessary or expedient to support legitimate non-financial business activities. Indeed, this could be regarded as almost a tautological statement, in that "support of legitimate non-financial business" may in itself be almost sufficient justification.

Noting the apparent parallelism between the functionality of much of modern Islamic financial instruments and those of conventional finance, some observers have supposed that Islamic finance is equivalent in all economically essential respects to conventional finance. But this is an overstatement. The instruments of Islamic finance today represent a restricted subset of what is available in conventional finance. Although this menu could be widened, the procedures for doing so are cumbersome and uncertain. In addition, while convergent evolution has meant that many of the most common conventional financial instruments has a functionally similar counterpart in Islamic finance, the similarities mask important differences. These hidden differences mean that a system which relies only on popular Islamic financial instruments may be weaker in delivering the underlying financial services needed to boost sustained economic growth. Such a system may also be more fragile, though this has been the subject of an extensive debate.

At the other extreme, there are observers who over-emphasize the differences between Islamic financial instruments and those of conventional finance. Here too this can

mudaraba and a *murabaha*. But this form of reasoning from synthetic contracts has not been universally accepted.

⁵ There is a parallel with conventional finance to the extent that financial engineering is employed to extend the scope of "tax expenditures" beyond their intended target group. Just as Islamic financial engineers must await the ruling of a *Sharia* committee before being able to employ their innovations in the market, tax-efficient finance schemes devised by a conventional finance house must await the verdict of the tax authorities or the courts as to whether the tax avoidance will prove effective.

⁶ But some scholars regard many of these as a mere circumvention in that most of them operate according to what are essentially individualistic policies, even if their ownership is theoretically mutual.

mislead, especially in regard to the degree of risk-sharing that is actually involved. Deposit-type contracts may embody implicit guarantees which will be called in a crisis. Failure to make provision for these guarantees, albeit implicit, partial and unintended, could result in severe social costs.

Islamic Financial Instruments in Practice

The blanket prohibition of interest in Islam has the practical implication that, in practice, Islamic intermediaries comply by restricting themselves to a positive list of financial contracts that have been approved by the relevant legal scholars or authorities. The list differs from country to country, and as between different traditions within Islam. The list is not immutable and scholars acknowledge the possibility of financial innovation within Islamic finance. The resurgence of Islamic finance in recent decades means that, in large part, experience with its functioning is quite recent. It is only in the last few years, for example, that the need for effective instruments of monetary policy in systems which are wholly or predominantly Islamic has led to innovations in wholesale short-term instruments that have already been implemented (Sudan) or under consideration (Iran). In Iran, where all of finance is governed by the Islamic constitution, the list of 13 permissible financial instruments was devised in the early 1980s and written into national law.

To some extent, the permissible contracts of Islamic finance bear a family resemblance to contracts known in Western finance. This is evidently an example of convergent evolution: the market realities representing the common pressure that has led to the contractual similarities.

Two general families

Most Islamic financial instruments can be thought of as falling into one of two general families.⁷

First, and often thought of as the essence of Islamic finance, are contracts that can be classified as *venture financing*. Here the provider of funds to a venture expects a return conditional on the success of the venture. In the literature, these are often termed profit-and-loss sharing (PLS) contracts. The most widespread contracts of this type for Islamic intermediaries are equitable participation (*musharaka*) in a venture such as an import consignment and a sleeping partnership (*mudaraba*) in a defined venture. Other contracts of this type include purchase of common stock (equity) in a joint stock corporation, crop-sharing arrangements on land or orchards owned by the intermediary, or outright forward purchase of commodities.

Second, and quantitatively more important in the balance sheet of most Islamic intermediaries today, are *payment smoothing* arrangements. Here the intermediary's client has a lumpy cash need in order to accomplish some project (e.g. housing, productive investment). The intermediary enters into an arrangement which, while profitable to it, enables the client to smooth their cash

⁷ The Annex shows how the 13 Iranian instruments can be classified into the two families.

outlay. For example, the provider of funds may acquire a productive asset and make it available to the user of funds for a fee, as in installment sale (*murabaha*), leasing (*ijarah*) or hire-purchase arrangements. Back-to-back forward sale and repurchase transactions fall into the same category.

In attempting to assign any given contract to one or other family, there is some blurring of boundaries inasmuch as even contracts of the venture financing type employed by Islamic intermediaries often embody side-conditions that greatly limit the commercial risk being assumed by the intermediary. Excessive use of devices such as rate-of-profit guarantees and the taking of collateral⁸ are frowned-upon by most Islamic scholars; contracts that use them to excess may be regarded as marginally compliant with Islamic principles.

Indeed, some strict jurists outlaw all of the payment smoothing family. It is easy to see why: except where there is default, the flow of payments related to a *murabaha* may be indistinguishable from an equivalent instalment credit arrangement provided by an interest-based financial intermediary. For these jurists, *murabaha* is nothing less than circumvention.⁹

Relative importance in bank assets

Nevertheless, payments smoothing contracts represent the majority of the assets in most Islamic banks around the world. *Murabaha* in particular is the most widely used contract. Venture type contracts account for only 10-20 per cent of the typical bank portfolio.

It is not hard to see why venture finance should be relatively little used even by Islamic intermediaries.¹⁰ Monitoring and enforcing the intermediary's stake is costly and unreliable in the sparse information environment in which most Islamic banks operate, with underdeveloped accounting and high exogenous risks and only weak sanctions against misinformation. As noted by Mills and Presley (1998), information problems may also be exacerbated by the adverse selection effect whereby a disproportionate number of the borrowers presenting themselves to the Islamic bank have been refused by conventional banks.¹¹

Bank liabilities

Much of the funding of the typical Islamic bank is in the form of current and savings (notice) accounts which do not yield a cash return. However, some Islamic banks make

⁸ Collateral is generally considered permissible to ensure that the counterparty acts in accordance with the contract, but not to insulate the financier from commercial or investment risks. In particular, non-interest *qard-hassan* lending can be collateralized.

⁹ Pakistan's Supreme Court recently outlawed the form of *murabaha* contract which had been practised by banks in that country as being incompatible with Islam.

¹⁰ Dar and Presley (2000) discuss seven possible reasons. For further discussion, including a theoretical model, see Aggarwal and Yousef (2000).

¹¹ This adverse selection effect would be absent if the whole system were Islamic as in Iran, and indeed the percentage of venture-type funding is rather higher in Iran, but still less than a half of the total facilities. (It remains low, though, in the other all-Islamic environment of the Sudan).

an *ex gratia* payment (sometimes in the form of a lottery for cash or non-cash prizes) on savings accounts out of their profits. This is not interest, because it is not a contractual undertaking of the banks when they accept these funds for safe-keeping. On the other hand, the bank typically does guarantee the capital value of these funds at maturity.

Most of the remainder of the bank's non-capital resources are so-called *investment accounts*, which formally are profit-sharing *mudaraba* (sleeping partner-type) contracts. Mostly these are unrestricted participations in the bank's overall business, but restricted *mudaraba*, where the depositor shares in the profitability of a designated subset of the bank's lending, are also known. In practice, the yield on such accounts tends to be smoothed by the intermediary and to be roughly competitive with what is being offered by conventional banks.¹²

Islamic instruments performing the deep functions of finance.

Current thinking on the role of finance in the economy highlights several key functions (cf. Levine, 1997):

- a) transfer of purchasing power over time and space;
- b) mobilizing savings;
- c) allocating capital funds;
- d) monitoring managers; and
- e) transforming risk (reducing it through aggregation and enabling it to be carried by those more willing to bear it).

How well are current instruments of Islamic finance attuned to perform these functions? As an overall observation, it can confidently be stated that Islamic finance does perform every one of these functions, at least to some extent. And, contrary to some naïve critiques of interest-free finance, it is at least arguable that an Islamic finance solution can be found to resolve most conceivable finance-related needs even of sophisticated market economies.

Nevertheless, the need to ensure compliance with the -- sometimes subtle -- requirements of Islamic law, and the tendency to rely on a pre-determined positive list of permissible contracts, does have the effect in practice of limiting or at least slowing the adaptability of Islamic finance to changing market needs and opportunities.

In addition, the most commonly used Islamic financial instruments have inherited characteristics which, in modern circumstances, may work less well (and in different ways) than they did in former times. If so, the implication must be that pro-active financial innovation is required in Islamic finance if it is not to fall behind in performance, threatening the viability of Islamic intermediaries operating in a largely interest-based market, and holding back the overall development of economies that rely wholly or largely on Islamic finance.

¹² Even in Iran, the expected return on investment deposits is announced in advance each year by the central bank and has almost always been equaled by the actual pay-out eventually made by the state-owned commercial banks at year-end.

These concerns exist to some extent for functions (a), (b) and (c) above, but they are most acutely felt in respect of (d) monitoring and control and (e) risk-reduction.

Monitoring and control with Islamic instruments

On monitoring and control, the underlying question is whether the somewhat soft budget constraint that is built-in to the various venture funding instruments impairs their ability to perform the monitoring function. The capacity of a conventional financier promptly to sanction non-performance of a loan contrasts with the weaker legal position of an Islamic intermediary who has taken a participation in a commercial venture that goes wrong. For one thing, information is at a premium: the incentive for the funds user to report truthfully on the performance of the venture is greatly weakened. By diverting funds wrongfully to his own private benefit, the user of venture funds does not place his control of the venture at risk in the way that the borrower at interest does (if the latter defaults, then he loses control of the pledged assets or may be placed in bankruptcy).¹³ Therefore the Islamic intermediary must devote more resources to monitoring the actual performance of the venture. Such information is difficult to acquire and costly to verify. There are, of course, circumstances where equity-type finance performs unambiguously better than interest-based debt: the point is that Islamic intermediaries may be using venture funding where the conditions are not best for its use.

Second, even if there is no information deficit, there may be a control issue: even if the intermediary knows that the venture is in trouble, he may have greater difficulty in intervening to prevent further losses, than if it was a debt contract. This is not just a question of debt-versus-equity. In particular, the widely used *mudaraba* contract, which we have characterized as a sleeping partnership, leaves the financier with particularly weak ownership and control rights – much less than would be demanded by conventional venture capitalists in advanced economies. In the words of Dar and Presley (2000), this is a contract which is hostile to the capitalist.

To be sure, some of the payment-smoothing contracts do have harder budget constraints and the intermediary may be more easily able to recover the asset being financed. However, the conditions under which the payment-smoothing contracts are used are rather limited. For example, none of the common contracts corresponds to a floating charge over all the assets of a firm as would be available to a lender-at-interest, and which allows him to provide general financing to the firm but with a hard budget constraint. Instead, payment-smoothing financing is typically tied to a specific asset.¹⁴

Imposing a hard budget constraint on intermediaries is important too, and the *mudaraba* contract underlying the investment deposits placed by wholesale depositors limits their ability to become effective external monitors.

Risk-reduction with Islamic instruments

¹³ This key incentive role of the debt contract was highlighted by Diamond (1984).

¹⁴ To be sure, title to this asset passes to the bank under a *murabaha* contract.

Turning to function (e), it is the case that risk transfer and mitigation can also be provided through Islamic financial intermediaries, but in practice Islamic finance has been slow to meet modern requirements here.¹⁵ For one thing there is the prohibition of conventional insurance, though this does not appear to be much of a practical constraint even in the all-Islamic environment of Iran. But there is clearly a difficulty in regard to the use of derivative instruments for risk-reduction. Their construction in interest-based financial systems relies on what can become quite complex mathematical formulae in which the concept of interest is deeply embedded. Deconstructing the logic of the instruments and reformulating them in a *riba*-free context is not always straightforward, though in principle it should generally be possible to do so, given that the goal of risk-reduction and risk-transfer is not *per se* precluded in Islamic finance.

If monitoring, control and risk management are all less easy, because of the limited menu of financial instruments available in practice to the Islamic intermediary, then allocation of resources to their optimal use may be compromised, and the potential contribution of finance to growth undermined. It would be silly to claim that the disappointing long-term economic performance of Iran and Sudan was all due to their adoption of Islamic finance. Indeed, done well, Islamic finance can likely outperform the average conventional financial system. What our reasoning suggests is that good economic performance of an Islamic financial system may require heightened monitoring performance and greater innovative efforts relative to conventional finance.

Prudential risks and other short-term considerations

Bank runs still possible

In practice, Islamic banks do offer withdrawal of deposits at par (on maturity). Thus, although the deposits are, at least formally, risk-sharing, the liquidity constraint on Islamic banks does tend to bind. If an Islamic bank wishes to avoid a run, it needs to maintain sufficient liquidity, and by extension a sufficient solvency reserve. This may seem to contradict the views of those who, argue that, to the extent that deposits with an Islamic financial intermediary are to be thought of as venture funding, such an intermediary should function like a mutual fund. It is indeed something like a mutual fund, but one with two unusual characteristics: (i) it maintains a continuous two-way market in its shares at par and (ii) its assets are hard-to-value and opaque. The first characteristic means that -- contrary to what is sometimes thought -- an Islamic bank can be subject to a depositor runs.¹⁶ The second characteristic means that these runs may happen even if the underlying value of the assets is sufficient to repay all depositors. Depositors may withdraw in a panic (at least as soon as their deposit matures) if they fear

¹⁵ That is not to deny that there has been innovation. For example, in Pakistan a contract known as *istijrar* has been introduced as a variant on *murabaha*. Whereas the settlement price in a *mubaraha* can be thought of as $p^* = (1 + r) p_0$, the *istijrar* sets upper and lower price bounds p_U and p_L and may be settled at either

p^* or $p^{**} = \frac{1}{T} \sum_{t=1}^T p_t$ provided $p_L < p^{**} < p_U$. Each party has the option to lock in either p^* or p^{**} at

any point. The *istijrar* thus introduces a bounded degree of price risk-sharing (cf. Bacha, 1999).

¹⁶ Here we deliberately finesse the issue of insolvency: some have argued that, with risk-sharing contracts, an Islamic bank could not become insolvent. But that issue is moot: depositors seeking to withdraw at par can drive an Islamic bank to failure. Hence the need both for liquidity management and adequate capital.

that the normal par-value withdrawal option is about to be terminated. In order to maintain orderly market conditions, therefore, it is clear that an Islamic bank must have (i) sufficient non-deposit risk liabilities (i.e. capital) and (ii) sufficient access to liquid assets in case of large depositor withdrawals.¹⁷ The fact that suspension of the normal par-value withdrawal option for depositors does not formally represent a default for an Islamic bank does not alter this situation.¹⁸

Liquidity management a challenge

Indeed, surveys show that Islamic banks tend to hold very high liquid assets, in recognition of the fact that they cannot rely on accessing the interest-based money market to meet a temporary liquidity shortfall. (Borrowing at interest from the central bank, or collateralized borrowing in general is also precluded).

But these problems of liquidity management and monetary control can be alleviated with financial innovation. Indeed, novel *riba*-free remunerative liquid assets issued by the government have been invented for Iran and Sudan, and have been implemented in Sudan (Marston and Sudararajan, 1998).¹⁹ Because the funds are issued by government, their yield should reflect the return made by government on these funds. The Sudanese instrument is a *musharaka* linked to certain state-owned banks: the yield is based on the profitability of the banks. For the proposed Iranian instrument (Haque and Mirakhor, 1998), the idea is that optimal use of public funds should always yield a social benefit at least as high as do private investments. Basing the instrument's dividend on a smoothed average of the dividend rate on private market instruments can thus be justified as not an excessive return. As is well known from the theory of monetary control that open market operations can be effective even with assets other than short-term bills, either of these instruments can be a useful basis for market-oriented monetary policy.

Overall, in the matter of short-term monetary management and crisis avoidance too we find a convergence of requirements as between conventional and Islamic finance, with a continued need for innovation on the Islamic side. Above all, there is a need to avoid complacency engendered by the false notion that Islamic depositors will passively share in the liquidity and capital risks that they seem to have assumed by virtue of the contract that is formally involved.

Hidden risks in Islamic instruments

Finally, though, it is worth recalling that, despite some general similarities, Islamic financial instruments do assign risks in somewhat different ways, and these need to be kept in mind by all participants. For instance, inasmuch as many Islamic instruments transfer risks to the lender, they present a risk-management challenge that Islamic intermediaries need to be alert to. For example, in a *murabaha*, title to the underlying asset to be financed passes to the bank: but this means that it now incurs risks of fire and

¹⁷ Errico and Farrabash (1998) arrive at the same conclusion.

¹⁸ It is noteworthy that depositor funds in Islamic banks in Malaysia appear to have been no more volatile during the East Asia crisis than were deposits at conventional banks. (Kaleem, 1999)

¹⁹ It has also been possible to develop marketable Islamic instruments by securitizing pools of *ijara* or *murabaha* loans, or what in Malaysia is termed a combination of *bai-al-inah* (deferred sale) and *bai-al-dayn* (debt-sale).

theft to the asset while it is being financed.²⁰ The partial similarity to conventional asset-financing should not lead one to neglect these significant risk differences.

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²⁰ I am grateful to Michael Taylor for pointing out this example.

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Annex: The allowable financial instrument in the Iranian banking law

Iranian banking law defines 13 different allowable financial instruments which we group into two categories corresponding to the discussion in the main text.²¹

I Venture finance types

Civil Partnership (Musharaka Madaniah). The provider of funds receives a predetermined share in the profit of a pool of investment; shares in any losses in proportion to their investment. The expected profit of the investment is determined in advance. But the actual contract may be modified by conditions stating that a bank provider of funds will forego any profits in excess of the regulated rate of return specified by Bank Markazi. Likewise, the other participants might agree to indemnify the bank in the case that the profit of the project falls short of expectations. Although collateral would not normally be directly involved, banks may achieve the same result by advancing an additional small but over-collateralized Qard-al-hassan loan (see below).²² In addition, the user may have to post a bond against misconduct (*Ta'ahod*).

Equity investment in joint-stock company (Musharaka Hoquoqi). The practical difference here is that the bank can sell out at any time: in this sense its funds are not part of a common pool.

Entrepreneurial financing or sleeping partner arrangement (Mudaraba) Here the provider of funds is in a business partnership with an entrepreneur and shares in the profit. Any loss is for the account of the provider of funds (in contrast to a *musharaka* where the losses may be shared). The entrepreneur may be obliged to provide insurance cover.

Own account direct investment by the provider of funds in a productive or development project.

Share-cropping (Mozara'ah²³). Bank, as landlord²⁴ (*Mozare'*), contracts with farmer or orchard manager (who is thus acting as *Amel*) to cultivate the land or trees and harvest crops, fruit, flowers etc, with the proceeds to be divided between the two on an agreed basis.

Outright forward purchase (Salam or Salaf). For example the bank purchases (payment made now) agricultural products now for future delivery. (When accompanied by a resale agreement, this is classified with the payment smoothing types below).

II Payment smoothing types

²¹ The description is based in part on unpublished work by Ghiath Shabsigh (IMF), Redha A. Faraj, Shahzad Iqbal and Yaser Al Sharif (Ernst & Young).

²² Failure of the funds' user to meet the terms of the contract would then be deemed to have also placed the qard-al-hassan loan in default, allowing the collateral to be seized.

²³ Or, in the case of orchards, *Mosaqaat*

²⁴ Or orchard-owner.

Not-for-profit deposits/loans (Qard-al-hassan). These are interest-free deposits which are on-lent also interest-free, but in addition to repayment of principal, the borrower must pay a 3% management fee. Since no interest is involved, this can be collateralized (*Rahen*). Qard-al-hassan depositors (at least those maintaining a minimum balance for a three-month period) share in a raffle for gifts purchased out of a 2% sum set aside for the purpose. Most of these arrangements are best thought of as having a quasi-charitable nature.

Forward purchase with resale agreement (Salam or Salaf). For example the bank purchases (payment made now) agricultural products for future delivery, but (as is typically the case) this is accompanied by a forward sale agreement to sell the goods back to the farmer, so that in practice the bank does not take delivery of the goods. The cash amount received by the bank will be known in advance unless the spot price of the product is far below the agreed forward price in which case the farmer may not honour the forward sale agreement and the bank may take a loss). The farmer may be obliged to provide insurance cover.

Installment sales (Murabaha). Used for financing machinery and construction including housing, the total value of the installments includes a mark-up on the initial cost of the goods acquired. These are typically pledged to the bank as collateral, and must be insured and maintained by the user. (This covers three of the 13 allowable financial contracts in Iran, with distinct contracts listed for (i) housing construction – this effectively being a form of progress payment contract also known as *Istisna*; (ii) machinery and equipment and (iii) other installment sales arrangements).

Finance leasing or hire-purchase (Ijarah Muntahia Bittamlees or Ijarah-bi-shart-al-tamaluk). The user receives title at the end of the period. Again the asset is insured and maintained by the user.

Service contract (Jo'aalah). Lumpy payments (e.g. property maintenance) are provided by the bank, and covered by a regular instalment payment by the user.

Finally, investment in **Government bonds** falls into an ambiguous category. The expected rate of return (in principle based on a participation in the proceeds of state, or public authority, assets) is announced in advance and has always been paid. The element of venture in this activity for the banks is arguably minimal.

Investment Deposits accepted by the banks also fall into an ambiguous category between I and II. Although some are in the form of *mudaraba* managed by the bank with the depositor as the "sleeping partner", most are paid the "expected" rate of return pre-announced by the central bank, regardless of the actual performance of the bank's assets.