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#### **TOPIC:**

## **Rethinking *Ribā* and the 'Islamic' Banking Experimentation**

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## Rethinking *Ribā* and the ‘Islamic’ Banking Experimentation

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### ABSTRACT:

The efficiency of a financial intermediation system is assessed by its ability to achieve allocative efficiency, asset transformation and the subsequent economic development. In case of an Islamic Banking and Finance as an alternate financial intermediation system adherence to the injunction of Islam is also critical. A critical appraisal of the state of contemporary Islamic Banking and finance (IBF) reveals that IBF has neither been able to achieve the aspirations of Islamic rhetoric, nor has been efficient in terms of asset transformation and economic development. This paper is an intuitive pursuit to explore the economic sense of established principles of IBF, and the reasons of the persistent divergence of IBF, being accused to be based on ruses and sophistry. Disentangling the varying viewpoints, the underdevelopment of IBF has been attributed to misinterpretation of *Ribā*, which has been explicated through a narrow *fiqhi* and legally deterministic approach. Deeming ‘a collaborative and dynamic *Ijtihād*’ as the elixir, this paper insists on the exigency of revisiting the definition of *Ribā* through a dynamic and collaborative *Ijtihādi* effort – i.e., a definition that incorporates the modern modes of economic cooperation and the contemporary financial intermediation ecosystem. The paper articulates *Ribā* in an agency theoretic framework to eschew expropriation of wealth, and assure protection of property rights, to sustain financial stability and economic development.

**Key Words:** *Ribā*, *Shari’ah* Compliance, *Ijtihād*, Information Asymmetry, Islamic Banking, Financial Innovation, Financial Development, Financial Deepening.

### Introduction

‘While IBF does greatly increase the resource mobilization (and presumably economic development) potential of the Muslim world, it does so by duping observant Muslims in two ways. IBF institutions attempt to convince the pious that their funds are invested islamically and, quite often, charge their clients more than would conventional banks’. (Khan, 2010). Despite of expansive growth of financial institutions and intermediaries operating in accordance with Islamic Law a.k.a *Shari’ah*, with total assets exceeding USD 2 Trillion approximately, the demand for Islamic financial services has been soaring significantly in recent years, which has attracted attention of international financial institutions and multilateral development banks as well. Even the likes of World Bank, IMF and ADB have also been recognizing Islamic Finance, as a means to achieve financial inclusion and sustainable development goals. The engagement of faith-based institutions; be it for or not-for-profit has been on the agenda of these organizations lately. The world of finance experienced an unprecedented roller coaster ride during the past decade, as experienced during the Global Financial crisis which has known to have befallen the world, and often compared to the great

depression of the 1930s. This crisis has broadly been attributed to poor regulation, corporate governance and stoic pursuit of unjustified profits and returns. Such a financial chaos, reinforced the censure for interest based economic system, usury (*ribā*); which ofcourse isn't a new phenomenon. Abhorrence towards interest has been there since early ages in the scriptures of Christianity and Judaism, however the development of Islamic finance and the pursuit of Islamizing financial and economic systems, established this in to a sophisticated sub-faculty of research in economics and finance.

Meanwhile, owing to its embeddedness in to the real economy, Islamic Financial Institution remained relatively immune and perhaps resilient to the devastating contagion of the GFC. Contemporary economists like Timur Kuran (2004), trace the origin of Islamic Banking and Finance, as a realization of the aspirations of the decolonized Muslim world to set an economic and political system in cohesion with their religious identity and preaching. According to Kuran (1997), the roll out of IBF was a rush measure to Islamize a highly secular discipline. A plethora of research across the dimensions of formative guidelines, characteristics, goals and principles of Islamic Banking and Financial Institutions was framed-in (El-Hawary, 2004). Moving forward, with the gradual establishment and progression of Islamic Banks, its divergence from the initially aspired goals of an equitable and profit-loss sharing format of banking, attracted the ruthless censure of the researchers (Khan, 2010). With Islamic Banks growing bigger in size and sophisticated in their operation, researchers found IBs to have completely lost the sight of their initially conceived purpose, principles, characteristics and goals which were solely destined to achieve the *Maqasid-e-Shari'ah*. The very idea of the proposed alternate economic system was grounded in the Islamic egalitarian principles, challenging the injustice, expropriation, exploitation, inequality and deprivation to assure equitable and just distribution of wealth across all economic agents. Nevertheless, the broadening wedge between the ideals and the reality of IBF attracted the refute of a lot of researchers, who articulated varying positions and stances to rationalize this blatant divergence. Some of them, undertook the pragmatist approach by calling it transitional phase in the right direction (Ausaf, 1993), while others reckon it to be the failure of Islamization of the knowledge vis-à-vis overall economic system, as elaborated in the new institutional economics framework (Ahmed, 2012). The political economist insisted on the need of the alignment of superstructure with that of the means of production and economic cooperation, sources of capital and forces of coercion (Ayubi, 2004). On the other hand, Ebrahim (2014) attributed it to the narrow *fiqhi* approach adapted to interpret *Ribā*/Interest, and the lack of dynamism in *Ijtihād* leading to the employment of legally deterministic methodologies, leading the IBF to operate in a *Shari'ah* compliant instead of a *Shari'ah*-based paradigm. The remaining researchers opted to produce an apologetic account of the contemporary IBF as being the 2<sup>nd</sup> best option (Asutay 2007), owing to the competitive pressures arising out of their coexistence with conventional counterparts. Orientalist like Weber (1905/2002) and Kuran (2004)

took it to a new tier, by ruling Islam Law and culture out, which according to them; happens to be anti-growth and non-congenial to business and commerce.

Despite of the above-described varying contours of thoughts, what remains ubiquitous and unanimous for the Muslims across the world, is the unshakable abhorrence for *Ribā*, as promulgated in their holy scripture and disapproval of Interest/*Ribā*/Usury persisted as the key rationale for an independent and alternate financial system for Muslims. The context set out above, solicits serious research to redefine *Ribā* in the broad spectrum of *Maqasid-e-Shari'ah* and financial contracting as practiced in the modern globalized financial world.

### **Aims of the Study**

The paper is built around conceptual and formative principles of Islamic Banking and Finance, to review the state of contemporary IBs. While specifying the divergence of practice from ideals, in its intuitive pursuit, it aims the following questions:

1. *To critically evaluate, as to whether the guidelines of the Islamic Banking as articulated by El-Hawari et. al (2004) and Khan (2010) make an economic sense, especially in the context of the subprime crisis, where the contagion of toxic debt has taken the developed world in to its fold.*
2. *To assess the fact that, if the so-called IBF Guiding Principles grounded in Quran and Sunnah – i.e. the practice of Prophet Muhammad (PBUH) fourteen hundred years ago, contribute towards the economic development of human kind?*
3. *Why these ruses exist, and have persistently been endorsed and practiced by the Islamic Banks? While taking on the Information Asymmetry argument coined by Kuran (1983) and Khan (2010), we attempt to explore the dynamics and mechanisms to eschew offshoots problems of adverse selection and moral hazard.*
4. *How the lack of an apt understanding of injunctions on Ribā and its implication on property rights, has led to the perennial economic underdevelopment of Muslim World?*

### **Literature Review**

We find enormous amount of work done, to set the epistemological and ontological frame of Islamic economics and finance. Islamic Economics claims its origin (Ayub 2007) to the Renaissance movement instigated in late 19th century, which later turned in to an intelligible academic pursuit. Eminent Scholars like Mawdudi, Dr Hameedullah, Baqar Sadre, Syed Qutab etc. are unanimously deemed as the forerunners of the early Islamic thought towards an indigenous Islamic Economic System. The second generation of Islamic economists, included Monzar Kahaf, Ahmad al Najjar, Abbas Mirakhor, Nejatullah Siddiqui, M.A. Mannan, Ahmad al Najjar, and Ahmad al Najjar, M. Umer Chapra, Khurshid Ahmad and many others. The contemporary Economists (i.e. the second and third Generation) took it further to articulate ideas around the key institutions and stakeholders towards an economy within broader frame of Islamic injunctions-be it Islamic Production function, Role of Sovereign and the management of Public Finances up to the extremes of promulgating Islamic standards for Accounting

and reporting financial transactions (AAOIFI, 2004), capital adequacy regulation (IFSB, 2005) and Monetary policy transmission Instruments.

Albeit, the early Islamization of knowledge ranging across the axis of utopian ideals and the adaptive pragmatism cannot be labelled as an arm-chairs speculation or a religious intervention or invention, nevertheless it clearly lacked theoretical cohesion (Spengler, 1964), uniformity, intellectual dynamism (Ebrahim 2009) and comprehensiveness (Kroessin, 2008).

### **Towards the Boons of *Maqasid-e-Shari'ah***

While scholars like Siddiqi 2006, contemplating on axioms of Islamic Law framed it to be around the idea of *Tawhid* (sovereignty and Unity of God) and *Rububiyah* (resource distribution and development) and '*Tazkiyah*' (purification of growth) & *Khilafah* (vicegerence of man on behalf of creator) that sets and controls the collective and individual's role. However, the operationalization and institutionalization of these axioms, in terms of economic policy and governance imperatives to steer economic cooperation and specifically financial intermediation apparently remained unfulfilled. Islamic Economist have been keen to lay down the axiomatic foundations at a micro level as *Tawhid*, *Tazkiyah*, *Rubuiyah*, *Khilafah*, *Ihsan*, *Iman* etc, but have yet to pull it to meso (organization) and macro (systemic) level, with the exception of *auqaf* and *zakah* which have been operating since the medieval ages. The same may be attributed to the growing deviation between the pragmatist Islamic Banks and the *Maqasidists* (upholders of *Maqasid-e-Shariah*) thought, the accomplishment of collective development by the interplay of *rushd* (self-development) and *Istimar* (physical self-development) (Ebrahim 2014) doesn't contradict with the contemporary economic thought, however solicits intellectual dynamism to conceptualize and operationalize the broader *Maqasid-e-Shari'ah*, at institutional level down to financial contracting and transactional level.

### **Through the *Fiqhi* Funnel**

While Islamic Economics converges with the idea of free markets as professed in the stoic capitalistic regimen, it doesn't leave it to the mercy of self-interest and utility maximization instinct of economic agent— it rather inculcates a moral control to assure mutuality, equity and equality (Iqbal and Abbas, 2007). However, the incorporation of such moral filters and controls at the transactional level warrants a contemplation of Islamic modes of financing under agency theoretic framework; wherein the interest assimilates the agency cost of debt (Ebrahim, 2014). Continuing with the prevalent literalist *fiqhi* approach, deriving analogies from Quran and Sunnah, primarily focusing on the *illah* (cause) than the broader *Hikmah* (wisdom) of the prohibition of interest, would leave us with trade-based mark-up financing, based on legal stratagems and *shari'ah* arbitrages. It is the same narrow tunnel of *fiqhi* instrumentalism that has stagnated the Islamic financial contracting to a *shari'ah* compliance checklist, as incorporated as a best practice of *shari'ah* governance across all IBF institutions.

## Appraising the Praxis of Islamic Banking and Finance

Before moving on to the investigation of theoretical foundations, a rigorous review of the practical vis-à-vis operational issues, and the current state of IBF is carried out in the following section, to set the foundation for an informed conceptual appraisal in the upcoming sections. The Islamic Banking industry despite of its four decades of operations, double digit growth, resilience, stability and performance, has been accruing a lot of censure not only from scholars but from the plebs as well. This criticism can primarily be attributed to its departure from the ideals of profit and loss sharing (PLS) modes, eventually turning in to a fixed profit debt oriented financial intermediary. Sarcastic yet catchy phrases like ‘*Old-wine in new bottle*’, ‘*Marriage of Convenience*’ (Samers M., 2015), *Shari’ah Arbitrage* (Elgamal 2006) and many others, have been coined by the literature, broadly due to its deviation from the originally conceived two-tier *Mudarabah* edifice to effectively a fixed return model both on the asset and liability on its balance sheet (Khan F. 2010). This section adapts a pragmatist or perhaps a realist approach to identify and subsequently rationalize this divergence by underscoring both the internal and external impediments and anomalies faced by an IB. The USD 1.3 Trillion, Islamic Banking Industry, starting from a modest initiative of Mit Ghamr (1963) and later on Dubai Islamic Bank in the mid-seventies to 432 Islamic Financial Institutions (IFIs) and 192 Islamic Banking Windows (IBWs) operating in around 78 jurisdictions. Table 1 below presents the growth of IBIs over the years.

**Table 1: Chronological Growth Milestones in Islamic Banking and Finance**

Time period	Development
Pre-1950s	<ul style="list-style-type: none"> <li>Barclays Bank opens its Cairo branch to process financial transactions related to construction of the Suez Canal in the 1890s. Islamic scholars challenge the operations of the bank, criticizing it for charging interest. This criticism spreads to other Arab regions and to the Indian subcontinent, where there is a sizable Muslim community.</li> <li>The majority of <i>Shariah</i> scholars declare that interest in all its forms amounts to the prohibited element of <i>riba</i>.</li> </ul>
1950s–60s	<ul style="list-style-type: none"> <li>Initial theoretical work in Islamic economics begins. By 1953, Islamic economists offer the first description of an interest-free bank based on either two-tier <i>mudarabah</i> (profit- and loss-sharing contract) or <i>wakalah</i> (unrestricted investment account in which the Islamic bank earns a flat fee).</li> </ul>
1970s	<ul style="list-style-type: none"> <li>Mitghamr Bank in Egypt and Pilgrimage Fund in Malaysia start operations.</li> <li>The first Islamic commercial bank, Dubai Islamic Bank, opens in 1974.</li> <li>The Islamic Development Bank (IDB) is established in 1975.</li> <li>The accumulation of oil revenues and petrodollars increases the demand for <i>Shariah</i>-compliant products.</li> </ul>
1980s	<ul style="list-style-type: none"> <li>The Islamic Research and Training Institute is established by the IDB in 1981.</li> <li>Banking systems are converted to an interest-free banking system in the Islamic Republic of Iran, Pakistan, and Sudan.</li> <li>Increased demand attracts Western intermediation and institutions.</li> <li>Countries like Bahrain and Malaysia promote Islamic banking parallel to the conventional banking system.</li> </ul>
1990s	<ul style="list-style-type: none"> <li>Attention is paid to the need for accounting standards and a regulatory framework. A self-regulating agency, the Accounting and Auditing Organization of Islamic Financial Institutions, is established in Bahrain.</li> <li>Islamic insurance (<i>takaful</i>) is introduced.</li> <li>Islamic equity funds are established.</li> <li>The Dow Jones Islamic Index and the FTSE Index of <i>Shariah</i>-compatible stocks are developed.</li> </ul>
2000–the present	<ul style="list-style-type: none"> <li>The Islamic Financial Services Board is established to deal with regulatory, supervisory, and corporate governance issues of the Islamic financial industry.</li> <li><i>Sukuks</i> (Islamic bonds) are launched.</li> <li>Islamic mortgages are offered in the United States and United Kingdom.</li> </ul>

Source: Khan (1996); IDB (2005).

## At the Cross Roads – What is Pulling IBs Back?

A critical appraisal of the underlying model of an Islamic Bank, its market dynamics and externalities need to be carried out for a better understanding of the inclination of

the IBs towards pseudo-debt products. The initially conceived two-tier *Mudarabah* model idealized for IBs with PLS modes on the asset and liability side on Balance sheet of an Islamic Bank, is represented in the stylized figure 1 below:

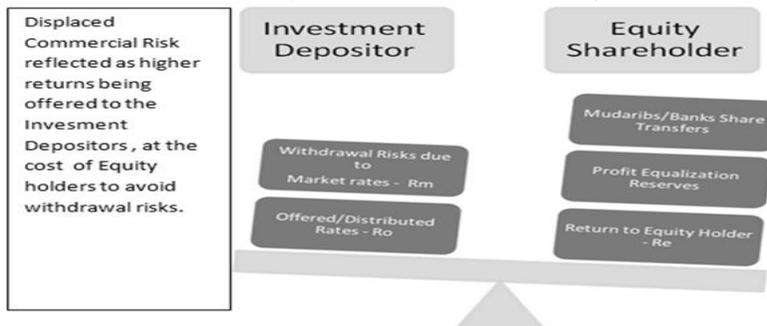
**Figure 1: Stylized representation of Balance sheet of a two-tier *Mudarabah* based IB.**

Asset	Liabilities and Equity
<b><i>Mudarabah/Musharakah</i> i.e., Profit Loss sharing based financing</b>	Profit Sharing Investment Accounts (PSIA- <i>Mudarabah</i> based) Demand Deposits ( <i>Qard Hasan</i> ) Capital

However, the present-day reality is in strict contradiction, wherein the asset side is primarily based in trade/debt/mark-up-based assets with a heavy weightage on *Murabaha*. This obvious discrepancy between the practice and theory can be attributed to many factors originating from the unique contractual arrangements vis-à-vis risk profile, regulatory pressures, coexistence with its conventional counterpart, customer segments and expectations, governance mechanisms, etc.

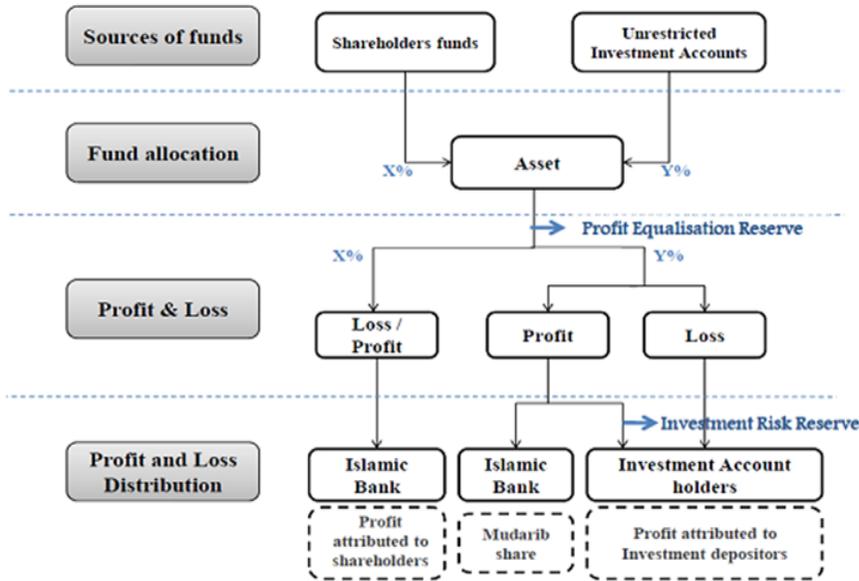
IBs coexist with their conventional counterparts in an interest based financial system, wherein the markets as well as the regulator, and even its monetary policy transmission operates in a predetermined fixed returns paradigm. The pricing of sovereign bonds is tagged to a conventional policy rate benchmark, turning it in to an at-source fixed rate arrangement proposition Even the effective pricing of sovereign debt is pegged to some conventional benchmark, turning it in to a fixed rate at-source arrangement. The criticism of a fixed return liability side, owes its roots to the withdrawal risk, wherein IB’s fears losing their deposit base, in case of offering less-than-the-market returns to its depositor. This subsequently gives birth to Displaced Commercial Risk (Sundararajan V, 2007), which is actually the degree of equity holder’s return being compromised in order to ensure market competitive rates being offered to the deposit share holder; thus, keeping the deposit immune to the rate of return risk. Thus, the unique risk of DCR, that pushes Islamic Banks to offer market-based rates to its depositor, is technically driven by a market externality beyond the control of an IB. Following figure 2 is a stylized representation of the risk of DCR:

**Figure 2: Stylized illustration of Displaced Commercial Risk unique to Islamic Banks (authors self-conceived)**



The displaced commercial risk is mitigated by maintaining prudential reserves such as Profit Equalization Reserves (PER) and Investment Risk Reserve (IRR), which subsequently brings in the sophisticated debate of agency problem and stakeholder corporate governance. A schematic representation of the overall profit distribution framework and prudential reserves is illustrated in Figure 3.

**Figure 3: Typical Profit Distribution Framework as Practiced in Islamic Banks**  
(Adapted from Hichem & Hamza 2009)



The pursuit to dish out market based and smoothed returns to its depositors has repercussions on the tenor and nature of the financing side and the overall risk appetite of an IB; enabling it to manage the asset-liability mis-matches vis-à-vis liquidity risk on its balance sheet. This subsequently justifies its logical inclination towards short-term, mark-up based blue-chip lending. The challenge that persists is that of the rate of return and overall asset liability management, where an IB is expected to fund a fixed term and fixed return financing (primarily *Murabaha* based) by an on-demand/ call market-based return deposit base. The lack of interbank and liquidity management instruments and Lender of last resort facilities further burdens the performance of the IBs. Interestingly the Capital adequacy regulations (CAR) stipulated by the Islamic Financial Services Board, assigns 4 times risk weightage to equity-based financing modes as compared to that of the trade-based financing arrangements; which obviously make IBs turn their back to the idealized profit-loss sharing modes. IFSB, however recognizing the PLS nature of deposit base of an Islamic Bank, incorporated the ‘Alpha’ factor (on the discretion of the local regulator) in the CAR, which technically eases out an IB’s pressure on Capital; it is still treated as capital protected fixed rate deposit in most of jurisdiction except for few. The table 2 below reports the level of alpha (a measure of DCR):

**Table 2: Alpha as a measure of DCR in comparable Islamic Banking Jurisdictions (Source: Farooq and Vivek 2012)**

Country	Level of Alpha (DCR)
Bahrain	0.3
Dubai	0.35
Indonesia	1
Malaysia	1
Qatar	0.35
Sudan	0.5

Additionally, the CAR of IBs is further burdened by the market risk on the inventory underlying the trade-based financing on the balance sheet of an IB. Needless to mention, the unique risk such as operational risk, reputational and *shari'ah* non-compliance in an IB. The heterogeneity of legal and regulatory framework and Banking laws makes it arduous for an IB to manage arbitration, dispute resolution and legal enforceability of their claims. The host of issues articulated above, pushes an IB to maintain a conservative risk profile with fixed return and short-term assets. It is pertinent to mention here that the human resource trained in conventional setting, being apprehensive about PLS modes, lack the capability and the will to experiment with PLS Financing.

#### **Market Appetite of PLS modes**

Khan T. 1995 provides an interesting explanation on the demand of PLS modes. On the asset side, i.e., the relationship between the supply (bank) and demand (borrower) of funds, mature companies tend to have a preference for Mark-up modes, to augment profit retention and re-investment in growth; on the contrary entrepreneurial growth-oriented companies are attracted towards PLS modes. Given the dual pressure on their risk profile and CAR, IBs can only viably extend PLS mode to mature companies. This mismatch contributes to overall lack of equity modes on the asset side. Moreover the lack of information infrastructure leads to information asymmetry, which also curbs sectoral and geographical diversity in IBs assets (Dar & Presley 2000).

#### **PLS Modes in Real World – Agency Theoretic Perspective**

In an agency theoretic framework, the PLS modes i.e., *Mudarabah* and *Musharakah* requires greater monitoring and supervision owing to its relatively weaker incentive compatibility grounded in the moral hazard to under-report profits or disincentive to perform. (Dar and Presley 2000), while Ahmed H. 2002 asserted on the need of collateralization to manage the agency cost. The table 3 below elaborates on the incentive compatibility and the remedial measures there against for the most practiced Islamic modes of Financing:

**Table 3: Incentive Compatibility Features of some Islamic Financing Modes**

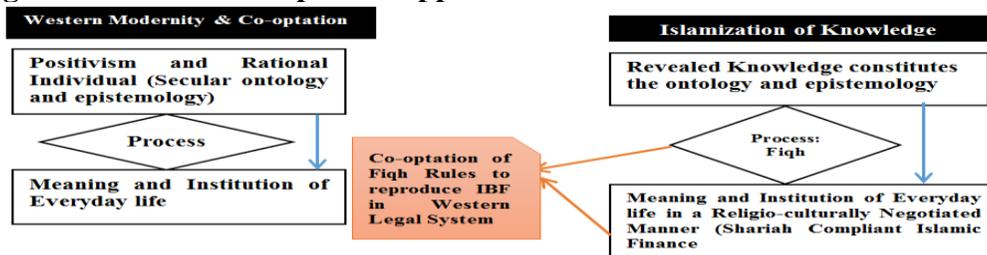
Modes	Residual rights	Control rights	Incentive compatibility	Remedial measures
<i>Murabaha</i>	Fund user	Fund user	Marginally less	Penalty clause, undertaking from buyer
<i>Ijara wa iqtina</i>	Fund user	Financier	Moderately less	Undertaking from financier
<i>Salam</i>	Financier	Fund user	Moderately less	Parallel <i>salam</i>
<i>Istisnaa</i>	Shared	Shared	Moderately less	Parallel <i>istisnaa</i>
<i>Mudaraba</i>	Shared	Fund user	Significantly less	Strong monitoring and supervision
<i>Musharaka</i>	Shared	Shared	Significantly less	Strong monitoring and supervision

The table above highlights the significantly less incentive compatibility of the PLS modes which may rationalize the reluctance of IBs towards them.

**What Went Wrong?**

In the logical pursuit of the manifestation of the deviation ideals and the practice, a lot of literature has expounded on the probable reason underlying this deviation. The present-day Islamic Banking and finance, being a consequence of the political movement arising in post-colonial Muslim countries, to fulfil their faith-based aspirations; depicted an idealistic and perhaps irrational obsession with the PLS based modes of financial intermediation Kahf (2003) and Zarqa (1980). However, the operationalization of these ideals warranted a holistic Islamization of knowledge vis-à-vis economic system on scientific and theoretical foundations. Ahmed H. 2012 mapped the impediments discussed in the earlier sections, to the inadequacies on the cultural and institutional tiers, as framed in the New Institutional Economics (NIE). Reconciled with this thought, (Asutay, 2009) asserted that IBs today as the key functionary of Islamic Financial System, is a rushed pragmatist co-optation of the secular finance, in absence of Islamization of knowledge. The figure 4 below is a schematic representation of the thought:

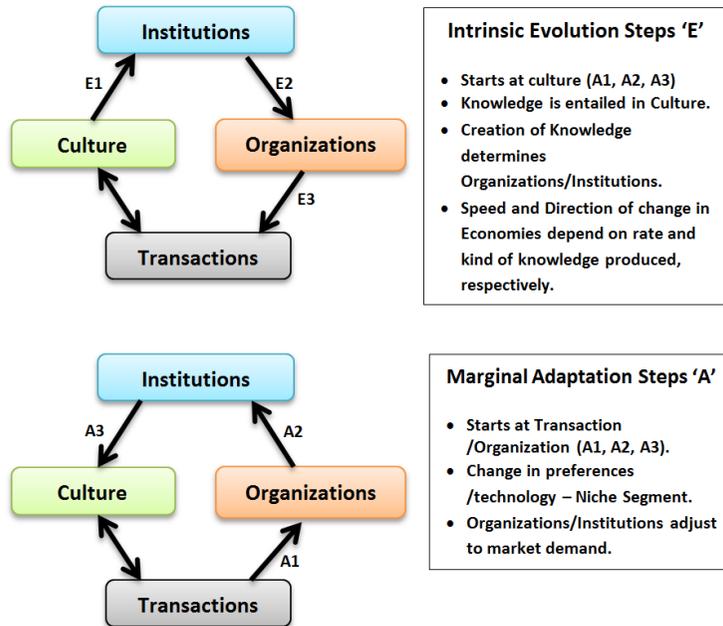
**Figure 4: Western Co-optation approaches Versus Islamization of Knowledge**



Expounding on the same grain of thought, Ahmed H. (2012) claims it to be the marginal adaptation, instead of an intrinsic evolution through knowledge creation based on Islamic

epistemological and ontological foundations, which caused the bleak ingenuity in the structures and formations of present-day Islamic banking. The idea of intrinsic evolution versus marginal adaptation, as articulated under the new institutional economics framework by Habib, 2012 is schematically represented in the figure 5 below:

**Figure 5: Marginal Adaptation versus Intrinsic Evolutionary Process of Knowledge Creation under the New Institutional Economics Framework.**



Nevertheless, the presentation of the above discursive recourse was by no means an apologetic rationalization of the inability of Islamic Banks to pursue the ideals of Islamic Banking. This is perhaps an effort aimed at developing a broader understanding of actual divergence of IBF vis-à-vis their operational causes. Moreover, it is to establish the idea that the pervasive reverse engineering based on methodological determinism through the prohibitionist lens, coupled with limited commercial research to produce Islamic equivalent of conventional products, would never be able to serve the ideals of Islamic Finance.

**Towards an Equitable Islamic Bank – The Way Forward**

As metaphorically exclaimed by Elgamal (2006), IBs need a turn in to ‘a good and fairly priced shoe’ from a ‘Christian shoe’. This transformation solicits a multidisciplinary effort employing innovative engineering approach, aimed at the creation of basic and applied knowledge to develop apt organizational formats – which could set-up a symbiotic eco-system for an ingenuous Islamic Financial system in cohesion with the Islamic. Alternate governance mechanism vis-à-vis the role of SSBs to propel the transition from *Shari’ah* Compliant to *Shari’ah* Based Islamic Banking solutions, also needs serious research endeavours. Moreover, a joint *Ijtihād* arrangement

by religious scholars, practitioners and economists needs to be instituted to expand the ambit of IBF, by reflecting on alternate organization formats such as Venture Capital, mutual cooperative, not-for-profits and waqf as effective disseminaries of an equitable financial system.

### **Islamic Financial Intermediation and Information Asymmetry**

Khan (2010) attempted an inquiry on the desired characteristics of an Islamic Banking system, and up to what degree the contemporary Islamic Banking practices, distinguishable from the mainstream or the so-called traditional banking system. However, Kuran(1993) deemed this expectation of IBF being distinguishable atleast in substance, to be irrational and somewhat illogical; as the current form of secured interest based financial intermediation rationalizes its existence on the basis of information asymmetry and transaction cost. Albeit, IBF may have had its own distinct contractual formats and an altogether glossary of Arabic terminologies, nevertheless respire in the same paradigm of information asymmetry based financial intermediation. Thus, in essence and in spirit, it inevitably would stick close to the traditional banking techniques. Hence, it shouldn't be surprising for someone to see IBF bearing virtually the same resultant as that of its conventional counterpart.

### **The Prevalent Debt Based Modes in Islamic Banking & Finance**

The insistence of trade/debt-based modes reliant on mark-up-based income, structured around two sales engaging banks as a seller/purchaser, in the present-day IBF has been subjected to discerning opinion by the researchers. A mix of apologetic, patronizing as well as severely critical attitude from the concerned quarter has been exhibited. Ausaf Ahmed (1993) supports it by calling it a step-in transition away from the conventional banking, and expect to phase-out with the passage of time. However, Khan (2010), found it to be contrary as even a decade later, *Murabaha* financing dominates the balance sheets of Islamic Banks. Tarik Yousef (2004) taking the criticism, a step forward declared the present-day IBF to be infected by '*Murabaha Syndrome*'. On the contrary, Siddiqui (2002) takes an accommodating stance on the trade-based mark-up arrangements as 'weak Islamic forms' being permissible as far as the financing contract integrates risk sharing in some form.

### **Theoretical Foundations & Guiding Principles of Islamic Banking and Finance**

The theory of Islamic Banking and Finance, revolves primarily around the severely expressed *Ribā* prohibition in the Holy Scripture i.e., *Quran*. *Ribā* is usually translated as interest or usury, but having a literal meaning of increase or excesses (El-sheikh, 2008). However, a more intuitively rationalized interpretation of *Ribā*, commands disapproval and detestation for profits earned on risk-free collateralized debt.

With the development of the Islamic Finance as a faculty, and its institutionalization in form of Islamic Banks and Financial Institutions, broad governing principles and governing framework were defined in the light of Islamic Law/*shari'ah*. The four basic guidelines or defining conditions are as follows (El-Hawary et al. 2004):

**One: Risk-Sharing** – symmetrical risk/ return distribution among the stakeholder of the financial transaction should be reflected and integrated in the financial contract

**Two: Materiality Finality** – This condition was aimed to rule out ‘speculative options and derivative based structures. It solicits all financial transaction to be embedded in real economy that is to be backed by real economic activity.

**Three: No Exploitation** – One of the key objectives of *Ribā* prohibition and subsequently the objective of an Islamic Bank is to wither away any possible exploitation of any participant of the financial transaction.

**Four: Not to extend financing to business or entities engaged in Sinful Activities** – i.e. to assure IBF don’t contribute to towards the production of destructive products banned by the Islamic Law e.g. pork, alchohol, gambling, drugs, arms and ammunition etc.

### **IBF through the Funnel of Guiding Principles**

The theory of IBF prefers and insists on the deployment of Equity Participatory financial contracting either through *Mudarabah/ Musharakah* contract to promote profit, loss and subsequently risk sharing arrangements. It is pertinent to note here that Iqbal and Molyneux (2005) reported a risk sharing financial system to pave way for better and equitable allocative efficiency, thus facilitating financial systemic stability and economic growth.

Nevertheless, the praxis of IBF is dominated by non-participative Islamic financial modes, which includes lease based such as *Ijarah*, and sale-based arrangements including but not limited to *Bai-Murabaha*, *Bai-Salam*, *Bai-al-Muajjal*, *Bai-ad-dayn* and the infamous *Tawarruq*. The practitioners rationalize their choice of sale-based modes, as being well-suited for the banking business model, liquidity and risk management limitations. Besides, the sale-based modes though not preferable, but are *shari’ah* compliant being backed by a real economic sale, and risk sharing even for a very short period in shape of the inventory ownership risk that the banks being the financier undertakes on its books (Hanry & Wilson, 2004).

### **History of Interest based Debt in Muslim Jurisdictions**

Interestingly, jurisdictions, government and economies managed by Muslims engaged debt-based financing and transactions. For example, in the 17<sup>th</sup> century during the Ottoman’s rule, it was permissible to finance transactions at interest rate below 20%. While in the 18<sup>th</sup> Century Egypt’s trade with the Barbary (western) states was financed through interest-based arrangement below 10%. Even, as late as the 19<sup>th</sup> century the Ottoman government use to pay their bills through a mix of cash and treasury notes paying around 12.5% per annum. In the subcontinent, Muslim clans, especially the proselyte ones (Memons, Khojas and Bohras) having been traders and businessmen for centuries carried their age-old practices of their ancestors of dealing in interest-based financing.

### **The State of Contemporary Islamic Banking and Finance**

Not much has changed with the modern layout of Islamic Banking, where non participatory modes such as *Murabaha* and other debt-based arrangements dominates the contemporary IBF scene, which is castigated by many, in all possible as being Islamic legal sophistry, casuistry, mimicry and what not. It has been labelled as an Islamic form of medieval *contractum trinius*, which refers to the contracts devised by the European merchants and bankers as a method to circumvent the Christian canonical law prohibiting usury back in the Middle Ages.

Moreover, *Murabaha* facility if analyzed on the four basic screening tests, it fails to fulfill 1<sup>st</sup> and the 3<sup>rd</sup> condition i.e., sharing of risk and no exploitation respectively. Even the Ijarah mortgages and Sukuk structure fall short the above mentioned El-Hawary's screening framework. This deviation is not limited to the financing side, but has also been exhibited on the deposit side, as has been pointed out by El-Hawary et al (2004), wherein bad debts are not passed on to the depositors as losses, i.e., depositors remain capital protected as against the contractually agreed *Mudarabah* based Investment Account. It is not just the capital protection, but also the depositor's retention is ensured by the IBs by offering the market competitive returns at the expense of equity shareholder (a risk called Displaced Commercial Risk), even in distress situation. The most cited example of this being that of the distressed Dubai Islamic Bank back in 1998, being rescued by the domestic central bank. A detailed account of the practical difficulties and challenges faced on the deposits and the underlying profit distribution formats is discussed in the later part of the paper.

The most sad and perhaps scandalous instances, was that of the blatant governance failure of the Islamic Banks not being able to adhere to the condition four, where Khan 2010 cites the example of (i) the sixth largest Islamic Bank in the world i.e. Faisal Islamic Bank holding conventional government bonds, while the payoff thereagainst being reported under the head of 'religious legal operations' and (ii) Albaraka Bank in Pakistan, reportedly in their Annual audited account exhibits 12.5% and 19.65% of their gross income based on interest based export financing back in 2005 and 2006 respectively.

### **Why is Islamic banking not Islamic at all?**

#### **A Pragmatist Alibi**

The Prevalence of Information Asymmetry, Moral Hazard & Adverse Selection

Expanding on the Kuran's thesis, the lacklustre financial information infrastructure vis-à-vis deteriorating information flows prevalent majority of the Muslim world, worsens the opacity and the accompanying moral hazards and adverse selection problem. The situation is further aggravated by the degree of corruption these countries are suffering from, with majority of the Muslim countries falling in the highly corrupt half of the Transparency Corruption perception index. Moreover, high expropriation levels and weak property rights owing to the patrimonialism and autocratic governance system (Fish, M.S. 2002), also characterizes most Muslim countries (Yousef, 2004). In the wake of such situation collateralized debt-based contracts

become gets even more preferable, as compared to equity based PLS modes for the financial intermediaries operating in the region, be it Islamic or traditional banks.

### **Rent seeking *Shari'ah* Arbitragers**

The infamous castigation by Elgamal (2006), finds evidences of validity, with the popping up scandalous *shari'ah* compliance, and fatwa shopping scams like 'Goldman Sachs Sukuk' structure find their way up to the markets. Besides their compliance mindset based Mubāh, and ruses (*Hiyals* and *Mubāh*), and preference for the conformity with the form, leaving aside the substance has been subjected to reproach. Hence, the lack of inventiveness, innovation and ingenuity during the past four decades of operations has left the discipline of IBF stagnated or perhaps underdeveloped.

### **Competitive Pressures Owing to Coexistence**

Other pragmatic explanation that El-Gamal presents again due to coexistence in a conventional economic system, is that the *shari'ah* compliant products have to be functionally identical to conventional products to seek acceptance not only from the consumer base, but also from the Islamic products have to be functionally identical to conventional products otherwise it would not be approved by banking regulators (El-Gamal, 2006).

### **Lack of Training and Human Resource Development**

Lack of educational, training and specialize human resource development has also been an impediment. Mostly Islamic Banks are being run by proselyte Islamic Banker, being groomed in conventional banking setup – thus live in a 'hangover' who cannot conceive banks to be an investor, rather than a lender (Ahmed, 2002).

### **Cost Efficiencies**

Higher moral hazard and adverse selection in equitable modes, demands greater monitoring cost, which again turns collateralized debt-based arrangements to be the preferred choice for Islamic Banks (Iqbal et al. 1998), on grounds of their cost efficiency.

### **Lacklustre Demand of PLS Modes**

Besides, Iqbal et al. 1998 reported that even on the demand side i.e., the borrower fancy debt arrangements, owing to the tax benefit that it accompanies. Khan (1995) reported lack of demand of PLS modes from consumers both on the asset and liability side, which may be rationalized by the risk averse nature of the bank depositor, and the unwilling borrower to share its business's upside payoffs.

### **Favourable Tax Treatment for Debt based Arrangements**

Interestingly on the other hand, governments not only from Muslim Countries, but also from non-Muslim jurisdiction such as the UK, have been considerate enough to roll-out tax reform to curb double taxation in *Murabaha* transactions especially for Housing finance; thus, encouraging debt-based structures and level playing field to Islamic Banks. The tacit fact underlying the above dynamics of the IBF, is that IBs rather than presenting an alternate model and crafting a niche of their own, have been

sucked-in to the bloody cut-throat competition with their conventional counterparts which have been there for the past four centuries (Ahmed, 1993).

### **Rethinking *Ribā* – Towards an Islamic Banking for Economic Development**

Having analysed the Islamicity of IBF, and its dynamics, against its fundamentals, which has long been declared as ‘not-at-all’ Islamic by the likes of from Kuran (1983, 1995), Aggarwal and Yousef (2000), El-Gamal (*Shari’ah* Arbitrage) and El-Hawary et al. (2004) – there exist an exigency to rethink and expand the research frontiers, to attend the following questions/ research objectives (referred in the earlier section as well):

- *To critically evaluate, as to whether the guidelines of the Islamic Banking (El-Hawari et. al, 2004) make an economic sense, especially in the context of the subprime crisis, where the contagion of toxic debt has taken the developed world in to its fold.*
- *To assess the fact that, if the so-called IBF Guiding Principles grounded in Quran and Sunnah – i.e., the practice of Prophet Muhammad (PBUH) fourteen hundred years ago, contribute towards the economic development of human kind?*
- *Why these ruses exist, and have persistently been endorsed and practiced by the Islamic Banks? While taking on the Information Asymmetry argument coined by Kuran (1983) and Khan (2010), we attempt to explore the dynamics and mechanisms to eschew offshoots problems of adverse selection and moral hazard.*
- *How the lack of an apt understanding of injunctions on Ribā and its implication on property rights, has led to the perennial economic underdevelopment of Muslim World?*

The paper employs a discursive conceptual and theoretical review methodology, to address the questions listed above. It is organized in the same order as that of the questions listing.

Albeit, the whats and hows of IBF has been rigorously probed by researchers, however the ‘whys’ of it at the fundamental level stands unaddressed. The discussion staged in this paper, would attempt to investigate the validity of the IBF Guidelines itself, and its cohesion to the ontological sources of *shari’ah* (i.e. *Quran* and *Sunnah*). Moreover, even assuming the validity of these IBF guidelines, the need to analyse the economic efficiency vis-à-vis development that it can offer, as an alternate financial intermediation system.

### **Economic Sense of *Ribā* Prohibitions**

The fundamental injunctions as stipulated by the *Shari’ah*, comprises of firstly prohibition of *Ribā*, and secondly that of *Gharar* and *Mayser*. Viewing it through the prism of financial economics to explicate the wisdom and the boons underlying such prohibition, Ebrahim et al. demonstrates that the basic idea of *Ribā* is to safeguard property rights, which subsequently curbs any possible expropriation; thus, cultivating economics development and prosperity (Acemoglu et al. 2005). The classification of *Ribā*, i.e., *Ribā-an-Nasihah*, which is implicated in the deferral of financial claims, should

incorporate the fulfilment of the following conditions:

- The returns on a commercial loan should essentially integrate the cost of funding i.e., the real interest rate (may be assumed to be the inflation rate).
- Payoffs should be range bounded within the following interval i.e. (0, unlevered returns of the project)
- To avoid fragility, it should be contingent on the returns of the project.

An elaboration of the above boundary conditions as deduced from *Shari'ah*, has been expressed in Ebrahim et al. (2015), wherein the economic rationale of these conditions is explicated to avoid expropriation, protection of property rights and assurance financial and systemic stability across the economy. The non-expropriation clause, often mis-construed as exploitation in the literature for example and Khan (2010) and El-Hawary et al. (2004), is to evade the unsustainable equilibrium owing to depletion of values on part of either participant. This also has regulatory and policy implication to shun wealth extrication in the underwriting of financial products.

### **Rationalizing Non-Expropriation**

The rationale behind the first constraint of no expropriation (misstated as no exploitation) clause in the Islamic finance literature e.g. is to avoid an unsustainable equilibrium due to depletion of resources of either party. This is of import to regulators who need to ensure that financial products do not extricate wealth (or 'exploit') their investors.

### **Rationalizing Risk Sharing for Financial Stability**

Similarly, the requisite of risk-sharing assures prevention of financial instability, as seen in the contagious devastation in the recent global financial crisis, originating from the substandard mortgage products underwriting to sub-prime borrowers (Reinhart and Rogoff, 2008). The famous economist Franco Modigliani portended the fragility in the plain vanilla debt, decades ago in his thought-provoking words quoted verbatim below:

*“As long as loan contracts are expressed in conventional nominal terms, a high and variable rate of inflation- or more precisely a significant degree of uncertainty about the future price level – can play havoc with financial markets”* (Modigliani, 1974, p.1).

### **The Need for Quasi Equity Financial Contracts**

Ebrahim et al. (2015) elucidated on the pareto-inferiority of the medieval PLS based contracts of *Musharakah* and *Mudarabah* heavily insisted by the professors of Islamic Finance (Siddiqi, 2002). They, instead professed the institution of a quasi-equity (hybrid format) product, which is an optimal financing instrument and is validated to be *Shari'ah* Pareto-efficient as well. It is worth mentioning here that quasi-equity instruments proposed by them are malleable across the dimensions of either sharing of income, equity claim or capital gains, offering underwriting of financial contracts to match the varying characteristics of projects and business ventures. Another prudence

that concealed in the Islamic injunction against *Ribā*, usually missed by the critiques is to avoid financial exclusion, which is proposed to be addressed by subsidizing financial services to the poor by deploying charitable funds (primarily zakah) in to the financial intermediation system.

### **Demystifying Materiality, *Mayser*, *Gharar* and Information Asymmetry**

One of most distinguishing features of IBF is that of its embeddedness in the real economy; as stipulated the IBF guidelines as the principle of materiality (El-Hawary et al., 2004, and Khan, 2010), with the underlying goal to evade the interlinked issue of *Gharar* and *Mayser*. Thomas (1995) defined *Gharar* as “deception based on the absence of knowledge on the likelihood of delivery with the prospect to do harm”. Even the most infamous of the IBF transactions like that Tawarruq and commodity *Murabaha*, though fictitiously, atleast comply with this condition (of asset backing). The intuition behind this compulsion is to avoid naked option writing, dealing speculative derivatives and short selling to avoid probable instability and its domino effect in an opaque economic setting as was experienced in the recent global financial meltdown (Reinhart, and Rogoff, 2008). Contrary to the opinion of El-Hawary et al (2004), Kamali (1996) and Ebrahim and Rehman (2005) deemed it to be permissible, strictly limited to be employed as a prudential measure towards risk management and hedging tool. Lastly, IBF being a value-driven socio-economic system, it is obviously expected not to finance an activity with deleterious effect which doesn't conform to the shari'ah stipulations (Acemoglu et al., 2005).

### **IBF beyond Ruses and *Shari'ah* Arbitrage**

Though a plethora of research probes the issue of divergence between the rhetoric and the practice of IBF as a financial intermediation; wherein a detailed account on the actual non-conformities based on the ruses and legal stratagems, limitations and challenges, practicalities and externalities have been manifested. But a gap is evident in the prior research as to how these ruses found their way in to the institutionalization of IBF, and more importantly how they continue to exist and are endorsed despite of enormous amount denunciation. Expanding on the rationale of information asymmetry as explained in earlier section, coined by Kuran (1993), an attempt is made to explicate the underlying issue of moral hazard and adverse selection by posing further questions:

#### **Question One:**

Why can't we mitigate the issue of adverse selection, by deciphering ex-ante information held by the obligor (participant in a debt contract) through?

- Tranche financing and managerial control through board representation as conducted as conducted in a venture capital entity as elucidated by Gompers and Lerner (2001);
- Exchanging financial claims over a multi-period time horizon as demonstrated by Hosios and Peters (1989); or through the amortization of a financial contract as exhibited by Wu (1993).

## Question Two

Why can't we control the issue of moral hazard, owing to the ex-post information opacity by means of meticulous underwriting of financial contracts and incorporating iron-clad covenants as portrayed by Smith and Warner (1979) & Billet et al. (2007)?

Though costlier than plain debt, but the issue of information opacity vis-à-vis moral hazard and adverse selection can be seized by ways described above. This adds to the depth to the puzzle at hand; i.e., why IBs resorts to ruses, or duping as phrased by Khan (2010). Thus, the so-called asset backed sale-based financing arrangements are more of a literalist *Ijtihādi* effort by the religious scholars, aimed at curbing the agency cost of debt as explained by Barclays & Smith (1995), instead of alleviating the information asymmetry as claimed by Kuran (1993).

### Causes and Fallouts of the Persistent Misconstrued Interpretation of *Ribā*

If critically analysed, probably it was the literalist interpretation by the early scholars (*Fuqaha*) to equate *Ribā* with 'increase' or 'growth', and then the classification of goods in to *Ribāwi* and *ghair Ribāwi mal* as asset with or without the attributes of *Ribā*. The rationale for ruses employed in Islamic banking is attributed to an aggregation of errors made by the early scholars (*fuqaha*) where they: (i) misconstrued the injunction of *Ribā* literally as an 'increase' or 'growth'; and (ii) segregated goods (or assets) with and without the characteristics of *Ribā* (*Ribāwi-mal* and *ghair-Ribāwi-mal*) respectively. Money and commodities were unanimously classified as *Ribāwi mal*, which was also defined as fungible goods that a measurable as well (Al-Zuhayli, 2006).

The interpretation was then extended to rationalize the credit (sale) as in practiced historically involving an exchange non-*Ribāwi* asset on spot, against a *Ribāwi* asset (such as money) in deferral to create a credit leg, underlying a trade transaction. This again erroneously led them to conclude that the historic *Murabaha* (i.e., credit) sale was permissible as it involved a non-*Ribāwi* asset (like a property) on the spot and a *Ribāwi*-asset (like money) to be deferred. This was further ratified by backing it by the Qur'anic verse: "Allah has permitted trade (implying *Murabaha* here) and forbidden *Ribā* (implying usury)" (2: 275), (Al-Zuhayli, 2006). Thus, the role of an IB, as a financier was incorporated in two back-to-back sale arrangement, i.e., between the supplier and the bank, and the subsequent sale on deferred payment loaded with a mark-up (usually grounded in conventional interest benchmarks) between the bank and the borrower. This arrangement, called *Murabaha-to-the-purchase-orderer*, with a compliant form, and a criticized substance eventually became the most practiced and favourite structure for the Islamic Bankers. The inclination towards the *Murabaha* also drew its support from the fact that the early jurist was researching in an era of subsistence, with no formal financial intermediaries. With the passage of centuries, the modes of economic cooperation have transformed altogether and so has the need and implications of a credit sale. It is imperative to note here that, fourteen hundred years ago with non-existent banks, a credit sale was meant to increase the demand of real commodities as articulated by Sen (1998) "when financial markets are imperfect,

*a seller can find it optimal to offer a menu of deferred payment plans*". The inability of the *shari'ah* scholars (*fuqaha*) to assess the economic boon and bane of a financial contract, aptly rationalized the IBF in its present shape. One may question, as to why has this not been exposed in the past. The possible answer may be that the contemporary institutionalization was monopolized by religious establishments and clergy, who were professing financial solutions based on the rudimentary and static Islamic Commercial law developed around a millennium ago. It is probably this static *Ijtihād* or as Al-Awani (1991) phrases it 'the crisis of *Fiqh*' that lead IBF in to intellectual dead end forced by an agglomeration of errors, that concocted the ruses on which contemporary IBF has been erected (to what Timur Kuran (2005) terms as 'Westernization')

It is the same stagnancy and departure from the reason towards a literalist canonical interpretation of the revelation that led to the downfall and the subsequent colonization of the Muslim world (Chapra, 1999). Whereas, the west's financial innovation and development turned out to be the harbinger of their economic development (Hicks, 2000). Furthermore, institutionalization of the various schools (*madhahibs*) in Islam, wherein the strict essentialist approach stifled the process of critical thinking. This essentialism warranted Muslims to think strictly in coherence with the school of thought that they belong to (Al-Alwani, 1993).

Another intricate reason leading towards the downfall of the scientific leadership and scholarship is the development of what is called as 'the dichotomy of science' by Ali (2002). This dichotomy as perpetuated by the religious scholars, narrowly limited '*ilm*' (i.e., true knowledge) to religious knowledge i.e., the learning of *Quran*, *Sunnah*, *Seerah* and perhaps the history of Islam; whereas the study of basic sciences such as mathematics, physics, medicine, chemistry were derogatively classified as Arts or 'funoon, (Ali, 2002).

### **Misinterpretation of *Ribā* Injunctions & Underdevelopment of the Muslim World**

As elucidated in Ebrahim et al. (2015), the perennial underdevelopment of the Muslim world is attributable to the poor and perhaps off-beam interpretation of the *Ribā* injunction, which was basically intended to protect the property rights. This deficiency in the comprehension of this crucial stipulation steered the Muslim world to: (i) to autocratic rule for centuries without repelling it and perhaps patronizing it (ii) eschew property rights of the commons; and (iii) impeded the redistributive justice through institutions for the economic advancement of the underprivileged and the poor.

The consequent pareto-inferior economic equilibria led the Muslim world in to a devastating 'poverty trap' emanating from the above three reasons. The intellectual and economic deprivation along with an oppressed majority made them fall prey to colonization leading to a further decline. Subsequently, the aftermath of the colonization left long-lasting imprints, and can still be felt.

### **Conclusion**

This paper presents a descriptive and critical account on how the incorrect conceptualization of the key injunction on *Ribā*, steered flawed institutionalization of

an Islamic Financial intermediation system. It also rationalizes the ‘long divergence’ in terms of the persistent economic downturn and underperformance of the Muslim world. Contrary to the thesis of Kuran (2011), it is not the Islamic Law (primarily *Ribā*) but the wrong interpretation of the ontological and epistemological sources of Islam that has done the damage to the Muslim world. This paper asserts the cruciality of the rethinking and revisiting the definition of *Ribā* in modern financial economic terms to achieve a) *shari’ah* adherence in true spirit and essence b) financial and economic development of the Muslim world.

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