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Expanding the Frontiers of Economics: Some Insights from the Qur’anic Revelation

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Abstract: The primary sources of economics are human thinking and observation through sense-perception. Economics does not accept any super-sensory source as a valid field of enquiry. However, divine revelation granted to Prophets by God is a source of knowledge that deals with wide-ranging issues including the economic problem. The main argument of the paper is that by integrating human understanding of the divine revelation with conventional economics, existing frontiers of the subject can be expanded. Although the divine revelation is found in the basic texts of all revealed religions, yet the present paper deals with the Islamic primary sources (the Qur’an and the hadith) only. The paper enumerates, by way of example, six problem areas where the Qur’anic revelation can give a lead. These areas are: inequality, human happiness and unhappiness, economic balance, philanthropy, financial crises and stock exchange instability, and waste in human society. However, such a conclusion would firstly require overcoming prejudice against religion and non-conventional fields of enquiry.

Keywords: Revelation and Economics; Religion and Social science; Qur’an on Distribution of Income and Wealth; Qur’an on Happiness; Economic Equilibrium; Financial Crises; Foreign Exchange and Stock Exchange Instability; Consumer Behaviour in Islam

JEL Codes: B59, D31, D63, F64, H53, I39, Q53, Z12

Introduction

Revelation as a Source of Knowledge

Economics as a social science is based on knowledge acquired through human thinking and sense-perception (Zaman, 2013, p. 5). It does not accept religion as a valid source for understanding the economic problems. In fact, the economists...
contend that religion and economics are two different fields of enquiry with no common ground. Several economists have argued for separation of religion from economics. For example, Boulding (1968, p. 187) thinks that the religion deals with subjects like God, prayer, worship, grace, salvation, communion, justification, and the likes which are manifestly different from economics. This is in line with the general revolt against religion after the Reformation (1517-1648) in Europe. However, this is an extremely limited perception of religion when we take a deeper look on the total canvas of the subjects discussed in all revealed religions which, no doubt, trace their origin to the revelation from God but deal with various socio-economic aspects of life as well. Besides spiritual development, they also deal with material welfare of human beings although the routes of material prosperity advocated by religion and economics may differ. This, for example, is true about Judaism, Christianity and Islam. It is not fair to say that religion deals only with some metaphysical aspects of life, as contended by Boulding. The present paper argues that economists can gain useful insights by understanding and interpreting the content available in the form of revelation. It does not plead for replacing economics. It only points to additional dimensions of knowledge, obtained through revelation-based insights, which can add, extend and deepen our understanding of the economic problem. This is in line with the position taken recently by some economists like Nelson (2014, p. 57) who pleads for incorporating religion into economic policy analysis, though it would require a major methodological change in the existing body of economics.

**What is Revelation?**

By revelation we mean the source of divine knowledge revealed by God to His apostles since the inception of humanity. The Qur’an says (Q. 42:51-52, 53:10) that God uses three methods of sending His revelation upon his chosen people (like apostles): (a) sudden inspiration; (b) by a voice from behind a veil; (c) through an angel. It further says that for revelation to Prophet Muhammad (pbulh), all three methods were used.

Adam (AS) was the first human being and the first apostle. At the time of Adam (AS)’s birth and apostle-hood, the whole earth was barren and undeveloped and his main assignment as God’s vicegerent was to develop the earth as habitat for the human beings. Besides spiritual and ethical teachings that all prophets preached, Adam (AS) and his successor apostles were also responsible for guiding the human beings in ways and methods of physical living. All apostles in their respective geographical areas provided guidance to the human beings about practical arts
and sciences such as agriculture, food, diseases, medicine, use of metals, designing of tools and weapons, etc. Each apostle added to the existing stock of knowledge in physical and social lives of the people he addressed. By the beginning of the 7th century when Muhammad (pbuh), the last of all apostles, presented his message, the total stock of human knowledge had evolved to a stage where it required minimal guidance for physical dimensions of life. The humanity had reached its adolescence from the time of infancy since Adam (AS)’s birth. The human beings could now lead their daily life considering their experience, accumulated knowledge and rational thinking. However, only a few areas still required guidance from God. These were the areas where the likelihood of arriving at a balanced and moderate approach through human endeavors was minimal and the risks of error were significant. Only in those areas, the Prophet of Islam provided guidance in the light of revelation he received from God.

Revelation and the Qur’an

The revelation received from God was compiled and preserved by Muhammad (pbuh) himself during his life-time in the form of Qur’an. His successors made sure that the original script was copied and circulated among later generations as it exists today. The Qur’an as compiled by Muhammad (pbuh) is available at present verbatim as revealed by God. There has been no change or modification in the original text. The revelation of the Qur’an is a continuation and climax of all divine revelations which have been going on since the dawn of human consciousness. All apostles of God received revelation according to the needs of their times. The Qur’an is the latest and the most comprehensive of all of these revelations and is relevant for all times to come.

The latest compilation of revelation, thus, is available to humanity in the form of Qur’an. There is a large accumulation of literature consisting of sayings, actions and approvals of the Prophet (pbuh). It is known as hadith. A lot of guidance and wisdom can be distilled from this source of knowledge as well.

The Qur’an repeatedly stresses the unchanging sameness of the spiritual and moral principles underlying all revealed religions (Q. 21:92, 23:52, 42:13, 53:56). It emphasizes that in its wider and general sense all revealed religions are the same and invite human beings to the same truth. Although in this paper we are focusing on the revelation received by Prophet Muhammad (pbuh), yet a similar exercise is possible and may be even necessary with respect to other revealed religions. For example, primary texts of Judaism and Christianity are also available and huma-
nity can benefit from these divine sources of knowledge as well. The Qur’an deals with all important matters relating to living in a civilized society. Most of its guidance is in ethical and spiritual framework, though it does provide guidance relating to physical and financial matters as well.

**Revelation as Economy of Human Effort**

People can learn about various socio-economic issues through thinking and experimentation. It is possible that the humanity may find the same solution, through rational thinking and experimentation, which the revelation had provided. The humanity has learnt, through hard way and over centuries, many lessons which have now become commonplace and generally acceptable. These lessons are also supported by the divine guidance. Examples are consensus on equality of human beings, accountability for all, respect for property rights, women rights, safety net for the poor, documentation of business dealings, government’s responsibility toward the governed, restraint on economic power, governance through consultation, etc. Many lessons have been learnt by the humanity over centuries through a process of hit and trial and at huge cost. These lessons could have been learnt by the humanity at a much smaller cost, and in a shorter span of time had it paid heed to the guidance from the revelation. Unfortunately, after revolting against religion post Renaissance (14th-17th centuries), the humanity had to discover such principles of civilized living by treading a roundabout and circuitous route.

In brief, the revelation is a source of knowledge that helps human beings in finding solutions to problems in a shorter time and with much less effort than they would require without it. *It is, in fact, an economy of human effort.* The Qur’an itself says: “And it rests upon God alone to show you the most economical path while there are many zigzag routes.” (Q. 16:9). Most of the above-mentioned achievements could have been possible at a much lesser cost and effort had the humanity heeded to the guidance from the revelation. This very fact encourages us to invite the humanity to see what the revelation offers in solving the contemporary economic problems.

**Revival of Interest in Religion among Social Scientists**

It is encouraging to note that interest on the inter-relationship of religion and economics is reviving centuries after Adam Smith wrote his *Theory of Moral Sentiments* (1759). Innaccone noted in 1998 (p. 1465) that since 1970s, dozens of economists and sociologists, ‘armed with tools of economics and a large body of data’ have written nearly 200 papers on economics and religion. Iyer (2015, p. 10)
says that since 1700s scholars like Galileo, Voltaire, and Mark Twain have been forecasting extinction of religion but it has not died; instead, its influence has only increased over time. He (2015, p. 4) also mentions Hungerman and Chen (2014) that during the last one decade there has been a six-fold increase in the number of papers on economics of religion. Ewest (2015) notes reemergence of interest in religious beliefs and accounts for recent philosophical shift in the organizational life away from secularism and technical competence to spirituality. Welch and Mueller (2001) argue that even though religion and economics, being concerned with human problems and human welfare, have a complex relationship, there are areas where the two disciplines can converge and benefit from each other. However, Iyer (2015, p. 63) endorses Innaccone’s (1998, p. 1490) point that economics of religion research had some gaps. One of these gaps was that it ‘had sidestepped the substance of religion and had not given enough thought to using broader conceptions of religion into formal models’. The present paper intends to fill this gap by pointing to the role of revelation in expanding the scope and approach of economics.

Potential Areas of Contribution by Revelation

In the following discussion, we shall point to six potential areas where the revelation of God provided in the Qur’an could help cover mileage in understanding various economic problems. These areas are only indicative. A deeper reflection and consultation process can point to more of similar areas. This is part of what, we can say, Islam offers to humanity. On the one hand, guidance from the revelation can help expand the frontiers of economics and on the other, methodology of economics, using hypothesis formulation and testing, can contribute to a scientific study of religion.

Inequality

Inequality in terms of opportunities for social and economic progress is a subject of several recent studies (Fabrizio et al., 2017). Its various dimensions are also subject of further research. Inequality can be seen in various shades and dimensions. It can be inequality of income and wealth among individuals, business enterprises, and regions of a country or among different countries. Economists are exploring reasons for economic inequality and have proposed vast ranging policy measures for minimizing its impact. However, the conventional economic analysis tackles the subject considering various socio-economic variables such as differences in in-born faculties, family traditions, educational opportunities, climate and physical
environment, development infrastructure, ease of doing business, protection of property rights, laws and governance practices, taxes and subsidies, use and misuse of economic power, political rent-seeking and inheritance laws, etc.

*Spiritual dimension of inequality*

Since economics does not accept any knowledge beyond sense-perception it does not cover spiritual dimension of inequality although it contributes significantly in generating inequality among people. The Qur’an discusses the subject of human inequality at length in a spiritual perspective. It points to inequality in terms of differences in *rizq*, which literally means ‘provisions’ or ‘means of sustenance’ but has a much wider connotation. The *rizq* covers not only income and wealth but also such intangible factors as health, knowledge, family life, peace of mind, social respect and honor, and ease of living, etc.11 The Qur’an discusses variations in *rizq* among human beings and relates them to inborn differences as well as to ethical dimension in human behaviour. It refers to two extreme kinds of persons having *rizq* ‘beyond any reckoning’ besides most of the common people who have it in varying degrees. We can imagine two extremes of a continuum on each end of which are visible minority of people having wealth beyond reckoning. In between these two extremes are ordinary people with various levels of income and wealth.

The two extreme models are: (a) people who acquire wealth through lawful and ethical means, like, for example, King Solomon (1010-931 BC)12; and (b) the other who acquire it through criminal and unethical means like, for example Qarun (Biblical name, Korah)13, one of the people of Prophet Moses (AS). Examples of such characters can be found even in the present world. In between these two extremes are most of the people who acquire wealth by intermingling ethical and unethical behaviour in varying degrees and at various points in time. The divine scheme of distribution of *rizq* combines many social-economic factors (covered by economics) and spiritual factors (not covered by economics) and determines the entitlement of a person for the *rizq*.

The study of inequality in the Qur’anic framework can open new areas for research in economics. For example:

- At present level of our knowledge we yet do not know the exact role that each spiritual factor plays, in combination with various socio-economic factors, in determining the entitlement of the *rizq* of a person.

- It would be a serious challenge for economists to explore the divine scheme of distribution of *rizq*, simultaneously considering empirical and spiritual factors.
The spiritual factors have both positive and negative dimensions. On the positive side, the examples of spiritual factors are philanthropy, gratitude, truthfulness, integrity, patience, contentment, trust in God, etc. On the negative side, examples of the spiritual factors are oppression, arrogance, dishonesty, corruption, fraud, persecution of the weak, ingratitude and self-conceit.

- It would require hypothesizing and testing about the distribution of *rizq* among people and across economies considering socio-economic and as well as spiritual factors, positive as well as negative, in the behaviour of people. Several long-term studies may be launched to collect cross-country data for large samples and over extended periods for understanding the role of ethical behaviour in the distribution of *rizq*. The research will help us understand the divine scheme of the *rizq* which is also a contributing factor to inequality.

Once we understand the divine scheme for the distribution of *rizq*, considering various socio-economic factors along with human ethical behaviour, we shall have more realistic understanding of the prevalent inequalities. It would then be possible to design appropriate public polices to bridge those inequalities.

**Human Happiness and Unhappiness**

*Human well-being (the Falah)*

A related problem is human well-being which leads to human happiness. Economists are now arguing that inequality should be seen in the broader context of human well-being rather than as mere inequality of income and wealth. In this regard, a landmark is the *World Happiness Report* (WHR) [the Report] which is regularly being published since 2012 under the auspices of the United Nations. The latest report in this series came out in March 2017. The WHR 2016 crystallized and refined the concept of human happiness. The Report focuses on six variables for measuring happiness levels of different countries (WHR 2016, p. 14). These criteria are as follows:

- Gross domestic product (GDP) per capita
- Healthy life expectancy - freedom from disease
- Social support - assurance that there will be support from family, community or government should there be a financial emergency
- Freedom to make life choices
- Generosity and philanthropy and spending on others
- Freedom from corruption, trust and good governance
The Report has broadened the concept of human well-being by including the above-mentioned six variables in the concept of happiness. These variables are much more than mere material well-being of the people. The World Happiness Report 2017 has refined this classification further. It treats the first two variables [(a) and (b) above] as economic foundations of well-being as they are generally considered to be fundamental goals of development. It classifies the other four variables [(c) to (f) above] as social foundations of well-being.

The World Happiness Report series is a valuable extension in the conventional economic studies. It has opened new vistas of knowledge to approach human well-being. It indicates the strategy for enhancing well-being by improving social foundations of happiness. The main message of these reports is that by changing the focus from income to happiness we can increase the number of ways human well-being can be increased. That lends a greater importance to social foundations of happiness. On the contrary, the WHR (2017, p. 38) candidly recognizes that “much more research is needed to fully understand the interplay of factors that determine the social foundations of happiness and consider alternative ways of improving those foundations”.

The concept of happiness presented in the report falls short of the concept of happiness presented by Islam in the form of human well-being (falah), which adds a spiritual dimension to the concept of physical happiness. Of the six happiness variables in the report, social support\textsuperscript{14} philanthropy\textsuperscript{15} and freedom from corruption\textsuperscript{16} three spiritual variables and to that extent the report brings the concept of happiness closer to the Islamic concept of falah.

It seems that the economists are gradually getting closer to the Islamic concepts of falah (human well-being) and hayat tayyeba (happy life). It is difficult to translate the Arabic term ‘falah’ appropriately. ‘Falah’ literally means to thrive, become happy and have luck or success. In the Islamic parlance, it means success in this life as well as in the hereafter. We have discussed the concept of falah elsewhere (Khan, 2013, p. 119) where we illustrated it with the help of a pyramid (reproduced below). The bottom most level of the pyramid consists of “capitalism”. On this base are higher tiers of (a) faith and righteous deeds; (b) spiritual purification; and (c) spiritual consciousness, leading to (d) falah. In this perspective, falah refers to a comprehensive concept of human well-being which starts from material welfare as in capitalism but has add-on spiritual factors for arriving at its culmination. Since the Report has related happiness to six variables which extend the narrow concept of well-being that revolves around maximization of utility, we can adopt this concept of happiness as our starting point for understanding the Islamic concept of falah.
‘Happiness studies’ in the framework of capitalist societies focus on human beings ‘having more and more’ of material goods and comforts. The Islamic concept of **falah** does not negate having more of material goods and comforts however it focuses on developing human personality in the spiritual and ethical sense. In brief, instead of ‘having more and more’, it refers to ‘being more and more’. The Islamic concept of **falah** adds three steps in the concept of ‘happiness’ in the capitalist framework (Q. 22:77, 23:1-9) (Figure 1):

a. **Faith and righteous deeds**: Faith means belief in One Omnipresent and Omnipotent God and belief in Resurrection after death and accountability on the Day of Judgment. Righteous deeds refer to such traits of character as being humble and persistent in prayers, truthful, keeping promises, honouring commitments, respecting other’s property, being fair and just in dealings, discarding frivolities, and safeguarding sexual chastity etc. The broad expression of ‘righteous deeds’ also encompasses the three variables of happiness – social protection, generosity and freedom from corruption – mentioned in the Report. Overall it is a much wider concept and covers all positive acts in personal social, political, environmental and legal contexts.
b. *Spiritual purification (tazkiya)* acquired through moral virtues like philanthropy, gratitude, humility, contentment, trust in God, patience, sacrifice, and moderation in all matters.

c. *Spiritual consciousness (taqwa)* is attaining a spiritual condition where one always feels presence of God, accountability before God and respect for other’s rights.

Falah can be attained through a long-drawn educational and training process. A government can also contribute to the individual achievement of falah by good governance and strong regulatory regime. Falah, includes growth on the spiritual path both at the individual level as an entity as well as a member of society. The Islamic concept of falah takes humanity many steps further on the path of well-being. It does not stop at the physical and mental happiness. Besides physical and mental peace, it leads human beings to the path of spiritual peace as well.

*Happy life (hayat tayyeba)*

The Qur’an discusses a related concept of happy life (hayat tayyeba) at various places (e.g. Q. 10:62-64, 13:29, 16:30, 16:97, 22:77, 28:67, 30:38, 31:4-5, 91:9-10, 92:5-7). The Qur’an relates happiness to faith in One God and Resurrection, constancy in prayer, righteous deeds, humility, philanthropy, and God consciousness in socio-economic dealings.

The ultimate objective of an individual’s life is to attain happiness or what the Qur’an says ‘hayat tayyeba’. Everything else is an instrument to achieve this objective. Wealth, health, family, education, and social prestige, all are instruments for achieving this one objective. If a person is not happy, no matter how much he possesses of other things, it would be of no avail to his final objective of leading a good life (hayat tayyeba).

Wealth is a mean to happiness. The Qur’an however warns that the pursuit of wealth must remain moderate. It should not become the supreme objective of life as it does not guarantee true happiness. In other words, though wealth is an instrument of good life, yet it is so if pursued with moderation. Otherwise, wealth may become an obstacle in pursuit of good life. It may create social and spiritual imbalance which derails good life from its proper path. The relationship of wealth and happiness is quite complex and requires deeper thinking. We need to identify when wealth becomes a source of happiness and when it is source of bad life. These limits have a lot to do with culture, religion, social norms and political dimensions of a society.
The Qur’an condemns hypocrisy or braging of being virtuous and insists that all righteous deeds should be done because they are virtuous and not for showing off. It means that the righteous deeds will lead to a good life (happiness) if they are genuine in nature and not for some other motive.

As the Qur’an relates *hayat tayyeba* with righteous deeds, it grants the subject a sort of dynamism. A person can earn the pleasures of a good life by adopting righteous deeds. Bad life or unhappy life is not an inborn curse from which a person cannot come out. Coming out of bad life is possible by modifying one’s behaviour.

It further means that the happiness of good life is more than feeling of happiness at individual level. It has a closer relationship with the manner a person uses his or her freedom of choice and the way a person deals with other individuals and the society. Seen in this perspective, the concept of good life is basically a social concept where loneliness is only a ‘bad’ that reduces happiness. A person is supposed to use his or her freedom of action for personal as well as for social and societal betterment. Mere selfish betterment is a truncated concept of good life.

The relationship between human well-being (*falak*) and happy life (*hayat tayyeba*) is that the former indicates the process of achieving happiness while the latter is its manifestation. By treading on the path of a human well-being (*falak*) one can achieve a happy life (*hayat tayyeba*).

**Unhappy Life**

The number of unhappy people in the world, measured from whichever angle and dimension, are many times more than the happy ones. It is amazing that economists have diverted their attention to the study of human happiness but have not paid much attention to the study of human unhappiness. An exception is, perhaps, the study by Clark, et al. (2017, pp. 122-137). However, they have candidly expressed that data on unhappiness indices is limited and is not generally available (pp.123). The focus of their discussion is the state of unhappiness (or ‘misery’ as they call it) due to various physical factors such as unemployment, physical and mental health, years of education, crime rate in the society, etc. They have not considered any spiritual or ethical factor relevant to human unhappiness. It is not to argue that the factors of unhappiness enumerated by Clark et al. (2017) are not important. They are significant. However, they do not tell the whole story. The total canvass of unhappiness is much wider and is a compound outcome of material, physical and spiritual factors.

The Qur’an discusses the subject of human unhappiness and hardship in terms of material and physical hardship as well as mental and spiritual distress. Unhap-
piness due to material and physical factors becomes easily visible by factors such as unemployment, prolonged physical and mental ill-health, death of near and dear ones, conjugal disharmony, and business losses, etc. However, unhappiness ensuing from moral and spiritual factors is not obvious and most of the people cannot relate the two easily. The Qur’an has discussed the moral and spiritual factors of unhappiness at great length. Some examples of the Qur’anic statements on human unhappiness and how they are the result of an unethical behaviour are: Q. 2:155, 6:42, 7:94, 7:96, 7:130, 7:168, 15:88, 16:112, 20:131, 28:37, 30:41, 42:30, 52:47, 59:9, 64:16, 92:8-10.

Briefly, these statements relate human unhappiness to various factors such as a means of testing human righteousness, human arrogance, unethical behaviour, jealousy, inequity, ingratitude, niggardliness, greed, covetousness and reckless destruction of environment. Besides, the Qur’an has also laid down a fundamental principle of human unhappiness. It says:

But as for him who shall turn away from remembering Me – his shall be an unhappy life (or life of narrow scope or Hard Life) (maeesha danka). [Q. 20:124]

For, he who shall turn away from the remembrance of his Sustainer, him will He cause to undergo suffering most severe. [Q. 72:17]

Nay, verily, it is against our messages that he knowingly, stubbornly sets himself – [and so] I shall constrain him to endure a painful uphill climb. [Q. 74:16-17]

The key phrases in Q. 20:124 are: (a) Remembrance of God (dhikr); (b) Unhappy life (maeesha danka). Q. 72:17 also relates suffering and hardship to the remembrance of God. Q. 74:16-17 further adds a stubborn and persistent opposition to the messages of God which are eminently covered by ethical teachings of religion. These are universally accepted moral standards in all societies and have been so throughout history. In brief, these verses need some explanation about (a) Remembrance of God; and (b) Life of narrow scope or hard life (maeesha danka).

Remembrance of God (dhikr)

In this verse, the term God’s remembrance (dhikr) has been used in its wider meaning. It refers to the sum of ethical advice to an individual for his or her daily life. When someone follows that advice he or she is engaged in God’s remembrance. Turing away from the remembrance of God means a persistent and deliberate disregard of God’s advice in leading one’s life. Examples of such situations are as follows:
• Engaging in any manner of livelihood which has been prohibited by God (haram) including corruption, fraud, riba \(^{17}\)
• Dishonesty and cheating in dealings
• Usurping other’s property unlawfully, specifically, that of the orphans
• Disobeying God’s law of inheritance
• Being miser and material to the extent of depriving one’s own self and dependents from necessities despite having resources
• Wasteful spending
• Excessive love of material pursuits to the extent of disregarding daily prayers
• Non-payment of obligatory zakah \(^{18}\)
• Violating contracts and commitments, in particular, pertaining to service delivery, keeping of promises, meeting of financial obligations, and cheating on weights and measures

Life or narrow scope or hard life (maaesha danka)

Life of narrow scope or hard life (maaesha danka) refers to life of hardship indicated by any of the following situations. The list is indicative. In real life, there can be many other factors causing unhappiness for a person or a community:

• Unemployment or insufficient income for supporting oneself and one’s family
• Physical and mental diseases, and material dependence upon others
• Anxiety about lack of social support, in case of financial hardship in the future
• Dependence upon others for making decisions
• Existence of corruption in public sector agencies, making daily life difficult
• Unexpected losses, accidents, abnormal wastages, etc.
• Involvement in unwanted legal and social disputes
• Perception of unfriendliness from employers, employees, colleagues, customers, and other stakeholders
• Spiritual void indicated by lack of daily routine for some spiritual activities like prayers
• Stark selfishness indicated by miserliness and too little philanthropy
The above discussion of human well-being (falalh), happy life (hayat tayyeba), remembrance of God (dhikr) and unhappy life (maeesh daanka) in the Islamic framework presents new challenges to economists. For example:

- Economists can expand the concept of human happiness by incorporating the spiritual and ethical values and developing indicators of happiness and tools for measuring it.

- The present-day revival of interest in happiness studies is not broad enough. The happiness studies undertake surveys of individual perceptions about happiness, which is only partly valid. The social dimension of happiness is also important. The tools of happiness studies need to be broadened to include social aspects of happiness as well. This will include measurement of actions of a person with respect to satisfaction of the needs of others and society at large.

- The study of falalh and hayat tayyeba can contribute significantly in developing appropriate strategies for human development.

- Similarly, study of human unhappiness is a vast potential area of study. We need to understand material, mental and spiritual factors leading to human unhappiness. We need to develop a consensus on indicators of unhappiness and on tools for measuring it.

Islamic economic teachings can make significant contribution in enhancing our understanding of these factors and in developing appropriate strategies for increasing human happiness.

**Economic Balance**

Economic balance refers to a steady state of an economy where markets are free, property rights are protected, private and public dealings are based on honesty, people pay taxes honestly and the government spends them with propriety. Obviously, this is an ideal economy and may not exist in all its dimensions anywhere. However, this is the most desirable state for human beings and all societies would aspire and strive to attain it. The Qur’an refers to economic balance from the opposite angle. It describes the collective behaviour of people of ‘Ad, Thamud and Pharaohs exceeding all limits of equity and balance (Q. 89:11-12). It enjoins upon people not to disturb the economic balance after it has been established. For this purpose, it uses a general term, ‘fasad fil ard’, which is untranslatable in English in its full meanings and impact. Generally, the translators of the Qur’an have translated it as ‘corruption on earth’. However, it is an extremely narrow meaning of this
term. In this age, we need to understand this term in a broader sense. The Qur’an uses ‘fasad fil ard’ to mean several things such as innocent bloodshed, terrorism, ethnic cleansing, internecine wars, religious persecution, illegal usurpation of property, destruction of properties, crops and orchards, non-fulfilment of commitments, discrimination, nepotism, extravagance, squandering of resources, bribery, corruption, fraud, environmental pollution, etc.

Such activities disturb the economic balance of any society. Most of these activities have economic implications though fasad fil ard can also be a subject of study of other disciplines such as sociology, psychology, anthropology, philosophy, politics, law, and history. Its maximum impact however is in the economic sphere. It has direct implications for the economic balance.

Economics, as a social science, does not study fasad fil ard as a stand-alone subject, though it does study economics of some of the above conditions. For example, Iyer (2015, p. 51) summarizes some recent studies about relationship of religion, economics and terrorism. The focus of these studies has been the operations of various terrorist groups, incentives for their work, their organizational set up and consequences of terrorist activities. However, the Qur’an relates impact of these activities to the behaviour of the people and enjoins upon them to restrain from such behaviour. Relating to environmental pollution, for example, it says:

*Corruption (fasad) has appeared on land and in the sea as an outcome of what men’s hands have wrought: so, He will let them taste [the evil of] some of their doings, so that they might return [to the right path]. [Q. 30:41]*

Asad (1980, note 39 on Q. 30:41) explains the above verse as follows:

Thus, the growing corruption and destruction of our natural environment, so awesomely – if as yet only partially – demonstrated in our time, is here predicted as an “outcome of what men’s frenzied activity” which now threatens mankind with previously unimaginable ecological disasters: an unbridled pollution of land, air and water through industrial and urban waste, a progressive poisoning of plant and marine life, all manner of genetic malformations in men’s own bodies through an ever-widening use of drugs and seemingly “beneficial” chemicals, and the gradual extinction of many animal species essential to human well-being. To all this may be added the rapid deterioration and decomposition of men’s social life, the all-round increase in sexual perversion, crime, and violence, with, perhaps, nuclear annihilation as the ultimate stage: all of which is, in the last resort,
an outcome of man’s oblivion of God and hence, of all absolute moral values, and their suppression by the belief that material “progress” is the only thing that matters.

The Qur’an says that acquiring material wealth by neglecting ethical considerations causes economic imbalance (Q. 11:116) through arrogant behaviour of the wealthy people. The Qur’an cites the example of Qarun, (Q. 28:76-77) who ‘showed off his wealth and economic power, refused to spend it on social needs, humiliated others for being poor, and treated all his wealth not as gift of God but result of his own effort and knowledge’. The Qur’an gives his example as the one who causes ‘fasad fil ard’. The behaviour of Qarun can be observed among people of the upper social classes even in the present age. It has a strong demonstration effect. It generates, among other people of lesser means, jealousy, envy, greed, consumerism, wasteful spending, and desire to become rich through whatever means even through crime, corruption and fraud. The study of behaviour of the wealthy class can provide important clues to the economic imbalance in the society.

_Fasad fil ard_ is also manifested when people deprive others of their rightful dues. The Qur’an mentions this in the context of Prophet Shu’aib (AS), who said to his audience, the people of Madyan, as follows:

_O my people! Give full measure and weight, with equity and do not deprive people of what is rightfully theirs, and do not act wickedly on earth by spreading corruption._ [Q. 11:85; also see Q. 26:183]

In this context, giving short measure and weight is only indicative of a behaviour where a person receives his due in full but does not give back the promised good or service in return. It applies to such situations where labour is not paid as per market rates, or the labourers do not work sincerely and honestly, promises are not kept, obligations relating to quality and quantity are not met, performance of contracts is delayed or denied, or someone tries to take a free ride at the cost of others, etc. All such situations are covered under the Qur’anic admonition of _fasad fil ard_.

The Qur’anic economic teachings open a vast field of study under the general rubric of _fasad fil ard_ or economic imbalance. For example:

- The Qur’an emphasizes cooperation, trust and mutual help and denounces social conflict. Study of the impact of trust, cooperation and mutual help on human happiness can be a subject of study.
- Study of individual and social behaviour as well as state laws and government
policies regarding effects of *fasad fil ard* can help enhance our understanding of human well-being and happiness.

- The financial, human and managerial capacity of a society to counter *fasad fil ard* could be an interesting area for study.

- There could be economic roots (e.g., extreme poverty, income inequality, or mass-scale illiteracy) to social conflict leading to implications for economic balance. There however are spiritual and ethical roots of *fasad fil ard* as well. Study of the relationship of unethical behaviour and human well-being can be a vast field of study.

- Islamic economic teachings which focus on more equitable distribution of income and wealth (e.g. Q. 59:7, and inheritance laws, Q. 4:9-11) can open large vistas of research on economic, ethical and spiritual roots of *fasad fil ard*.

The departments of Economics in universities and colleges should introduce ‘Study of Socio-economic Imbalance (*Fasad fil Ard*)’ as a comprehensive area of study.

**Philanthropy**

Economics studies human behaviour in a free market setting where consumers produce, consume, save and invest. Governments collect revenues, raise debts, prepare budgets, spend public funds and undertake various types of development projects. However, there is another activity which is found in all societies and has been so throughout history. It is the act of philanthropy where people spend on the welfare of others without any material consideration or expectations of reward from the other party. All religions recommend some sort of philanthropy. In a significant percentage of cases, in all societies, consumers with surplus income and wealth set aside some segment of their income for the welfare of other human beings and living creatures.

Like all religions, Islam places a great emphasis on spending to meet needs of those who cannot help themselves. It is technically known as “*infaq*”. The Qur’an has numerous verses on this subject. It refers to spending willingly and voluntarily on needs of family members, friends, relatives and community and for promoting the common good or social welfare. The Qur’an says that giving others is spending in the cause of God. It must be done with the intention of getting reward from God in the hereafter and no recompense from the beneficiary (Q. 92:18-19). God treats *infaq* as a loan upon Himself and promises to return it with manifold increase (Q. 2:
245, 2: 262, 8:60, 57:11, 57:18, 64:17, 73:20), providing comfort to the giver that spending on others would not lead to any diminution in the wealth of the giver.

The person spending money on others should not injure the dignity of the beneficiary in any form by hinting about his or her generosity (Q. 2: 264-74). It is preferable if the spending is done secretly, although open giving is also acceptable (Q. 4:38, 13:22, 14:31). The Qur’an says that giving for the sake of God brings spiritual peace and tranquillity and protects the givers against undue fears and anxieties (Q. 2: 274, 277). The Qur’an states that *infaq* is a vehicle for increase in wealth at individual and social levels. The society that withholds *infaq* treads on the path of destruction (Q. 2:195).

While spending on others is a desirable trait of character, it is closely linked to resource endowment of the person spending on others. Spending on others should be out of what one can spare from his or her resources (Q. 2:219) and should be at a moderate level so that there are no regrets afterwards (Q. 17:26-27, 25:67, 47:36-37).

Although philanthropy has been a subject of discussion and reflection among social philosophers and thinkers throughout history, it is not yet part of standard curricula of economics. There are several aspects of philanthropy which can enrich economics. Some of these are as follows;

- Incentives and motives for philanthropy at individual and state level
- Relationship of poverty and philanthropy
- Effect of philanthropy on incentive to work and human dignity
- Risks in organized charity – likelihood of the deserving being left out and queuing up of the undeserving for easy money
- Effect of charity on distribution of income, unemployment, investment
- Charitable giving as social security net and its role in minimizing social conflict
- Relationship of charity with the income and wealth of the givers
- Negative implications of charity
- Management of charity in urban situation where anonymity of the receivers is dominant
- Philanthropy and religious organizations like mosques, religious schools, and trusts (*awqaf*) – flow of resources to these organizations and effect of expenditure on various socio-economic indicators such as income levels of the poor people
• Role of philanthropic organizations in providing social services such as education, health, and drinking water etc., facilities and their suitability with the state as providers of these services

• Spending on others and state of spiritual peace, tranquillity and happiness for the spenders

Taking guidance from the Qur’an, a comprehensive subject on economics of philanthropy can be developed. It would enrich our understanding about poverty and income distribution besides incentives for work and effort.

**Financial Crisis and Stock Market Instability**


It seems that frequent financial crises leading to extensive unemployment, market depression, and huge public expenditure on bank bail-outs is a permanent feature of capitalist economies. After each major crisis, there are efforts to tighten the internal controls, improve supervision and regulation of financial institutions, introduce new rules and regulations for stock markets, enhance focus on accountability of banks and stock market staff, and increase emphasis on ethical training and compliance with codes of conduct. However, despite all these measures the economists fail to predict the onset of a new crisis on time, creating an environment of blame-game on each other.

There cannot be a dispute about the need for better controls, better supervision, tighter regulation and more intensive training for the staff. But recent research has pointed out that the main culprit behind all financial crises is the human behaviour. For example, Lewis (2014), after detailed analysis of financial crisis of 2008
concludes that it was caused by excessive greed, outright lying and cheating by banks, and collusion of banks and regulatory authorities, (who deliberately created smoke screens to blackout information) and negligence of senior managements at banks and regulatory authorities. Murninghan (2012, p. 172) refers to two major reports, one by Financial Crisis Inquiry Commission and the other by US Senate Investigations Committee. Both reports convey the same message: 'The financial crisis was caused by human actions, inactions and misjudgements - warning signs that were ignored.' The current IMF Chief, Christine Lagarde (2015) arrives at the same conclusion when she says, “One clear solution is to set a strong tone at the top of the institution— establishing a culture where ethical behaviour is rewarded and where lapses in ethical integrity are not tolerated”. Stiglitz (2015, p. 10) concludes that the 2008 subprime home finance crisis was caused by moral depravity of the banks ...‘their willingness to engage in exploitative practices, or their recklessness... The banks were engaged in widespread discriminatory lending, manipulation of foreign exchange markets, sloppy record-keeping, extensive fraudulent activities, collusion with rating agencies, low or no-documentation loans to entice unwary borrowers, predatory lending taking advantage of the most uninformed and least educated borrowers.’ (p. 172).

In brief, the financial crises are caused by multiple factors. However, the most significant factor is the human behaviour which is steered by greed, avarice and unethical practices. Tressel and Verdier (2014) argue that supervision of financial institutions becomes ineffective because of the collusion between the banks and the borrowers. They recommend further tightening of supervision and regulation of the banks. However, their mind does not divert to moral and ethical training of the banking staff and borrowers. If the bank staff and borrowers are trained to restrain themselves against excessive pursuit of profit they might abstain from colluding against the investors and avoid taking excessive risks. This does not mean that we want to replace supervision and regulation by moral training. We want to supplement it with training of the banking staff and borrowers in morality and ethics.

One unsaid factor in recent bank failures in mature economies like USA has been the greed of the bankers in earning as much profit as possible even if that comes with unbearable risk. The banks displayed a sense of irresponsibility while approving loans to obviously unworthy clients. Their decisions were driven by unbridled greed.

Another important cause of financial instability lies in the speculative trade in derivatives and options. This is possible if the seller can sell short in the hope of ma-
king a delivery by arranging to buy the financial assets from the market at the time of 
delivery. There is no inherent reason for a person to get into this type of trade in the 
first place except that he or she intends to make money out of nothing. This is diffe-
rent from short selling to hedge against a genuine risk. For example, a farmer faces a 
risk of low prices at the time of harvesting or a buyer of the agricultural commodity 
has a risk of non-availability or higher prices. In such situations both the buyer and 
seller have a genuine need for protecting themselves against risk of adverse move-
ments in supply and prices. The Islamic law allows both parties to enter into a deal 
through a contract of advance sale (bai’ al-salam). In this way, they can protect them-
selves against these risks. Similarly, the manufacturers face the risk of low demand or 
low prices once the product is produced and launched in the market. The consumers 
or users of manufactured products also face the risk of short supply or very high 
prices in the future. For protecting buyers and sellers of the manufactured products 
against risks of short supply and higher/lower prices, the Islamic law recognizes legi-
timacy of short selling through contract of bai’ al-istisna’.

In case of financial assets however, such as share certificates, bonds, options, etc. 
the motive of the person selling short is nothing but earning a profit should the pri-
ces move favourably. There is no risk that a person selling short is hedging against. If 
you do not have a financial asset, you do not sell it. The fact that in capitalist system 
persons can sell short in the hope that they will make the delivery by buying from the 
market at the required time creates a speculative market in financial assets. The bu-
yers who do not receive delivery but can sell again enables every player in the market 
to enter in multiple bargains which they may or may not conclude by delivery. That 
creates speculative bubbles which burst and create havoc in a stable financial market. 
The motive of short sellers is nothing but greed to make money without adding any 
utility of space, time or form. With minimal stakes (margins), they create multiple la-
yers of bargains, which become difficult to mature as the size of the bubble increases. 
Only if the players of the financial market display some restraint on their greed the 
situation will not develop into a bubble and the crisis will not develop.

The analysis of frequent financial crises in the capitalist system points to the 
need for expanding the frontiers of economics in the following directions:

• Development of a theory of greed
• Development of theory of lying, cheating and faking in economic deals
• Regulating short-selling in stock markets
• Strengthening the existing theory of collusion
It is in this perspective we think the Islamic economic teachings can considerably contribute. Islam has a strong foundation in all these areas. The Qur’an strongly condemns pursuit of greed and other unethical practices for acquiring income and wealth. However, these teachings cannot change the behaviour of the people until they are trained in the belief in One Omnipotent and Omnipresent God, resurrection after death and accountability on the Day of Judgment. But that is a subject of religion and has no appeal for economists.

Without chiselling out an agenda for human reformation, as most of the Muslim economists would tend to suggest, economics has some fundamental work to do in these areas. For example:

- The economists need to define greed, study its motives, and develop a theory of greed that helps in making predictions should the human beings fail to restrain themselves from it.
- Similarly, the economists need to develop a theory of lying and faking and hypothesize about human behaviour and its likely outcome should people resort to lying rather than telling the truth.
- Thus, the Islamic condemnation of greed and other unethical practices can open new ways of thinking and theorizing in economics. While getting into the business of developing theories in these areas, economics need not restrict itself to Islam. Other faiths such as Christianity, Judaism, and Buddhism can also provide insights into human behaviour and help extend the frontiers of economics.
- Besides, economics would need to interact more intensively with disciplines like social psychology, anthropology and sociology for better understanding of human behaviour. In this regard, developments in behavioural economics bode well in extending frontiers of economics.

**Waste**

Contemporary societies of the world, rich and poor included, cause colossal amounts of waste at all stages of production and consumption. In capitalist societies, private businesses have a bottom line: net profit. The entrepreneurs remain vigilant about any waste for maximizing profit. However, the ability to control waste is directly related to size of the business. As businesses grow, the management and operations are passed on to the paid staff. It becomes cumbersome and expensive to implement internal controls. The businesses start experiencing unsold inven-
tories, unused capacities, obsolete machinery, idle space and unused staff time, mismatch of supply and demand, accumulated receivables and penalties for unmet financial obligations, etc.

Waste in government and public-sector enterprises is even more pervasive which do not have bottom line of the net profit like that of the private sector. Examples of waste in the public sector are over-staffing, incomplete and abandoned projects, empty spaces, construction of monuments, damaged machinery and equipment, unsold and undistributed outputs, lavish public functions, unnecessary travelling, luxurious office furnishings, unnecessary procurement of supplies, outdated and uninstalled machinery, outmoded and cumbersome procedures, outright theft, corruption and fraud, etc.

Besides, agricultural produce, particularly, food is wasted at a massive scale. For example, Neff, et al. (2015, p. 1) report that 31 - 40 percent of the post-harvest food supply in the US goes as waste. Royte (2014, p. 3) quotes The Food and Agriculture Organization of the United Nations that ‘one-third of the food produced for human consumption worldwide is annually lost or wasted along the chain that stretches from farms to processing plants, marketplaces, retailers, food-service operations, and our collective kitchens.’ The consumers are no less responsible for the waste. They purchase food in excessive quantities and then throw it away after some time.

Not only in food, the culture of consumerism is dominant everywhere. People buy clothes, gadgets, equipment, household linen, crockery and kitchen silver, furniture and curtains, and everything on sale in large quantities and numbers. In a significant number of cases, they would hardly find time and occasion to use and enjoy these goods, equipment and supplies. The power of advertising creates allurement and an artificial demand and stimulates impulsive buying. To this fire of burning desire for more goods, the financial institutions add fuel by offering credit repayable in easy instalments. Thus, the culture of consumerism promotes and supports the culture of waste.

Then there is waste in social expenditure. The pressure to ‘keep up with the Jones’, compliance with customs and traditions like wedding ceremonies, birthday parties, and religious rituals, induce people to spend beyond their means and in some cases to incur debt as well.

The discussion above is only a skeletal description of the waste going around us everywhere and is hardly a subject of economic enquiry. The subjects of food
waste, economy and efficiency in business and government organizations are under discussion, no doubt. However, waste is a subject of a much wider spread. It is prevalent from households to organizations and in almost all spheres of life. It has become a cultural phenomenon. The waste of resources deprives some other people of food and other necessities of life. The food and goods that can satisfy the need of a larger population around the globe go to waste. For example, Royte (2014, p. 3) says the 2.8 trillion pounds of food that is wasted worldwide annually is enough to feed three billion people. Four billion dollars’ worth of food that is wasted in sub-Saharan Africa alone for lack of storage facilities is enough to feed 48 million people for a year. These are figures of food waste only. The colossal waste in governments, public sector enterprises, and in households on the other hand is not adequately documented. There are no global statistics on waste in all societies. Economics does study wastage and efficiency at micro-level. However, it does not address the issue of wastages at full length at the macro-level. Waste at macro-level is not a subject of any social science so far, though sporadic studies may be found in different disciplines.

The Islamic economic teachings approach the subject of waste in consumption and production from a worldview perspective. All resources of the earth are gifts of God. Human beings who happen to own these resources are trustees of God for these resources. They should show gratitude and humility before God for granting them trusteeship of these resources. Waste is a direct violation of the fiduciary responsibility that all human beings have towards God for managing and securing these resources. Thus, waste in any form and at any stage of life is reprehensible in Islam. However, waste can also be in degrees and stages. At the first level, it is waste of resources beyond what is needed for achieving the objective in hand and the resources one has. Spending more than what is necessary or borrowing for meeting some objective without reference to the benefit to be achieved is termed as israf in the Qur’an (e.g., Q. 6:141, 7:31, 25:67, 26:128-129; 26:151-52). However, we also come across examples where resources are squandered senselessly without any regard for the benefits to be received from their use. The Qur’an terms it as ‘tabdhir’ (Q. 17:26-27). The Islamic teachings on waste are so sensitive to the preservation of resources that God forbids the guardians of orphans to hand over the resources owned by the orphans until it is certain that the orphans will not waste these resources through negligence, incompetence and lack of maturity. (Q. 4:5-6).

Economists have not yet paid attention to the concepts of israf and tabdhir. Despite being simple intuitively, the concepts are complex and intricate when it
comes to their definition and measurement. For each phase in the production and consumption cycles, for each cost centre, function or activity in public or private business and for each type of social activity, the criteria for \textit{israf} and \textit{tabdhir} would be different and would have to be decided in its specific context. We cannot have one definition or one set of criteria for these concepts that fit all situations. For using these concepts in economics, the first step would be to define them and collect data around them. For this purpose, at least the following steps are necessary in each situation:

- Definition of \textit{israf} and \textit{tabdhir}
- Criteria for \textit{israf} and \textit{tabdhir}
- Indicators of \textit{israf} and \textit{tabdhir}
- Data to be collected
- Data analysis techniques
- Best practice guides for all major types of businesses, programs and projects, household functions, social activities.

By performing this exercise, actual data on \textit{israf} and \textit{tabdhir} can become available. The data would be raw for economists to develop a theory of \textit{israf} and \textit{tabdhir} and to predict about their impact on different variables such as income distribution, poverty and human happiness. The abovementioned strategy for developing a theory of \textit{israf} and \textit{tabdhir} will open a vast area of enquiry and would have an interface with several subjects of public welfare in economics.

\section*{Concluding Remarks}

In this paper, we have argued that the knowledge received though revelation can guide the humanity in solving the economic problem. For substantiating this assertion, we have listed six issue areas as examples where the revelation can provide wholesome solutions to economic problems of the present age. The six issue areas identified in this paper are: inequality, human happiness and unhappiness, economic balance, philanthropy, financial crises, and waste at micro- and macro-levels. Based on these issue areas, economics can expand its frontiers to include the study of the following subjects:

- Divine scheme of distribution of income and wealth, leading to a better understanding of inequality
• Study of human happiness and unhappiness in a broader ethical and spiritual context, supplementing the existing knowledge on material well-being

• Study of socio-economic imbalance, focusing on human activities leading to destruction, bloodshed, terrorism, ethnic cleansing, religious persecution, illegal usurpation of others’ properties, arrogance, internecine wars, unfair distribution of public benefits, bribery, corruption and fraud, environmental pollution, and intangible things such as obstinacy on irrational position in knowledge, unethical practices in acquiring wealth, and diminution in the quality of goods and services to be delivered.

• Study of obligatory and voluntary spending upon weaker sections of the society, its impact upon the givers and the receivers, implications for income and wealth distribution, management and risks of philanthropic spending and relationship of such spending with social justice, economic growth and poverty alleviation.

• Study of greed, cheating, lying and fraud as ingredients of economic behaviour leading to frequent financial and stock market crises.

• Study of waste at micro-level and macro-level including waste in social life having economic implications.

These six areas are a few examples of the ways Islamic economic teachings can contribute to the existing knowledge of economics. Deeper reflection on the Islamic teachings as well as those of other religions can help expand the frontiers of economics further.

The foremost condition for benefitting from the revelation is to shed off prejudice against religion and super-sensory sources of knowledge. This should not be taken as an impossible demand. The history of knowledge development tells us that prejudice and bias is the greatest enemy of truth. If economics transcends its barrier against religion and divine sources of knowledge, the likelihood of opening new vistas of knowledge are just at our door-sills. While doing so, guidance should be sought from the divine sources and the revelation sent by God through His apostles. If the proposal is found plausible, it should initiate dialogue and discussion among economists and religious scholars of all faiths. The existing barriers of refrain from religion will be broken and a new era of expansion in economics would dawn.
References


Notes

1 I am thankful to Anwar Abbasi, Haider Zaidi, Raﬁqul Islam Molla, Syed Abdul Hamid al-Junid, Muhammad Tahir Saleem and an anonymous referee for valuable comments on an earlier draft. I have beneﬁtted from these comments. However, remaining short-comings are entirely my own.

2 The Qur’an is the book revealed upon Prophet Muhammad (peace be upon him) during 610–632 AD in Makkah and Medina (now in Saudi Arabia) and preserved by him during his life-time verbatim. Its authenticity is guaranteed by God.

3 Hadith refers to compilations of sayings, actions and approvals of Prophet Muhammad (pbuh). Most of this literature has been subjected to rigorous scrutiny for validity and authenticity. In this paper by ‘hadith’ we mean only authentic traditions of the Prophet.


5 In this paper, Q. stands for the Qur’an and digit(s) before the colon refer to the chapter(s) of the Qur’an and after the colon to the verse(s) of the chapter. For example: Q. 42: 51-52 means chapter 42 and verses 51-52 of the Qur’an.

6 Lit. ‘peace be upon him.’ It is customary for Muslims to add this phrase with the name of the Prophet of Islam.

7 Lit. ‘on him be peace’. It is customary in Islamic tradition to insert these words with the names of all Prophets.

8 Asad (1980, n.71 on verse Q. 17:59).

9 The Qur’an refers to this aspect of its guidance at Q. 17:9: “Verily, this Qur’an shows the way to all that is most upright, and gives the believers who do good deeds the glad tiding that theirs will be a great reward.” Explaining this verse, Asad (1980, note 10 on this verse) says that “most upright” means ‘conformable to ethical rectitude and beneﬁcial to man’s individual and social life.’

10 The Theory of Moral Sentiments at Wikisource: Searchable, free

11 Asad (1980). Note 4 on verse Q. 2:3.

12 The Qur’an says: “And unto Solomon [We made subservient] the stormy wind, so that it sped at his behest towards the land which We had blessed (i.e. Pa-
lestine). And among the satanic forces [which We made subservient to him] there were some that dived for him [into the sea] and performed other works besides... (Q. 21:81-82).

And unto Solomon [We made subservient] the wind: its morning course [covered the distance of] a month's journey, and its evening course, a month's journey. And We caused a fountain of molten copper to flow at his behest; and [even] among the jinn there were some that had [been constrained] to labor for him by His Sustainer's leave – and whichever of them deviated from Our command, him would We let taste suffering through a blazing flame – they made for him whatever he wished of sanctuaries, and statues, and basins as [large as] great watering troughs, and cauldrons firmly anchored.. [Q. 34:12-13].

13 The Qur'an (Q. 28:76) says: “Qarun was one of the people of Moses, but he arrogantly exalted himself above them – simply because We had granted him such riches that his treasure-chests alone would surely have been too heavy a burden for a troop of ten men or even more.”

14 The Islamic system of family network, where all members have rights and obligations towards each other provides a strong system of social support. In the Islamic parlance, it is known as sila rehmi (joining kinship ties). The Qur’an emphasizes joining of kinship ties at several places (e.g. Q. 2:27, 8:75, 13:21). The Prophet (pbuh) has treated it as a basic ingredient of faith. For example: “Abu Ayyub narrated: A man said: “O Messenger of Allah, tell me of a deed that will gain me admittance to Paradise.” The Messenger of Allah (pbuh) said: ‘Worship Allah and do not associate anything with Him, establish the daily obligatory prayers, pay the zakah and uphold the ties of kinship. Let go!’” - as if he was riding his camel.* (Sahih) *As if he was riding his camel and the man had grabbed hold of its reins to ask this question.[ Sunan Al-Nasai Chapter No: 5, The Book of Salah, Hadith no: 469]. Available at http://ahadith.co.uk/searchresults.php?page=1&q=joining+kinship+ties&rows=10

15 The Qur’an is replete with injunctions about spending upon Besides obligatory zakah prescribed by law as a right of the poor upon the wealth of the rich, the Qur’an persuades repeatedly and eloquently for spending upon others (infaq) and treats such spending as a loan to God Himself which He promises to repay in full others (See, e.g., Q. 2: 261, 262, 265, 274, 277; 8:60; 34:39). Similarly, the hadith literature is full of sayings and actions of the Prophet (pbuh) relating to spending upon others. See e.g. Khan (1989).

16 The Qur’an emphasizes honesty, integrity and trust in mutual dealings. It exp-
licitly forbids from such crimes as bribery of government officials and enjoins to fulfill commitments and promises.

17 Riba, literally, means ‘an excess’. But in the Islamic law, it means any excess claimed by a creditor from a debtor in a transaction of loan.

18 Zakah refers to obligatory payment of a tax on wealth and income of the rich for the benefit of the poor and deserving besides social welfare.

19 Wikipedia writes: “Ad (also called Aad) is the great-grandson of Shem, son of Noah (Arabic: Sam ibn Nuh سام بن نوح) who came from the northeast and was the progenitor of the Adites. Noah is said to be Ad’s third grandfather, he being the son of Awadh(Uz) اسماعيل, who was the son of Iram اسم زمزم, who was the son of Shem اسم شم the son of Noah نوح.” The Qur’an says that Prophet Hud (AS) was sent for their guidance.

20 Wikipedia writes: “The Thamūd (ˈθɑːmʊd; Arabic: ثمود) is the name of an ancient civilization in Hejaz known from the 1st millennium BC to near the time of Prophet Muhammad. The Thamud civilization was located in the north of the peninsula.” The Qur’an mentions that Prophet Salih (AS) was sent for their guidance.

21 Wikipedia writes: “Pharaoh is the common title of the monarchs of ancient Egypt from the First Dynasty (c. 3150) until the Macedonian conquest in 305 BCE…”

22 See, e.g., Q. 2:11, 7:56, 7:85

23 For example, Berman & Laitin (2004); Sandler & Enders (2004); Krueger (2007); Keefer & Loayza (2008); Berman (2009).

24 Shah (2013) says: The total amounts that governments have spent on bailouts have skyrocketed. From a world credit loss of $2.8 trillion in October 2009, US taxpayers alone will spend some $9.7 trillion in bailout packages and plans, according to Bloomberg. $14.5 trillion, or 33%, of the value of the world’s companies has been wiped out by this crisis. The UK and other European countries have also spent some $2 trillion on rescues and bailout packages.


27 It may sound that the suggestion requires a person to be a Muslim in the usual sense. However, other revealed religions such as Judaism and Christianity also uphold this belief-set. Other religions such as Buddhism, and Hinduism also have the concept of some sort of reward and punishment as consequence of one’s actions in this world. We need to conceive this idea in the broader human context rather than in typical Muslim context.

28 Asad (1980, note 32 on Q. 17:26) says: ...the term tabdhir does not relate to the quantity but, rather, to the purpose of one’s spending. Thus, Ibn Abbas and Ibn Mas’ud defined tabdhir as ‘spending without a righteous purpose’ or ‘in a frivolous cause’; and Mujahid is reported to have said, ‘If a man were to spend all that he possesses in a righteous cause, it could not be termed squandering; but if he spends even a small amount in a frivolous cause, it is squandering.’
The Effects of Market Interest Rate on Islamic Indices: A Heterogeneous Panel Data Analysis of Participation 30 Index Companies

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Mucahit Aydin

Abstract: The aim of this article is to investigate the influence of market interest rate on Participation 30 index companies. The interest rate of Turkish government bonds traded in the secondary market was used for representing market interest rate. The study uses a panel data of 41 Participation index companies from 2011 to 2017. Using LM bootstrap panel cointegration test, we obtained results showing that the market interest rate affects the stock prices of P30 index companies. This effect is negative for ALBRK, KONYA, BAGFS, KOZAL and PRKME, but positive for all other companies. The least affected company from market interest rate is TTKOM, while the most affected company is LOGO. Moreover, it is noteworthy that 5 of the 10 companies with the lowest long-run coefficient are operating in the construction-raw material industry.

Keywords: Islamic Index, Participation Index, Heterogeneity, Bootstrap, Panel Cointegration

JEL Codes: G10, G20, C21, C23

Introduction

Islamic indices, which began to be formed in the late 1990s, helped investors having Islamic sensitivity invest in stocks more easily, by determining the compatibility of stocks with the criteria set by the Shari’ah scholars. Two basic screening criteria have been set for companies to enter these indices. One of these criteria was the criterion of the activity field and the other was financial ratio criterion. In activity field criterion, the main activity of the company had to be of field that Islam accepted as legitimate. According to this criterion, if a company’s main ac-
tivities are conventional banking, alcohol, tobacco products or pig products, these companies are not allowed to enter Islamic index. The companies compatible with activity field criterion are subject to second screening criterion i.e. financial ratio criterion. In financial ratio criterion, the following three sub-criteria are adopted:

- The ratio of total interest-bearing loans to total market value of the firm must be less than 33 percent
- The ratio of total interest-bearing financial assets to total market value of the firm must be less than 33 percent
- In case some subsidiary activities of the firm do not comply with the Shari’ah, the revenue generated by such activities must be less than 5 percent of the total revenue (O. Al-Khazali, Lean, & Samet, 2014a)

The criteria set by the scholars for early Islamic indices such as FTSE, Dow Jones Islamic Market Index were adopted by AAOIFI and were added to their Shari’ah standards in 2004 (AAOIFI, 2015: 549). AAOIFI announced the Shari’ah basis of this criterion as application of the rule of removal of hardship, acknowledging of general need, widespread practice, the acknowledged principles of surplus, shortage, and predominance (AAOIFI, 2015: 573). It referred to some decisions of the Shari’ah Boards of Islamic Banks. These criteria adopted by AAOIFI are still being discussed and there are studies proposing a new index as criteria (Gamaleldin, 2015; Yildirim & Ilhan, 2018; Hashim et al., 2017). Intense criticism has been made on the criteria related to the interest ratio. It has always been discussed that 33 percent interest ratio cannot be legitimate for Islamic law, which has been a controversial issue in the literature.

In this study, we tried to investigate how the existing criteria related to the interest rate has an effect on the companies. It is known that companies in Islamic indices are subject to criteria related to interest based financial ratio. If so, what are the consequences of these criteria in practice? In other words, how do these criteria affect the companies in the market? To answer these questions, we treated the market interest rate as a basic variable.

The market interest rate is accepted as the basic measure of the cost of debt financing. Since almost all the debt financing of the companies consists of interest-based loans today, the alteration in interest rates has significant impact on companies, especially on ones that are highly leveraged. When the market interest rates increase, their financing cost is also expected to increase. This situation causes their profitability to fall and would ultimately be reflected in their stock retur-
If the companies use equity financing rather than interest-based loans, in other words, adhere strictly to these elimination criteria related to interest ratio, the alteration in interest rates would probably not have a significant impact on these companies. So what is the situation in the companies listed in Islamic indices? (Saraç & Ülev, 2017). Does the change in market interest rates affect these companies?

In this study, we aim to determine whether the market interest rate affects companies listed in the Islamic indices and, if it does, which companies does it affect and how. For this purpose, the companies in Participation 30 (P30) index, which were selected from the companies traded in BIST 100, were subjected to analysis. P30 index that was launched in 2011 is the first Islamic index in Turkey. This study using LM bootstrap panel cointegration test examines the relationship between daily closing stock prices of P30 index companies and the market interest rate.

One of the original contributions of this study is that each company in the P30 index is included in the analysis separately. The vast majority of the studies in the literature merely involve the own value of the P30 index in the analysis and do not analyze each company separately.

**Literature Review**

When we look at the studies dealing with Islamic indices, we observe that these studies can be classified into three basic categories. These categories are; studies analyzing the performance of Islamic indices, studies investigating the relationship among indices, and studies examining the relationship between indices and interest rates. This classification also gives a quantitative ranking of the studies at the same time. In other words, among studies on Islamic indices, the number of studies that deal with the topics in the first category is the highest. While the number of studies in the second category is less than the first, though not low. The studies in the third category are the ones with the lowest number.

The studies in the first category are studies evaluating the return performance of Islamic indices. When the return performance of Islamic indices is evaluated in these studies, it is generally compared with the conventional counterpart. The studies in this category and their results are summarized below.

Hassan, (2002) examined market efficiency and risk-return relationship of DJIMI between 1996 and 2000, and found that DJIMI was efficient and its revenues were normally distributed. Elfakhani, Sidani, & Fahel, (2004) assessed the
performance of 46 Islamic funds by separating them into 8 categories according to their regions and sectors. They compared these funds with both the performance of Islamic indices and conventional indices. When fund categories were compared to Islamic indices, four of the eight fund categories performed better than the Islamic indices. When they were compared with conventional indices, four categories performed better than conventional indices as well. Girard & Hassan (2005) compared the performance of Dow Jones Islamic Index with its counterpart conventional index using various measures including Sharpe, Treynor, Fama, Charhart and analyzed the cointegration relationship between these two indices. They did not find any significant difference between the performance of Islamic index and non-Islamic index. Hussein (2004) compared the performance of FTSE Global Islamic Index with FTSE All World Index between 1996 and 2002. He found that FTSE Islamic index had a significant positive return performance in bull market period, but it fell behind the performance of FTSE All World index in bear market period. Forte & Miglietta (2007) compared Islamic funds with social responsible funds and demonstrated their similarities and differences. Hussein (2007) analyzed the returns on DJIMI and FTSEGII by dividing the study period into four sub-periods: introduction period, bull period-1, bear period, and bull period-2. He found that both Islamic indices outperformed their conventional counterparts in the introduction and bull-1 period, while they showed lower performance in the other two periods. Girard & Hassan (2008) analyzed the performances of FTSEGII, FTSE Asia Pasific Index, FTSE Islamic America Index and FTSE Islamic Europe Index using various measures including Jenson, Sharpe, Treynor and Jenson & Fama, and compared the results with those of conventional counterparts. In addition, he tested the cointegration link between Islamic indices and conventional ones and found that FTSE Islamic index and its counterpart were cointegrated, contrary to the findings of Hakim & Rashidian (2004). Kok, Giorgioni, & Laws (2009) examined the relationship between Islamic indices, conventional indices and sustainability indices. They constituted four different portfolios including DJIMI, DJ conventional index, DJ Sustainability index, FTSE Islamic index, FTSE conventional index and FTSE4G sustainability index and investigated the possibility of risk diversification among these indices using the Johansen cointegration test. They found that there is a possibility of risk diversification when a portfolio containing the conventional index, the sustainability index and the Islamic index is created. Al-Khazali, Lean, & Samet (2014b) compared the performance of the DJIMI with the performance of the DJ conventional index using the stochastic dominance (SD) approach. Islamic indices performed better than conventional indices only in crises times,
while conventional indices performed better than Islamic indices in all other times. Al-Khazali et al. (2015) investigated the efficiency of 9 Islamic indices in comparison with conventional indices using random walk and martingale hypothesis. The study included 1997-2012 period and examined this period by dividing it into five different sub periods. The author found that Islamic indices are more efficient than conventional ones in some periods. Yıldız (2015) and Seçme et al. (2016) compared Participation 30 index to BIST100 index. In both studies it was found that the performance of the Participation 30 Index is better than the BIST100 index. Sarılı ve Yıldırtran (2016), in their study comparing the performance of S&P, Dow Jones, Morgan Stanley and FTSE Islamic indices, found that S&P Islamic index had the highest return, while FTSE Islamic index had the lowest.

The studies in the second category are those examining the correlation, cointegration and causality relationship between Islamic indices and its conventional counterparts. Theoretical and empirical studies based on the specific characteristics of these indices can also be added to this category. The studies in this category and their results are summarized below.

Abdul Rahim et al. (2009) investigated the correlation and the level of information transfer among the Islamic indices in Southeast Asia. They found a low correlation between Kuala Lumpur Syariah Index (KLSI) and Jakarta Islamic Index (JII). They also showed that there is a one-way information transfer that influences the return and volatility from KLSI to JII. El Khamlichi et al. (2014) examined the relationship between Dow Jones, FTSE, S&P, MSCI Islamic indices and their conventional counterparts. They found a cointegration relationship between the FTSE Islamic index and FTSE World index, MSCI Islamic index and MSCI World index, while they did not find any cointegration relationship between DJIMI and its conventional counterpart, and S&P Islamic index and its conventional counterpart. Majdoub & Mansour (2014) examined the correlation between US stock market and Islamic indices of five developing countries (Turkey, Indonesia, Pakistan, Malaysia and Qatar) and found that there is a weak correlation between these markets. Ata & Buğan (2015) examined the causal relationship between Islamic and conventional indices. They used MSCI and Dow Jones indices which are launched for Turkey. They found causality relationship between conventional indices and Islamic indices in different periods. Rizvi & Arshad (2018) examined the nature of time-varying systematic risk for both Islamic and non-Islamic sectoral indices. They show that both Islamic and conventional indices follow a similar cyclical pattern over time. Abu-Alkheil et al. (2017) analyzed 32 conventional and 32 Islamic indices from FTSE, DJ, MSCI,
S&Ps and Jakarta series. They did not find any incidence of cointegration links over the long-run between 31 pairs of Islamic and their respective conventional benchmark indices. Using various unit-root tests Savaşan et al. (2015) tested whether the effect of exogenous shocks on the participation index is permanent. Their study provides evidence that such effect is permanent. (S. Elfakhani et al. (2005) measured fund managers’ timing and securities selection abilities using Treyno Mazury model. The results show that Europe, America, Emerging Markets and Technology funds have a positive security selection, but only the positive selection of emerging market funds is significant. Zandi et al. (2014) compared the criteria of the Malaysia Shariah Advisory Council with the criteria of other Islamic indices (DJIMI, FTSE, MSCI, S&P) and investigated which index is more rigid, in other words which index is more Islamic.

The studies in the third category are those that investigate the relationship between Islamic indices and market interest rates. In some of these studies, besides market interest rates, the effect of some economical indicators on Islamic indices was also measured. The studies in this category and their results are summarized below. Hakim & Rashidian (2004) investigated how Dow Jones Islamic Market Index (DJIMI) is related with Wilshire 5000 and treasury bonds with three-year maturity. Their unit-root test showed that both DJIMI and Wilshire 5000 are efficient. In addition, they found that DJIMI is not cointegrated with W-5000 and three-month T-Bills. Yusof & AbdulMajid (2007) measured the effect of macroeconomic variables on Islamic and conventional indices. They found that the reaction of Islamic index to variables except interest rate is not different from the conventional index, however, reaction of the Islamic index were not significantly responsive to changes in interest rates. Shamsuddin (2014) compared DJIMI with its conventional counterpart by examining whether DJIMI was exposed to interest rate risk. They found that DJIMI is less exposed to interest rate risk. Saraç & Ülev (2017) examined the relationship between Participation 30 index and BIST100 index using cointegration and causality test. They found that while there exists no causality between participation index and market interest rates, there is causality between BIST100 index and the market interest rates. Akhtar et al. (2017) analyzed the impact of interest rate surprises on Islamic and conventional stocks and bonds. They found that interest rate surprises affect Islamic bonds less than their conventional counterparts, and Islamic stocks more. Umar et al. (2018) analyzed the sensitivity of DJIMI and its conventional counterpart on market interest rate. They found that the sensitivity of DJIMI on market interest rate is not different from conventional index.
Data and Methodology

Research Data

In this study, daily closing stock value of the companies listed on P30 index (SP) and daily interest rates of Turkish government bonds (BND), having two year maturity and once in 3 months coupon payment, data is used for the period 2011-2017. The interest rates of these government bonds are called indicative interest rates because they have high volume and sound price mechanism.

The companies in the P30 index are subject to quarterly monitoring as other Islamic indices. Companies that do not meet the index criteria are removed from the index. Instead of those companies, other companies which meet the index criteria and have the highest market value are included in the index (Participation Index, 2011). Therefore, the companies involved in the index may change over time. For this reason, the companies which are in P30 index for a total of 27 periods between 03/2011 and 09/2017 were selected. In these 27 periods, the companies being in P30 index for at least 5 periods were included in the analysis and it was determined that the number of these companies is 48. Since the data used in this study started from January 2011 which is the launch date of the P30 index, we removed the data of 7 companies (TMSN, TATGD, NETAS, TKNSA, IZMDC, EDGE, PGSUS) from the analysis. The companies included in the analysis are shown in the table below.

<table>
<thead>
<tr>
<th>Stock</th>
<th>Number of Periods</th>
<th>Stock</th>
<th>Number of Periods</th>
<th>Stock</th>
<th>Number of Periods</th>
</tr>
</thead>
<tbody>
<tr>
<td>AKCNS</td>
<td>27</td>
<td>PETKM</td>
<td>20</td>
<td>BAGFS</td>
<td>9</td>
</tr>
<tr>
<td>ALBRK</td>
<td>27</td>
<td>MRDIN</td>
<td>19</td>
<td>TTKOM</td>
<td>9</td>
</tr>
<tr>
<td>BIMAS</td>
<td>27</td>
<td>CIMSA</td>
<td>18</td>
<td>ERBOS</td>
<td>8</td>
</tr>
<tr>
<td>FROTO</td>
<td>27</td>
<td>PETUN</td>
<td>17</td>
<td>HEKTS</td>
<td>8</td>
</tr>
<tr>
<td>GOODY</td>
<td>27</td>
<td>BOLUC</td>
<td>15</td>
<td>TRKCM</td>
<td>8</td>
</tr>
<tr>
<td>NUHCM</td>
<td>27</td>
<td>EGEEN</td>
<td>15</td>
<td>VESBE</td>
<td>8</td>
</tr>
<tr>
<td>PNSUT</td>
<td>27</td>
<td>KONYA</td>
<td>15</td>
<td>GOLTS</td>
<td>7</td>
</tr>
<tr>
<td>TTRAK</td>
<td>27</td>
<td>LOGO</td>
<td>15</td>
<td>KOZAL</td>
<td>7</td>
</tr>
<tr>
<td>SODA</td>
<td>25</td>
<td>ALKIM</td>
<td>14</td>
<td>CEMTS</td>
<td>6</td>
</tr>
<tr>
<td>AYGAZ</td>
<td>23</td>
<td>THYAO</td>
<td>14</td>
<td>EGSER</td>
<td>6</td>
</tr>
</tbody>
</table>

Table 1. P30 Companies and Frequency of Being in Index
Research Methodology

In this study, the relationship between variables was examined using cointegration tests. For this purpose, firstly, the possibility of cross-sectional dependency in the model using CD tests was investigated. Secondly, the stationarity of the variables was determined using CIPS panel unit root test which take cross-sectional dependency into consideration. Thirdly, using the unit rooted series, the long-run relationship between the variables was examined via LM bootstrap panel cointegration test. Finally, the long-run coefficients of the variables that were found to be cointegrated in the long run were estimated.

Cross-sectional dependency

If the relationships between the cross-sectional data are not taken into consideration, they cause misleading results. Since the study used companies with the same characteristic, we first conducted cross-sectional dependence tests. For this purpose, cross-sectional dependence of the panel was examined using Breusch and Pagan (1980) LM test and Pesaran (2004) LM tests. We used the following panel data model for testing cross-section dependence.

\[
\ln \ln SP_{it} = \alpha_i + \beta_i \ln BND_{it} + \epsilon_{it} \quad i = 1, \ldots, N \quad t = 1, \ldots, T
\]  

where \( i \) and \( t \) are the indices of the cross-section units and time dimension, respectively. \( \alpha_i \) and \( \beta \) are the constant and slope coefficients that change for each cross-section unit, respectively. Breusch and Pagan (1980) developed the following test statistic from the equation 1.

\[
CD_{BP} = T \sum_{i=1}^{N-1} \sum_{j=i+1}^{N} \hat{\rho}_{ij}^2
\]

Breusch and Pagan (1980) test has a disadvantage. As per literature it is inapplicable in situations where \( N \) is large i.e. \( N \to \infty \). Pesaran (2004) developed the following LM statistic in order to overcome this problem.
\[ CD_{LM} = \sqrt{\frac{1}{N(N-1)} \sum_{i=1}^{N-1} \sum_{j=i+1}^{N} (T \hat{\rho}_{ij}^2 - 1)} \]

Pesaran (2004) suggests the use of the following test statistic in case the cross-sectional size is larger than the time dimension \((N > T)\).

\[ CD = \sqrt{\frac{2T}{N(N-1)} \left( \sum_{i=1}^{N-1} \sum_{j=i+1}^{N} \hat{\rho}_{ij} \right)} \]

The \( \hat{\rho}_{ij} \) in all the test statistics indicates the correlation between the errors which is estimated from equation 1. The null and alternative hypotheses used in all models for the cross-sectional dependence test are as follows.

\[ H_0 : \text{Cov}(u_{it}, u_{ij}) = 0 \quad \text{no cross-section dependence} \]

\[ H_1 : \text{Cov}(u_{it}, u_{ij}) \neq 0 \quad \text{cross-section dependence} \]

**CIPS Panel Unit Root Test**

The panel unit root test can be evaluated in two groups according to whether it considers cross-section dependency or not. Since cross-section dependency was determined in this study, we used the panel unit root test which takes it into consideration. Pesaran (2007) developed a cross-sectional augmented ADF (CADF) panel unit root test, which takes into account the cross-section dependency. The model developed for the CADF test is as follows;

\[ \Delta y_{it} = a_i + b_i y_{i,t-1} + c_i \bar{y}_{t-1} + d_i \Delta \bar{y}_{i} + e_{it} \]

It is defined here \( \bar{y}_i = N^{-1} \sum_{t=1}^{N} y_{it} \) and \( \Delta \bar{y}_i = N^{-1} \sum_{t=1}^{N} \Delta y_{it} \). Using the CADF statistics obtained for each cross-section unit, cross-sectional augmented IPS (CIPS) panel unit root test statistic is calculated as follows:

\[ CIPS(N,T) = N^{-1} \sum_{i=1}^{N} t_i(N,T) \]

Pesaran (2007) obtained the critical values of the CIPS statistic. The null hypothesis is based on the assumption that no series in the panel is stationary.

**LM Bootstrap Panel Cointegration Test**

In this study, panel cointegration test developed by Westerlund and Edgerton (2007) was used, which can be used in heterogeneous and cross-sectional dependency situations.
where $s_{it}^2$ shows the partial sums of error terms, $\hat{\omega}_i^2$ shows long-run variances of error terms. The null hypothesis that cointegration exists is tested by the calculated test statistic. In case of cross-section dependency, critical values calculated by bootstrap are used in the test. Monte Carlo simulations demonstrate that the test can also be used in small sample situations.

**Research results and discussion**

In the study, it was first investigated whether the model used has cross-sectional dependency. Table 2 shows the results of cross-section dependency tests. The results demonstrate the presence of cross-sectional dependency in the model according to three different test statistics. In this case, the companies in the panel are likely to influence each other.

<table>
<thead>
<tr>
<th>Tests</th>
<th>Statistics</th>
<th>P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>CD$_{BP}$</td>
<td>6628.924*</td>
<td>0.000</td>
</tr>
<tr>
<td>CD$_{LM}$</td>
<td>1495.891*</td>
<td>0.000</td>
</tr>
<tr>
<td>CD</td>
<td>697.409*</td>
<td>0.000</td>
</tr>
</tbody>
</table>

* indicates the rejection of null hypothesis at 1% significance levels.

Table 3 shows the CIPS panel unit root test results considering cross-section dependency. According to the obtained results, all variables have a unit root at the level, while they are stationary in first differences.

<table>
<thead>
<tr>
<th>Level</th>
<th>First difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interceopt</td>
<td>Intercept and Trend</td>
</tr>
<tr>
<td>lnSP</td>
<td>-2.50</td>
</tr>
</tbody>
</table>

* indicates the rejection of null hypothesis at the 1% significance level.
The results of the panel cointegration test, which is applied by using variables having unit root at the level and taking into account the cross-section dependency, are shown in Table 4. According to the panel cointegration test, a long-run relationship was found between variables in the model where lnSP is dependent variable and lnBND is the independent variable. The coefficients of this long-run relationship were calculated using MG estimator which takes cross-section dependency into consideration.

<table>
<thead>
<tr>
<th>Dependent variable</th>
<th>LM statistics</th>
<th>Bootstrap p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>lnSP</td>
<td>150.724</td>
<td>0.820</td>
</tr>
</tbody>
</table>

Table 4.
Results of LM bootstrap panel cointegration test

Note: The bootstrap is based on 1000 replications. The null hypothesis of this test is cointegration between variables.

Table 5 indicates the results of MG Long run estimations. According to the results, interest rates of bonds have a significant effect on stock closing prices for all companies. This effect is negative for ALBRK, KONYA, BAGFS, KOZAL and PRKME, but positive for all other companies.

Table 5.
Results of MG Long-run Estimations

<table>
<thead>
<tr>
<th>Company</th>
<th>Industry</th>
<th>Coefficient</th>
<th>Z-stat</th>
<th>P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>TTKOM</td>
<td>Communications Services</td>
<td>0.005*</td>
<td>0.44</td>
<td>0.000</td>
</tr>
<tr>
<td>KONYA</td>
<td>Construction - Raw Materials</td>
<td>-0.0468*</td>
<td>-3.3</td>
<td>0.001</td>
</tr>
<tr>
<td>KARTN</td>
<td>Containers &amp; Packaging</td>
<td>0.0764*</td>
<td>4.54</td>
<td>0.000</td>
</tr>
<tr>
<td>MRDIN</td>
<td>Construction - Raw Materials</td>
<td>0.1086*</td>
<td>7.72</td>
<td>0.000</td>
</tr>
<tr>
<td>BUCIM</td>
<td>Construction - Raw Materials</td>
<td>0.1368*</td>
<td>7.22</td>
<td>0.000</td>
</tr>
<tr>
<td>BAGFS</td>
<td>Chemical Manufacturing</td>
<td>-0.1381*</td>
<td>-6.91</td>
<td>0.000</td>
</tr>
<tr>
<td>NUHCM</td>
<td>Construction - Raw Materials</td>
<td>0.1915*</td>
<td>15.76</td>
<td>0.000</td>
</tr>
<tr>
<td>PNSUT</td>
<td>Food Processing</td>
<td>0.2829*</td>
<td>11.42</td>
<td>0.000</td>
</tr>
<tr>
<td>GOLTS</td>
<td>Construction - Raw Materials</td>
<td>0.3377*</td>
<td>13.5</td>
<td>0.000</td>
</tr>
<tr>
<td>ALBRK</td>
<td>Finance</td>
<td>-0.3468*</td>
<td>-17.34</td>
<td>0.000</td>
</tr>
<tr>
<td>AKMGY</td>
<td>Real Estate Operations</td>
<td>0.3986*</td>
<td>17.17</td>
<td>0.000</td>
</tr>
<tr>
<td>PRKME</td>
<td>Metal Mining</td>
<td>-0.4124*</td>
<td>-14.05</td>
<td>0.000</td>
</tr>
<tr>
<td>KOZAL</td>
<td>Gold &amp; Silver</td>
<td>-0.4656*</td>
<td>-12.88</td>
<td>0.000</td>
</tr>
<tr>
<td>Company</td>
<td>Industry</td>
<td>Price</td>
<td>Beta</td>
<td>Alpha</td>
</tr>
<tr>
<td>--------------------</td>
<td>-------------------------------</td>
<td>--------</td>
<td>----------</td>
<td>--------</td>
</tr>
<tr>
<td>THYAO Airway</td>
<td></td>
<td>0.4814</td>
<td>8.25</td>
<td>0.000</td>
</tr>
<tr>
<td>BRISA Tires</td>
<td></td>
<td>0.62561</td>
<td>14.35</td>
<td>0.000</td>
</tr>
<tr>
<td>BIMAS Retail (Grocery)</td>
<td></td>
<td>0.6379</td>
<td>17.72</td>
<td>0.000</td>
</tr>
<tr>
<td>SELEC Biotechnology &amp; Drugs</td>
<td></td>
<td>0.6382</td>
<td>20.32</td>
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</tr>
<tr>
<td>GOODY Tires</td>
<td></td>
<td>0.6563</td>
<td>16.07</td>
<td>0.000</td>
</tr>
<tr>
<td>TRKCM Constr. - Supplies &amp; Fixtures</td>
<td></td>
<td>0.6746</td>
<td>18.57</td>
<td>0.000</td>
</tr>
<tr>
<td>ENKAI Construction Services</td>
<td></td>
<td>0.7658</td>
<td>25.06</td>
<td>0.000</td>
</tr>
<tr>
<td>AKCNS Construction - Raw Materials</td>
<td></td>
<td>0.8349</td>
<td>26.04</td>
<td>0.000</td>
</tr>
<tr>
<td>AYGAZ Oil &amp; Gas Operations</td>
<td></td>
<td>0.8360</td>
<td>26.06</td>
<td>0.000</td>
</tr>
<tr>
<td>ULER Food Processing</td>
<td></td>
<td>0.8733</td>
<td>13.07</td>
<td>0.000</td>
</tr>
<tr>
<td>TTRAK Constr. &amp; Agric. Machinery</td>
<td></td>
<td>0.9540</td>
<td>16.56</td>
<td>0.000</td>
</tr>
<tr>
<td>ALKIM Paper &amp; Paper Products</td>
<td></td>
<td>0.9794</td>
<td>19.35</td>
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<tr>
<td>CIMSA Construction - Raw Materials</td>
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<td>0.9829</td>
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<tr>
<td>EGSSER Constr. - Supplies &amp; Fixtures</td>
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<td>1.0088</td>
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<tr>
<td>ADANA Construction - Raw Materials</td>
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<td>1.0453</td>
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<td>0.000</td>
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<tr>
<td>PETKUN Food Processing</td>
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<td>1.0507</td>
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</tr>
<tr>
<td>FROTO Auto &amp; Truck Manufacturers</td>
<td></td>
<td>1.0679</td>
<td>20.4</td>
<td>0.000</td>
</tr>
<tr>
<td>ERBOS Constr. - Supplies &amp; Fixtures</td>
<td></td>
<td>1.2976</td>
<td>26.97</td>
<td>0.000</td>
</tr>
<tr>
<td>CEMTS Iron &amp; Steel</td>
<td></td>
<td>1.3118</td>
<td>30.99</td>
<td>0.000</td>
</tr>
<tr>
<td>AFYON Construction - Raw Materials</td>
<td></td>
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<td>22.31</td>
<td>0.000</td>
</tr>
<tr>
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<td>0.000</td>
</tr>
<tr>
<td>HEKTS Chemical Manufacturing</td>
<td></td>
<td>1.5648</td>
<td>25.42</td>
<td>0.000</td>
</tr>
<tr>
<td>AKSA Chemicals - Plastics &amp; Rubber</td>
<td></td>
<td>1.586</td>
<td>30.2</td>
<td>0.000</td>
</tr>
<tr>
<td>BOLUC Construction - Raw Materials</td>
<td></td>
<td>1.8679</td>
<td>25.68</td>
<td>0.000</td>
</tr>
<tr>
<td>VESBE Appliance &amp; Tool</td>
<td></td>
<td>1.9742</td>
<td>23.64</td>
<td>0.000</td>
</tr>
<tr>
<td>SODA Chemical Manufacturing</td>
<td></td>
<td>2.081</td>
<td>35.56</td>
<td>0.000</td>
</tr>
<tr>
<td>EGEEN Auto &amp; Truck Parts</td>
<td></td>
<td>2.3505</td>
<td>26.5</td>
<td>0.000</td>
</tr>
<tr>
<td>LOGO Software &amp; Programming</td>
<td></td>
<td>3.256</td>
<td>22.95</td>
<td>0.000</td>
</tr>
</tbody>
</table>

* indicates the rejection of null hypothesis at the 1% significance level.
Conclusion

In this study, the effect of the market interest rates on the companies in the P30 index has been investigated. For this purpose, the long-run relationship between stock prices of companies listed in the P30 index over 2011-2017 and interest rates of Turkish government bonds, having two year maturity, has been analyzed using LM bootstrap panel cointegration test. According to the results of the cointegration test, it is found that there is a long-run and significant relationship between the market interest rate and all of the examined 41 companies. The coefficients of the long-run relationship are calculated using the MG estimator taking into account cross-section dependency.

The least affected company from market interest rate is TTKOM, while the most affected company is LOGO. The long-run coefficient of TTKOM is 0.005 while of LOGO is 3,256. This means that an increase of 1 percent in market interest rates affects TTKOM by 0.005 percent while affects LOGO by 3.256 percentage points. Moreover, it is noteworthy that 5 of the 10 companies with the lowest long-run coefficient are operating in the construction-raw material industry. According to this result, it can be said that the companies operating in the construction-raw material industry are less affected by the market interest rates. Another result of the model is about the stock prices of the first Islamic bank in Turkey, namely ALBRK that indicates a negative correlation with interest rates. This result is in line with the expectation towards stock prices of conventional banks for which profit declines in the increasing interest rate environment because of the narrowing net interest margin. Although ALBRK is not using interest in their operations, they are affected by the market rates because of the small size of the Islamic banks (around 5%) in the Turkish banking sector.

As a result, the companies in the P30 index are subject to two different elimination criteria, the latter requiring interest-related rates to be below a certain level. It can be considered that the companies which qualify the second elimination criteria will not be affected by the market interest rates. But the results of this study demonstrate that P30 companies are affected by market interest rates. In this context, it is important to consider the criticism of those who believe the upper limit on interest rate ratio in the second elimination criterion to be too high.
References


Why Islamic Banks Are Reluctant to Offer Musharakah Mutanaqisah for Home Financing: The Case of Maybank Islamic and Affin Islamic Bank

Nurul Iffah Binti M A Zaaba
Rusni Hassan

Abstract: This paper focuses on the challenges faced by the Malaysian Islamic Banks in implementing Musharakah Mutanaqisah (MM) Home Financing. Even though the study is specifically on the Malaysian Islamic banks, but the issues and recommendations addressed in this study are also pertinent to other Islamic banks across the world since they are also offering it. Drawing upon in-depth semi-structured interviews with the senior officers in two leading Islamic banks in Malaysia, one is the bank which terminated its MM Home Financing products however the other one continues to offer it. Knowing the contradicting perspectives of both banks gives insight of the real challenges faced by them in offering MM for home financing which are advance rental and the system’s incapability to capture the unique nature of MM, and at the same time to know the motivation of offering it i.e. product diversification and comprehensive risk mitigation. This paper concludes by making recommendations that may be adopted by Islamic banks and the regulators to facilitate the promotion of MM Home Financing. Notably, this paper offers empirical findings which are different from the previous literature.

Keywords: Musharakah Mutanaqisah, Islamic Bank, Reluctant, Reasons
JEL Codes: G20, Z12

Introduction

Musharakah Mutanaqisah is an alternative contract that can be offered under home financing and can replace Bai’ Bithaman Ajil (BBA) as BBA is similar to fixed rate ‘debt financing’ or Murabahah (Asadov et al., 2018; Mydin Meera & Abdul Razak, 2005; Osmani & Abdullah, 2010; M. Ridwan & Shahruddin, 2013, Maulin, 2017; Subky et al., 2017). Yet, MM Home Financing is not used widely in the pra-
ctice in Malaysia, Indonesia and Pakistan. These countries are still dominated by Murabahah Financing as MM is considered more complicated in its system and its calculation technique (Akram, Rafique & Alam, 2011; M. Ridwan & Shahrudin, 2013; Maulin, 2017; Rohmi, 2015; Subky et al., 2017). Thus, the issues that will be addressed in this paper are common in Islamic Finance industry across the globe.

In Malaysia, many Islamic banks have now shifted their focus from MM to Commodity Murabahah (CM) after phasing out BBA. The current situation shows that most products especially home financing ones, are granted under CM which could raise the concentration risk issue in the future. It is important to note that currently there are only five banks that still continue to offer MM Home Financing. Thus, it is essential to conduct a study to investigate the reasons behind Malaysian Islamic banks stopping promotion of MM Home Financing and to discover the factors that inspire a few of them to continue offering this type of financing.

The objectives of this study are to investigate the challenges faced by one of Islamic banks in implementing MM Home Financing and to investigate the factors leading to the continual offering of MM Home Financing on contrary. Thus, the research questions this paper seeks to answer are; What are the reasons for discontinuing MM Home Financing? and “What are the factors leading to continual offering of MM Home Financing?”

The present study significantly contributes to multiple fields. Firstly, this study enables banks to evaluate their position with regards to offering or discontinuing MM Home Financing. Secondly, the study’s findings will assist other researchers in investigating the challenges and reasons behind promotion of discontinuation of MM Home Financing. Thirdly, it would allow policy makers to address the challenges in offering MM Home Financing by implementing new guidelines. Lastly, it may act as a valuable source of reference for future studies in MM Home Financing as it is based on in-depth interviews with the experts of the field.

**Problem Statement**

MM Home Financing was introduced in 2007 as a better substitute for BBA. Bank Negara Malaysia (BNM) encourages the Islamic banks to offer MM as one of their home financing products. In 2012, seven banks were offering MM Home Financing (Lee, 2013). The figure increased to nine banks in 2013 (Muhamad, Abd Rahman, & Khalid, 2013). This however decreased in the later period with only five banks currently offering this kind of financing (Subky et al., 2017).
The current trend shows that many Islamic banks have stopped offering MM and are focusing on other types of products like CM. A study by Subky et al. (2017) stated that most Malaysian Islamic banks that were offering MM financing had stopped providing it and instead were offering other financing contracts such as CM, Ijarah Muntahiyah bit Tamlik (IMBT), and Istisna. The reasons for its discontinuation include advance rental and ownership risks for under construction properties in case the project is abandoned. The force majeure risk in completed property and refinance and remortgage issues constitute other reasons. Thus, it is vital to highlight the pros and cons in MM Home Financing so that the product can be improved, and more Islamic banks will re-offer MM Home Financing in the future.

**Literature Review**

This part examines the literature in three parts, namely the definition of MM, its advantages and disadvantages, and issues pertaining to MM Home Financing.

**Definition of MM**

On February 5, 2006, the Shariah Advisory Council (SAC) of BNM resolved that MM-based financing product is permissible as MM is a contract recognised under Islamic Muamalat. In implementing MM contract, it is permissible for the contracting parties to combine the two contracts of Musharakah and Ijarah in one document of agreement, as long as both contracts are concluded separately and are clearly not mixed. This serves to impose a pledge on the shares owned by the customer because the right of beneficial ownership is recognised by Shariah (Bank Negara Malaysia, n.d.).

According to Shuib, Borhan & Abu Bakar (2011), Asian Institute of Finance (2013), and Hanafi (2014), MM is a combination of three contracts, namely Musharakah, Ijarah, and Bai’. The Musharakah part of the contract is concluded between the bank and the customer in the capital contribution for the purchase of the housing property. Meanwhile, the Ijarah contract comes into the picture when the bank leases out its portion of the property to the customer. The Bai’ contract is concluded when the customer buys the bank’s portion of the property as the monthly instalments which consist of partly the gradual purchase price of the bank’s portion and partly the rental. As explained by Azli et al. (2011), the modus operandi of MM is as follows:

1. The customer identifies the property and approaches the bank to obtain financing. The bank agrees to pay 90% of the property’s price. The bank and the customer enter into Musharakah contract where the bank provides 90% capital and the customer provides 10% of the property’s price. Consequent-
ly, the bank owns 90% beneficial ownership of the property and the customer owns the remaining 10%.

2. The bank leases its portion to the customer.

3. The customer pays monthly instalments (the instalment consists of partly the gradual purchase price of the bank's portion and partly the rental) to the bank.

4. The bank’s portion will gradually decrease, and the customer’s portion will gradually increase. At the end of the financing tenure, the customer will own 100% of the property.

5. The bank will transfer the ownership of the property to the customer.

**Advantages and Disadvantages of MM**

MM was introduced as an initiative to replace the controversial BBA Home Financing. As explained by Azli et al. (2011), MM is a better alternative contract for home financing and is well accepted by the Muslim scholars worldwide compared to BBA. Hassan (2011) added that MM can be operated in a Shariah compliant way because it shuns interest. Asadov et al. (2018) stated that MM is a global product that may be applied in many types of financing that could be arranged as partnership. Zaidi and Mohammed (2018) propose the usage of cash waqf in MM model. However, implementing MM as a contract for home financing is not an easy task. Smolo and Hassan (2011) claimed that “MM looks like a perfect mode of finance literally, yet in practice, it is far from being perfect. All of the current practical problems faced by MM are man-made and caused by the current policies and regulations that can be amended or replaced.”

**Issues Pertaining to MM Home Financing**

The issue of rental rates has always been raised in the application of MM Home Financing. Mydin Meera and Abdul Razak (2005) and Muhamad et al. (2013) highlighted the issue of banks charging customers profit rates which are benchmarked against the interest rate. The study done by Muhamad et al. (2013) also raised the issue of maintenance of asset; the legal contract does not state that ultimately, only one out of the two owners bears the cost of maintenance. Plus, Haneef, Kunhibava and Smolo (2011) argued about the issue of advance rental charged by the Islamic banks that needs to be returned to the customer if the property is abandoned. Notably, both parties are to share the loss according to their capital share.

The fourth issue in the application of MM as stated by Asmadi (2011) is waad, whereby purchase undertaking by the customer should be at the market value rat-
her than the floating price of the house as it will considerably affect the client. The research of Shofni (2012) also questioned the issue that why the customer, instead of the bank, is required to deliver the undertaking. The practice of the purchase undertaking is actually one sided and was supported by Subky et al. (2017).

There are various issues related to the current MM Home Financing offered by the Islamic banks. Hassan (2012a) tried to present a new model namely the Zubair Diminishing Balance Method (ZDBM). He claims that ZDBM is Shariah compliant and cheaper than usual MM Home Financing (Hassan, 2012b). However, it is found that ZDBM still remains as a theory upon which Islamic and conventional banks can practice in future.

**Banks Offering MM Home Financing**

The table below shows the list of Islamic banks offering MM Home Financing in 2014 and 2017. It can be seen that there is a declining trend from 2014 to 2017, from eight banks dropping to five banks in three years’ time.

<table>
<thead>
<tr>
<th>Bank</th>
<th>MM Home Financing 2014</th>
<th>MM Home Financing 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Affin Islamic Bank</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Al Rajhi Bank</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Bank Islam</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Bank Muamalat</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Bank Rakyat</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>CIMB Islamic Bank</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Citibank Malaysia Berhad</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Hong Leong Islamic Bank</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>HSBC Amanah</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Kuwait Finance House</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Maybank Islamic</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Public Islamic Bank</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>RHB Islamic Bank</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Standard Charted Saadiq</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Source: Mat Ali (2017) for year 2014 and Subky et al. (2017) for year 2017
Research Methodology

This paper employs a qualitative method, whereby library research focusing on related journal articles was done for the literature review and empirical study was performed through interviews with the banks. One of these banks does not offer MM Home Financing but the other one still offers it and has a robust MM framework since it’s the pioneer and has been offering the product since 2007.

The interviews were conducted using a semi-structured method. The semi-structured interviews were conducted with questions prepared to capture the challenges faced by both the banks in promoting MM Home Financing. The face-to-face interviews lasted one to two hours per session and both interviews were conducted in English and Malay languages. In the interviewees, the bank that has stopped offering MM Home Financing was represented by its Head of New Product and Business Development who has 19 years experience in the field. From the other bank we interviewed it’s Head of Shariah Department who has 12 years of experience in Islamic banking. The interviews were tape-recorded and transcribed.

Findings and Discussion

Factors Hindering the Implementation of MM in Home Financing

One of the respondent banks is the biggest Islamic bank in Malaysia has offered MM Home financing between year 2007 and 2016. Nevertheless, it offered MM home financing for completed construction only from 2012 and stopped offering MM Home Financing in 2016. The interview conducted with the bank revealed that the following are the real challenges that the bank faced and lead to termination of MM Home Financing.

Advance Rental and Ownership Risks for Under Construction Property in the Case of Defaulting Developers, and Force Majeure Risk in Completed Property

In 2011, BNM issued the Ijarah concept paper that discussed the advance rental and ownership risks. The bank highlighted that due to the new Ijarah concept paper, the bank had to return advance rental collected from the customers while the financing disbursed had to be forfeited in the case of an abandoned project. Unfortunately, this risk was too great, which ultimately led to the bank’s decision to terminate MM Home Financing product for under construction properties in 2012, despite the product’s stellar performance. The bank eventually terminated MM Home Financing for completed properties in 2016, taking into consideration the force majeure risk that could prevail.
Refinance and Remortgage Issues

MM is not applicable for refinance or remortgage as it involves the conversion from sale-based contract to a partnership contract. For example, a BBA Home Financing customer from another bank seeks to refinance with the bank, thus the bank will become a partner to the customer by buying the house from another bank and this scenario is possible. Conversely, in the case of a customer who seeks refinancing from the bank under BBA Financing to MM Home Financing, there will be confusion on matters pertaining to how the bank will buy the share from itself. There is no clear transaction in such a scenario. Remortgage also cannot be done because customers do not have partners and banks, thus, this is a confusing situation for the bank.

Comfortable with CM-based Products

In contrast, CM Home Financing addresses purchase, refinance, remortgage, and top-up financing. CM seems to present lots of possibilities with no limitation, so the bank decided to have CM as its core product. The bank’s system has a comprehensive and complete platform for CM. There are more operational issues rather than Shariah related issues in CM, therefore, bank is comfortable to offer CM and has stopped offering both BBA and MM via phase out. Thus, the bank is now focusing on its financing products based on CM.

Factors Encouraging the Islamic Bank to Continue Offering MM Home Financing

In contrast to Malaysian Islamic Banks that have stopped offering MM Home Financing, there are others that continue to offer this product. This research explores the factors and reasons that are behind another bank’s decision of continuing to offer this product. Some of these factors are as follows:

The Legality Issue and Controversy of Tawarruq Contract

The bank tries to minimise the use of Tawarruq in the financing offered by the bank as much as possible although the bank still uses Tawarruq for purposes other than the cash and liquidity management. The maximum capping that has been agreed for Tawarruq is 40%. In order to ensure the limit for Tawarruq is not transgressed, the bank has offered other Shariah contracts for their financing, including the MM Home Financing.

Hence, the Musharakah financing takes up approximately 20% of the bank’s total financing portfolio, while approximately 22% to 23% is attributed to the Tawarruq portfolio. Furthermore, the BBA legacy customers make up the majo-
rity of the bank’s financing portfolio. Although MM is the default contract used in home financing, the bank also offers CM-based home financing in the event that Musharakah is deemed unfit or the risk of the development is too high.

**MM Home Financing Offered Conforms to the Ijarah Guidelines Issued by BNM**

BNM issued the Ijarah guidelines that lay down the conditions that need to be fulfilled by the bank in issuing Ijarah contract to the customers. MM Home Financing also includes Ijarah as one of its underlying contracts when the bank leases out its portion to the customers. Most of the banks find it hard to comply with this requirement and choose to stop offering MM Home Financing. On contrary, these conditions were already included in the agreement for their MM Home Financing even before the guidelines for Ijarah were issued by BNM. Thus, the conditions prescribed in the guidelines issued by BNM do not in any way affect the existing MM Home Financing offered by the bank.

**No Previous Case of Abandonment or Force Majeure Event**

MM Home Financing is offered both to housing projects under construction and completed houses. Since the risk borne by the bank in offering MM Home Financing for house under construction is higher, the bank is more stringent and selective in choosing the developer before granting the customers this contract. The bank screens the track record of the developer thoroughly. If the customers propose to buy a house developed by reputable developers like Mah Sing, Sime Darby, and IJM, the bank offers them MM Home Financing. For less reputable developers, developers who develop on a smaller scale, and developers in remote areas, the bank offers other financing products.

Thus, with the precautionary measures taken by the bank, up until now, there has been no case of abandonment for MM Home financing or the projects under construction that have been granted by the bank. Besides, there has not been an issue of serious force majeure event in the past and the bank’s risk in this event is also mitigated by the Takaful coverage.

**Diversification of Financing Products**

Learning from the year 2008’s experience, when most of the bank’s financing for purchase of houses was concluded via BBA’s contract and suddenly, the legality of this contract was questioned, causing a distress for most of Islamic banks. Thus, the bank decided not to focus on certain Shariah contract in offering financing to
the customers. This was done to reduce the concentration risk that may be higher if no diversification is made in the financing products offered by the bank.

For home financing, the Shariah contracts which are offered include MM as well as Tawarruq. In the bank’s overall financing portfolio, 20% are based on MM, 23% are based on Tawarruq, and the remaining is made up of the previous BBA’s legacy and Al-Ijarah Thumma Al-Bai’ (AITAB) i.e. the modes of financing with the highest proportion.

**Comprehensive Risk Mitigation Plan**

The issue of abandonment is a huge risk for the banks. In order to mitigate this risk, the bank has been working closely with the Ministry of Urban Wellbeing, Housing, and Local Government. A project that has stopped working for six months is deemed as an abandoned project by the ministry. The next stage is then to look for a replacement for the developer or to resume the project with the current developer under new terms. During this waiting period, the bank halts its advance rental collection and the collection only resumes upon the revival of the project. In the case where customers do not wish to wait for the revival of the project and instead wish to exit the Musharakah contract, the customer shall compensate the bank and the bank will return the advanced rental collected.

**Recommendations**

The above findings and discussions reflect that there is room for further implementation of MM-based financing products. This paper offers several recommendations that can be adopted by the Islamic banks and regulators in order to enhance the performance of Islamic banking products as well as innovate in the future.

Firstly, the current legal framework for the operation of MM Home Financing product needs to be improved through amendments to existing laws or the enactment of a new statute to govern its operation. Therefore, constant improvement and amendment to the legal framework will guarantee the development of Islamic finance, particularly for the equity financing, whereby it may be necessary to establish different legal and regulative structures for the operation of Islamic finance. Different treatment and consideration must be given to legal Islamic structures on various issues such as ownership, consequences of default, and to the asset in the event of an abandoned project. Increasing transparency by product disclosure is also important to ensure customers’ awareness and confidence in the products they subscribe to. Henceforth, enhancement in legal framework in Malaysia is nee-
ded to ease the implementation of MM Home Financing in the Islamic banks. BNM as the regulator should pay attention to this aspect.

Moreover, there is a need for further research focusing on legal framework of MM Home Financing aiming to determine whether there is a real need for a new act for the operation or simple amendments in the current legal framework would be sufficient for its operation. The skilled talent pool is a valuable asset in supporting the development of Islamic finance. They are closely committed to the spirit of Shariah and are adept to uphold justice for the economic development, mainly for the Muslims as a whole, in order to accommodate the new legal framework of MM Home Financing. As a result, it is hoped that the application of MM Home Financing would become an incentive for further dependence to equity financing in Islamic finance, particularly in Malaysia (Hanafi, 2014).

Based on the findings, both banks did not use rental rate as their pricing mechanism in MM Home Financing; they applied the Islamic Base Rate (IBR) that still uses conventional interest rate as its benchmark. Therefore, a benchmark to determine the rental rate in MM Home Financing should be introduced to avoid Islamic banks using the interest rate as the rental rate which creates misinterpretation in the public. A research has been performed regarding the use of a rental index or house price index in determining the rental to be charged for each specified Ijarah contract period. The model is a practical alternative to the conventional floating rate financing since the rental rate can be adjusted if there is any fluctuation in the economy. As it is more flexible, the Islamic banks will not be too worried about variances in the economic conditions (Mydin Meera and Abdul Razak, 2005).

Moreover, an independent institution with authority needs to be established to set rate and update the periodic rental rate for every area. It is hoped that the pricing of home financing would be able to capture the true value of the property, while being fair, equitable, sustainable, and resilient to economic exposures. At the same time, it would remain competitive with the conventional banking as the rates are comparable, without relying on and being benchmarked against the interest rates. (Yusof, Mahfudz, Arif, & Ahmad, 2016)

From the interview, it was found that MM Home Financing is offered to both the housing projects under construction and the completed houses. As the risk taken by the bank in offering MM Home Financing for houses under construction is higher, the bank is stricter and more careful in choosing the house developer before giving the customers the contract. The process begins with the bank screening the
track record of the developer. Remarkably, with the precautionary measures taken by the bank, up until now, there has not been any abandonment for MM Home Financing in the projects under construction that have been granted by the bank. There is also no issue of serious force majeure event in the past and the bank's risk in such an event is also mitigated by the Takaful coverage. Therefore, the strict screening of developers should be followed as a guide by other Islamic banks as one of the methods to mitigate the risk in MM Home Financing.

Fourthly, tawarruq has evolved as a dominant concept in Malaysian Islamic banks. Nevertheless, the extensive use of Tawarruq in Islamic financial institutions has led to numerous arguments from both Shariah scholars and Muslim economists. The fact that Tawarruq is designed to simply imitate the characteristics of conventional products challenges the claims of Islamic finance proponents that Islamic financial institutions offer a genuine alternative to conventional finance. Concentration risks towards one Islamic contract will grow, and the question at the outset is that whether banks will take the time to develop other contracts instead of just building the CM product structure.

When BBA was introduced, no other product was developed in the market and the situation is now similar with CM. Nevertheless, there are opportunities for the development of other Islamic contracts. Maybe once the thinking to understand the transactional and Shariah risks of the new products emerges, the market would accept the idea that Shariah-compliant banking can be a different way of banking.

In the case of the bank that continues to offer MM Home Financing, the bank still uses Tawarruq for purposes other than the cash and liquidity management, yet it tries to minimise the use of Tawarruq in the financing offered by the bank as much as possible. The maximum capping that has been implemented by the bank for Tawarruq contract is 40% from all Shariah contracts used by the bank in its activities. In order to ensure that the limit for Tawarruq is not transgressed, the bank also offers other Shariah contracts for its financing, including the MM Home Financing.

Lastly, MM is a universal product that may be applied in many types of financing that could be arranged as partnership. For certain types of financing products such as personal financing and credit cards, CM appears as the most ideal structure. However, for working capital, Islamic banks may consider a profit-sharing structure such as Mudarabah and Musharakah although the risks associated with this kind of structure could be relatively higher. Undeniably, Islamic banks are en-
couraged to consider this profit-sharing structure for their financing products as it is deemed as the most acceptable form by a majority of Shariah scholars.

Nonetheless, it is vital for Islamic banks to be equipped with appropriate risk mitigation mechanisms, backed by risk officers with the right expertise. Besides, practising the MM contract in its true Shariah spirit, the use of MM contract should be extended to automobile and trade financing where rent or profit could be easily identified, and the value of the asset is more certain (Asadov et al., 2018).

Furthermore, one effective way for the future development of the MM model is that the banks can participate in joint venture with the developers. However, in reality, the banking industry is too regulated to venture into other equity products, especially via joint venture. Equity contracts and partnerships are better suited in an environment that is not bound by any kind of banking regulation. Banks do not want to put themselves at risk, therefore, eventually fall in practices which are similar to conventional banks (Kevin & Hassanudin, 2017).

Islamic bank is a Shariah-oriented business entity and is expected to be guided by the philosophies of Islamic business. The management or policy makers of the banks will use the philosophies in the process of constructing corporate objectives and policies, and the philosophies act as an indicator as to whether the specific Islamic bank is upholding true Islamic principles or not. Thus, the representatives of Islamic banks should know these philosophies. Islamic banking is a subdivision of the overall Islamic economic system. It must strive for a just, fair, and balanced society as prescribed by the objectives of Shariah (Maqasid al-Shariah). However, not many representatives of Islamic banks know and understand these philosophies and objectives (Muhamad et al., 2013). This is because most of them are from the conventional banks which are the parent banks of the subsidiary Islamic banks.

**Conclusion**

This paper examined the application of the MM Home Financing product as practised by two Islamic banks in Malaysia. It further highlighted numerous issues and challenges faced during this implementation. Notably, this research found a gap between the literature review and empirical findings on the issues of MM Home Financing; the reasons for the biggest Islamic bank in Malaysia to stop offering MM were its other operational aspects such as refinance issue and marketing reasons. However, one similar issue was found in the literature review and empirical findings, namely the issue of advance rental that needs to be returned to the customer.
if the house is abandoned. Thus, this research contributed significantly with its empirical findings compared to other previous studies.

It is hoped that this research will provide new insights to further promote MM Home Financing in Malaysian Islamic banks in specific, and globally in general. More Islamic banks are urged to adopt MM Home Financing to benefit the clients and to ensure its conformity with the Shariah principles. However, few legal rules related to Islamic banking contracts, ownership, pricing mechanism, and other aspects need to be modified to implement MM effectively.

Moreover, it is hoped that there would be continuous attempts to improve the facility in the future, and eventually, the reliance on equity financing would increase due to the inherent benefits associated with it and to avoid concentration risks on CM. Even though MM has its own shortcomings, the advantages of MM are greater. The Shariah-based mode of finance is accepted internationally and is compatible with the underlying ethical basis of Shariah financing i.e. the benefit of the society as a whole.

References


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**Interviews**

Abstract: Islamic banks are financial intermediaries with the claim of being an alternative to commercial banks. Recently a considerable literature has been produced around the theme of whether or not the alternative presented in theory has been reflected in practice. However, these studies are exploratory and interpretative in nature. The quantitative researches presented thus far provide indirect evidence for the central theoretical issue. To date, very little attention has been paid to the role of the relationship between interest rates and profit-share accruals. These studies have also suffered from shortcomings with regards to the methods applied. The primary aim of this paper is to provide empirical and theoretical evidence to the claim of Islamic banks to be alternative to commercial banks. It does so by investigating the relationship between profit share accruals and deposit rates by employing wavelet coherence method for the first time. This study uses longitudinal monthly data for the 2000 to 2018 period, particularly from Turkey, and provides an exciting opportunity to advance our knowledge about the structure of Islamic banking with focusing specifically on fund supply. The results have revealed that Islamic banks are an alternative to fund suppliers in short-term. In addition long-term maturities had shown a strong alternative characteristic in the pre-2006 period; however, they were unable to preserve it in the post-2006 period after the effectiveness of Banking Act No. 5411. Findings also show bidirectional causalities to be found in different periods. The findings have important implications for the market players and policy makers.

Keywords: Islamic banking, Wavelets, Participation banks, Special finance houses

JEL Codes: C01, G21, G29, Z12

Introduction

Islamic banks have emerged as the alternative to commercial banks, particularly in context of an interest-free financial system (Iqbal, 2001, p. 26). In spite of this, Muslims have not considered Islamic banks as the alternative due to lack of awa-
reness during their early years of development (Ariff, 1988, p. 60). Later, Islamic banking was recognized as the alternative from certain perspectives (Khan, 2010). Many studies have proven Islamic banks to diverge from their conventional counterparts when their ratios were analyzed through econometric models (Naceur & Samy, 2003; Yudistra & Donsyah, 2004; Cihak & Hesse, 2008; Beck et al., 2013).

The difference that the business model brings has been influential on how Islamic banks exhibit their distinct characteristics. Islamic banks, which collect funds through a risk-based system, generate profits by incorporating the resources they’ve acquired into production through asset transfer. They share the profit they obtain at the end of the process with the fund holders.

The basic divergence occurs on return, as the output of collection performance. Instead of a guaranteed interest, they set up a risk sharing model and handle the financial intermediation activities. From this perspective, presenting profit accruals as an alternative to deposit rates makes Islamic banking a natural alternative to commercial banking.

Islamic banks, which perform activity through their designation as special finance houses were assessable as shadow banks prior to Banking Act No. 5411 that was enacted in Turkey on January 1, 2006, and have been called participation banks ever since. Islamic banks, which thus moved into a regulatory field, have been exposed to obligations similar to commercial banks within the framework of secular legislation and have lost their regulatory arbitrages. At the same time, the infrastructure called for by the interest-free business model had also been done away with after 2006.

Through the example of Turkey, this study compares the yields Islamic banks offer through fund-raising methods as the main determinant by examining whether or not they are an alternative to commercial banks. Addressing the period from June 2000 to January 2018 using monthly data, the weighted-average interest rates for 1-month and 3-month maturities are debated over the profit-share ratios that three participation banks have presented to accounts with 1-month and 3-month maturities. In Turkey, 88% of the participation funds on total deposits are in debit accounts or 3-month-maximum maturity accounts. For this reason, comparing deposits and participation funds with maturities longer than three months has not been felt necessary (Dinc, 2017, p. 74).

The wavelet coherence model is one of the most effective methods in researching alternative characteristics. This study has employed wavelet correlation and coherence methods which are pioneering qualitative methods for statistically pro-
voking alternativeness. Previous studies have generally focused on causative relationships. This study fills a significant gap in the literature in this respect.

The findings show that Islamic banks offer an alternative with regards to short-term maturities. However, when considering long-term maturities, the strong alternative structure of the special finance houses had disappeared after the change in participation banking. One of the Islamic banks included in the review did not reveal this quality even on medium-term maturities while emerging as the alternative on short-term maturities. Results also show bidirectional casualties.

At the same time, participation banks reveal alternative structures in crisis periods. Alongside this, the secular legislation infrastructure is understood to have distanced Islamic banks from their original model.

The findings are important for investors who oversee short-term and long-term maturities, for professionals in the field as well as researchers who work on this issue.

**Literature Review**

Studies over the past two decades have provided important information on Islamic banking. A considerable amount of literature has been published on comparative analyses between the conventional and Islamic financial institutions. However, debate continues about the differentiation between both banking models. Most of these studies have only taken into account certain performance indicators. Much uncertainty still exists about the relationship between the overall outputs for fund suppliers of two different banking models.

Examining the relationship between the profit shares distributed to participant accounts and the deposit interest rates in Malaysia and Turkey using cointegration and Granger-causality tests on monthly data covering the period from 1997 to 2010, Charap and Cevik (2011) found that profit shares were positively correlated with deposit interest rates and deposit rates cause return on profit shares.

Using the Malaysian sample of data stretching from 1996 to 2011 and applying the cointegration analysis, Latiff and Halid (2012) found that the rates were positively related in the pre-2004 period, and, afterwards, they turned to be inversely related because of regulations on profit equalization reserve.

Ergeç and Arslan (2013) investigated the relationship between interest and profit share rates using the vector-error correction model for the 2005-2009 period. The study, which addressed the sample from Turkey, showed that profit shares were influenced by interest rates.
Yusoff (2013) examined the 2009-2012 period in his study investigating the causality relationship between profit-share rates and interest rates for Malaysian banking system. The study which employed Toda-Yamamoto technique found bidirectional causalities.

Ito (2013), whose study examined a sample from Malaysia and reviewed the relationship between deposit interest and profit-sharing returns, applied the causality test for the period of 2005-2012. Ito showed deposit interest to be affected by profit shares in 3-, 6-, and 12-month maturities. Ito (2017) extended the addressed period to 2005-2014, which further confirmed the findings.

Strong association between the profit share and interest rate was also found by Anuar et al. (2014) on Malaysian market covering 1994-2012 period. They employed Granger causality and found deposit interest rates have unilateral effect on profit-sharing rates.

Similar conclusions are made by Hussan and Masih (2014) for the Malaysian market by employing the cointegration analysis on data ranging from 2004 to 2013.

Investigating the long-term relationship between the profit shares and deposit interest rate in Turkey by employing the cointegration analysis on data covering the 2002-2013 period, Saraç and Zeren (2015) found that significant links between the rates do exist (except in case of one bank).

The study of Ata et al. (2016) focusing on Turkish market for the years between 2004 and 2014 revealed that profit-sharing rates Granger-cause deposit rates in 1-, 3-, and 6-month maturities, while bidirectional relationships are found in 12-month maturities.

The study of Adewuyi et al. (2016), one of the few multi-country studies, examined the long-term cointegration relationship between deposit interest and profit-share rates. The findings show the existence of two-way causality between profit-share rates and deposit interest during the addressed 2007-2015 period.

Tekin et al. (2017) examined the relationship between interest and profit shares in Turkey in particular in their study addressing the 1998-2016 period. By detecting extensive correlation when market volatility is low, the study, which had applied boundary testing, cointegration, and the Granger causality test, observed the decrease in correlations in the 2001 and 2008 crises.

Addressing crisis periods is important for revealing the differentiation. Aysan et al. (2016) addressed a sample from Turkey for the period of 2004-2012 in their
study investigating the behaviors of participation and commercial banks during times of crisis. The findings of the study, which used the risk-exposure method, showed the behavior of the two bank groups to diverge in times of crisis and the participation banks to provide protection in difficult times.

Meslier et al. (2017) addressed the period of 2000-2014 through an investigation of the relationship of deposit interest and profit shares in dual banking systems over their study of 20 countries. The findings confirmed differentiation to exist. Commercial banks were found to have relatively higher rates in Muslim societies while interest-free banks presented higher rates in non-Muslim societies. In the study, the profit-share rates of interest-free banks were revealed as the determinant of deposit interest. Çetin’s (2017) study, which used simulation, compared the deposit-interest and profit-share rates of the 2005-2015 period for a Turkish sample and arrived at the result that profit shares present higher yields.

Yüksel et al. (2017) dealt with the causal relationship between interest and profit-share rates on studies investigating Turkey in particular. The result of the study, which examined the period of 2000-2016, showed the relationship between deposit interest and profit shares to be strong. The study put forth the view that the effect, which was claimed to be shaped by other variables, was unable to yield divergence in dual systems.

Korkut and Ozgur (2017) conducted a research on the link between profit share accruals and deposit rates by employing Ordinary Least Square (OLS) method. They found significant positive correlation between the two rates, which is argued to exist because of murabahah. However, Dinç (2018) showed in his research that the main factor behind the link is the inflation which is the key determinant of credit rates and the murabahah rates.

Koç’s (2018) study examined whether or not the interest rates of participation and commercial banks in Turkey were exposed to risk. The study, which addressed the period of 2005-2016 using the unrelated regression model, showed the interest rates of both banking systems to be exposed to similar risk. The empirical findings of the study provide a parallel understanding with previous researches that rates cannot be alternative to each other empirically.

Arıcan and Çetin (2018) employed simulation and examined the relationship between the deposit rates and profit share accruals for 2005-2015 period. They found strong positive correlation between these two variables which implies a non-alternative structure.
No study applying the wavelet coherence method for revealing the relationship between deposit interest and profit-share rates could be found in our investigation. At the same time, no study is found to have examined the pre- and post-2006 statutes of interest-free financial institutions in Turkey. Again, studies have examined the relationship by separating it into types according to participation accounts and deposit maturities; however the finding has not been presented for investors with short-, medium- or long-term maturities.

From this perspective, the examination done in this study reveals the relationship of profit-share rates (Turkey’s interest-free financial institutions had proposed this in the statutes for special finance houses and participation banks) with deposit interest during the relevant periods, at the same time examining the relationship that emerges in times of crisis. Alongside this, the alternative relationships of short-, medium-, and long-term maturities are also shown.

**Research Methodology**

**Data**

The weighted-average deposit interest is compared with the profit shares paid to participation accounts for revealing whether or not participation banks present an alternative to commercial banks.

The 1-month and 3-month maturity profit shares of alBaraka Turkish Participation Bank, Türkiye Finans Participation Bank, and KuveytTürk Participation Bank taken from the Participation Banks Association of Turkey (PBAT) database were compared with the weighted-average deposit interest rates of 1-month and up to 3-month maturities taken from the Central Bank of the Republic of Turkey (CBRT) for each of the deposit/participation funds’ two maturity groups, as they had largely gathered in maturity accounts of 1-month or up to 3-months. The data covering the period from June 2000 to January 2018 is monthly and includes the data of participation banks that were operating during this period.

**Methodology**

Over the past decade, wavelets gained wide acceptance in the field of economics and finance (for example, Pal & Mitra, 2019; Nagayev & Dinç, 2018; Altarturi et al., 2016). The important feature of wavelets is that it can handle both stationary and nonstationary data. Another benefit of wavelets is its ability to decompose (‘denoise’) the original data and present it in the time-scale dimensions, which is
helpful for analyzing the long-term low-frequency (high scale) movements based on short-term high-frequency (low scale) movements. Wavelets are categorized into two groups: discrete and continuous.\(^1\)

To address the research objective, we employ wavelet correlations and wavelet coherence techniques. Firstly, we decompose the time series data (i.e. the deposit interest and profit shares in participation accounts) using wavelet transformation method which produces the vectors of wavelet and scaling coefficients. Then, we estimate correlations between the variables over various time scales (horizons) using the ‘treated’ data.

The wavelet correlation analysis uses the maximal overlap discrete wavelet transform (MODWT) built on the Daubechies least asymmetric family of wavelets - LA(8). Wavelet correlation can be defined (Barunič, Kočenda, & Vácha, 2016) as:

\[
\rho_{xy}(j) = \frac{\text{cov}(W_x(j, s)W_y(j, s))}{\sqrt{\text{var}(W_x(j, s))\text{var}(W_y(j, s))}} = \frac{r_{xy}(j)}{\sqrt{\sigma_x(j)\sigma_y(j)}}
\]

where \(W_x(j, s)\) and \(W_y(j, s)\) are vectors of the MODWT wavelet coefficients for time series \(x(t)\) and \(y(t)\) at scale \(j\). So, the estimator of the wavelet correlation (1) can be rewritten as:

\[
\rho_{xy}(j) = \frac{\text{cov}(W_x(j, s)W_y(j, s))}{\sqrt{\text{var}(W_x(j, s))\text{var}(W_y(j, s))}} = \frac{r_{xy}(j)}{\sqrt{\sigma_x(j)\sigma_y(j)}}
\]

where: \(r_{xy}(j)\) is the estimator of wavelet covariance at scale \(j\), whereas \(\sigma_x(j)\) and \(\sigma_y(j)\) are estimators of wavelet variance and covariance, respectively (Barunič et al., 2016).

Wavelet coherence is another advanced multi resolution analysis tool that allows to consider not only the time and frequency dimensions, but also the strength of association between the time-series variables (Nagayev, Disli, & Ng, 2016; Bredin, 2015). It is based on continuous wavelet transformation. The continuous wavelet transform (CWT) is obtained by applying a mother wavelet \(\psi\) on the tested time series \(x(t) \in L^2(R)\), which can be presented in the following form:

\[\text{CWT}(x) = \frac{1}{\sqrt{a}} \int_{-\infty}^{\infty} x(t) \psi^*(\frac{t-b}{a}) \, db\]

\(a\) and \(b\) are the scale and translation parameter, respectively, with \(a \in (0, \infty)\) and \(b \in (-\infty, \infty)\).

\(^1\) For the further details on the wavelets and its application in economics and finance, please refer to Addison (2017), In and Kim (2013), Crowley (2007), and Gençay, Selçuk, and Whitcher (2001).
Where: the integer \( j \) determines the exact position of the wavelet in the time domain, while the integer \( s \) defines how the wavelet is stretched, i.e. its position in the frequency domain.

To assess the degree of association between two vectors, we employ the wavelet coherence which can be defined as:

\[
W_x(j, s) = \int_{-\infty}^{\infty} x(t) \frac{1}{\sqrt{s}} \psi(\frac{t-j}{s}) dt
\]

(3)

\[
R^2(s) = \frac{|S(s^{-1}W_{XY}(s))|^2}{S(s^{-1}|W_{XY}(s)|)^2 \cdot S(s^{-1}|W_{XY}(s)|)^2}
\]

(4)

Where: \( S \) represents a smoothing operator in both time and scale, \( s \) is a wavelet scale, and \( W \) are the continuous wavelet transforms of the time series \( X \) and \( Y \), respectively, and is a cross wavelet transform of two variables (Madaleno & Pinho, 2012).

Wavelet coherence results are graphically visualized in form of ‘hot’ (red zones with strong correlation) and ‘cold’ (blue zones with low correlation) regions. The phase difference between the variables is indicated by arrows (Figure 1). Arrows pointing to the right shows that the variables are in-phase (positively related), and the ones pointing to the left means out-of-phase (negatively related). Phases also
capture the lead-lag relationship between two time series. Arrows pointing to the southeast (or northwest), shows that $X$ is leading, while $Y$ is lagging. Similarly, arrows pointing to the northeast (or southwest), indicate that $X$ variable is lagging, whereas $Y$ is leading.

**Empirical Findings**

**Preliminary results**

A marked difference is seen at the beginning of the examined period between the deposit interests and the profit-share rates of participation accounts. However, a slight parallel trend is seen from *Figure 1* and *Figure 2* for 1-month and 3-month maturity deposit and profit shares during 2006-2018 period.

This initial findings imply that after effectiveness of Banking Act No 5411 the characteristics of Islamic banks resemble to their conventional counterparts, although interest rate generally offers higher yields. Moreover, lower rate deposits that public conventional banks collect from public institutes are also included in the weighted-average data.

*Figure 2. 1-month maturity deposit interest and participation banks’ profit shares from CBRT, PBAT*

A marked differentiation could emerge over the trend when addressing data apart from public institute funds. This situation has been included simultaneously among the constraints of the study. Since data excluding public funds could not be reached, hence examinations were conducted over the general averages.
Figure 3. 3-month maturity deposit interest and participation banks’ profit shares from CBRT, PBAT

Table 1 below presents descriptive statistics of time series of variables. Deposits have the highest volatility. The fat tail rate series is apparent from the excess kurtosis of all rates, particularly for the deposits, hence indicating that extreme values are expected more. Profit-share rates are skewed to the right implying a tendency towards positive values.

<table>
<thead>
<tr>
<th>Statistics</th>
<th>Deposit 1-month</th>
<th>ABAT 1-month</th>
<th>TFK 1-month</th>
<th>KT 1-month</th>
<th>Deposit 3-month</th>
<th>ABAT 3-month</th>
<th>TFK 3-month</th>
<th>KT 3-month</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>11.65</td>
<td>12.72</td>
<td>12.79</td>
<td>12.87</td>
<td>13.65</td>
<td>13.62</td>
<td>12.87</td>
<td>13.06</td>
</tr>
<tr>
<td>Minimum</td>
<td>5.29</td>
<td>6.21</td>
<td>6.12</td>
<td>5.66</td>
<td>6.59</td>
<td>6.29</td>
<td>6.26</td>
<td>5.74</td>
</tr>
<tr>
<td>Maximum</td>
<td>7016.42</td>
<td>45.95</td>
<td>40.55</td>
<td>47.13</td>
<td>104.20</td>
<td>46.42</td>
<td>36.14</td>
<td>36.42</td>
</tr>
<tr>
<td>St.Deviation</td>
<td>481.23</td>
<td>11.83</td>
<td>11.48</td>
<td>12.19</td>
<td>19.50</td>
<td>11.27</td>
<td>10.44</td>
<td>11.06</td>
</tr>
<tr>
<td>Coef Variation</td>
<td>41.31</td>
<td>0.93</td>
<td>0.90</td>
<td>0.95</td>
<td>1.43</td>
<td>0.83</td>
<td>0.81</td>
<td>0.85</td>
</tr>
<tr>
<td>Skewness</td>
<td>211.27</td>
<td>1.43</td>
<td>0.67</td>
<td>0.95</td>
<td>4.63</td>
<td>0.64</td>
<td>-0.26</td>
<td>-0.20</td>
</tr>
<tr>
<td>Kurtosis</td>
<td>14.52</td>
<td>1.54</td>
<td>1.36</td>
<td>1.41</td>
<td>2.15</td>
<td>1.30</td>
<td>1.05</td>
<td>1.06</td>
</tr>
</tbody>
</table>

Note: ABAT is alBarakaTurk Bank; TFK is Turkiye Finans Bank; and KT represents KuveytTurk Bank.
Empirical Results

Table 2 presents wavelet correlation outputs. The differences can also be seen between pre-2006 and post-2006 periods. The results show mainly negative correlation during 2000-2006 while positive correlation from 2006 to 2018 though different Islamic banks have separate findings. Especially for 3-month maturity profit-shares, all Islamic banks have negative correlation in mid and long term horizons in pre-2006 period. The results are similar for short-term horizon except for alBarakaTurk. For 1-month maturity again all Islamic banks profit shares have negative correlation in long-term. For mid-term only KuveytTurk and for short term only alBarakaTurk have negative correlation in the same period.

Table 2. Wavelets Correlations

<table>
<thead>
<tr>
<th>Term</th>
<th>D:ABAT</th>
<th>D:TFK</th>
<th>D:KT</th>
<th>D:ABAT</th>
<th>D:TFK</th>
<th>D:KT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-2006</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ST</td>
<td>-72.9%</td>
<td>33.7%</td>
<td>15.2%</td>
<td>24.51%</td>
<td>-22.03%</td>
<td>-20.12%</td>
</tr>
<tr>
<td>MT</td>
<td>53.8%</td>
<td>75.6%</td>
<td>-33.4%</td>
<td>-23.52%</td>
<td>-46.11%</td>
<td>-27.69%</td>
</tr>
<tr>
<td>LT</td>
<td>-8.4%</td>
<td>-26.1%</td>
<td>-22.4%</td>
<td>-48.06%</td>
<td>-59.54%</td>
<td>-51.02%</td>
</tr>
<tr>
<td>Post-2006</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ST</td>
<td>-10.63%</td>
<td>-15.28%</td>
<td>7.65%</td>
<td>-29.04%</td>
<td>-28.73%</td>
<td>18.02%</td>
</tr>
<tr>
<td>MT</td>
<td>23.36%</td>
<td>11.29%</td>
<td>47.28%</td>
<td>-3.62%</td>
<td>14.13%</td>
<td>48.62%</td>
</tr>
<tr>
<td>LT</td>
<td>52.50%</td>
<td>69.09%</td>
<td>62.08%</td>
<td>34.27%</td>
<td>64.08%</td>
<td>55.88%</td>
</tr>
</tbody>
</table>

Note: ST stands for short term; MT – medium term; and LT – long term; D is for deposits. ABAT is alBarakaTurk Bank; TFK is Turkiye Finans Bank; and KT represents KuveytTurk Bank.

In the post-2006 period alBarakaTurk and Turkiye Finans banks have negative correlation for only short-term horizon for both 1-month and 3-month maturity. KuveytTurk has negative correlation only for 3-month maturity mid-term horizon.

1-Month Maturity Wavelet Coherence Results

When comparing weighted-average interest rates of deposits with those of the monthly profit-shares, alBarakaTurk Participation Bank is seen to have developed an alternative on short-term horizon throughout the entire period. Figure 4 illustrates the wavelets coherence results for 1-month maturity rates of deposit and alBarakaTurk profit-share rates. At the start of the period in the 2001 crisis, alBarakaTurk presented a strong alternative on short-term horizon.
Figure 4. 1-month maturity profit shares and deposit interest (alBaraka Türk)

While a strong alternative structure was presented on long-term maturities in the pre-2006 period, this characteristic is seen to have been lost in the 2006 and beyond. While the findings continued to prove the claim of being an alternative for short-term horizon in the post-2006 period as well, a high positive correlation emerged in long-term. In addition, bidirectional causalities are seen in the results in different periods. This can be considered as the anticipated inflation effect.

The results are similar for Turkiye Finans Participation Bank’s profit shares over 1-month deposit rates. Figure 5 demonstrates the wavelets coherence results for 1-month maturity deposit rates and Turkiye Finans profit-share rates. The alternative characteristic on short-term horizon is seen to have been reflected throughout the entire period. Profit-share rates in the short-term horizon are seen to have been presented the same structure especially in the period of the 2008 global financial crisis and in 2013 when the Gezi protests were experienced.

Figure 5. 1-month maturity profit shares and deposit interest (Türkiye Finans)
The strong alternative characteristic, which had been seen in the pre-2006 period on long-term horizon, became lost in the 2006 and later period again like alBarakaTurk. Besides bidirectional casualty is seen between rates since the inflation had upward and downward trend during the period.

KuveytTurk Participation Bank, similar to the other participation banks, succeeded in developing an alternative characteristic on short-term but not long-term horizon. Figure 6 displays and overview of the the wavelets coherence results for 1-month maturity rates of deposit and KuveytTurk profit-share rates. The strong alternative structure seen on medium-term horizon in the pre-2006 period, dwindled during the 2010-2012 period. However, it again emerged on same horizon in the 2013-2014 period. This period is significant as it is when the gold account introduced by KuveytTurk and followed by immediate volume hike.

KuveytTurk Participation Bank's monthly participation accounts on short-term horizon can be dealt with as the alternative to deposits throughout the entire period. However, it should be noted that the relationship is not strong. Parallel to previous results bidirectional casualty is seen for KuveytTurk as well. The causality effect is the same for the 3-month period results.

The common business model for Turkish Islamic banks is the main factor of similar results for all three examined institution. Accordingly, Islamic banks exhibit the conversion effect from special finance houses to fully regulated participation banks.

Figure 6. 1-month maturity profit shares and deposit interest by KuveytTurk
3-Month Maturity Wavelet Coherence Results

AlBarakaTurk Participation Bank had presented its alternative characteristic in short-term horizon throughout the period for 3-month maturity, as well. Figure 7 provides the results obtained from wavelets coherence for 3-month maturity rates of deposit and alBarakaTurk’s profit-share rates. Alternative structure appears strongly detached during the 2008 global financial crisis in particular.

Again the sustainability of alternative characteristic could not be preserved in the post-2006 period for mid-term horizon while it is strong before 2005. The same happens in long term horizon.

Figure 7. 3-month maturity profit shares and deposit interest (alBarakaTurk)

Figure 8 displays the statistics for wavelets coherence for 3-month maturity rates of deposit and Türkiye Finans profit-share rates. The alternative characteristic, which was strong during 2009, continued till the last years of the period for short-term horizon. However, it disappeared after 2017. For mid-term horizon the alternative structure was strong after the 2001 crisis except 2008-2011 period which again sustained post 2011.

Unlike alBarakaTurk, Turkiye Finans was unable to present itself as strong alternative before 2005 on long-term horizon. In the post-2006 period, it completely converges to deposit interest.

The findings show divergence among participation banks while explaining the relationship of deposit rates and the profit shares. Results for alBarakaTurk have more significant Islamic bank characteristic than the others during the pre-2006 period.
Wavelets coherence results for 3-month maturity rates of deposit and Kuveyt-Türk profit-share rates are presented in Figure 9. KuveytTurk is the largest participation bank through its strong performance in the last 5 years with increasing gold account volume.

KuveytTürk Participation Bank has generally presented an alternative characteristic to interest rates in 3-month maturity on short-term but not on long-term horizon. However, this effect is not strong. Its alternative feature on short-term horizon was lost during 2015. The results are very similar to Turkiye Finans participation bank.

The alternative structure cannot be found for mid-term horizon during the 2008-2012 period. However, a strong alternative structure was exhibited throughout 2014-2016.
Within the results KuveytTurk provides a structure similar to the other participation banks. As it cannot be said to have brought a strong alternative against deposit interest through the profit shares it presented on both 1-month maturity accounts and up to 3-month maturity accounts in long-term horizon.

The results till now imply negative effect of being fully regulated for post-2006 period or positive effect of regulative arbitrage for pre-2006 period in the context of alternative characteristic.

**Conclusion**

Islamic banks have emerged as an alternative to commercial banks. The fund collection method that proposes risk-based profit sharing in the face of a guaranteed interest rate is at the center of alternative characteristic. So, the proper address of examining whether or not Islamic banks can be treated as an alternative is profit share rates. To date, however, there has been no conclusive evidence that explains the positioning of Islamic banking in the market.

This study employed wavelet coherence analysis to have concrete evidence on alternative characteristic of Turkish Islamic banks. The findings mainly show participation accounts and deposit accounts to be alternatives to each other on short-term horizon when examining both the 1-month maturity and up to 3-month maturity profit-share rates and deposit rates. KuveytTurk is not significantly different from other Islamic banks, in line with the findings of Sarac and Zeren (2015). The divergence is evident at the beginning of the period, particularly when hitting the 2001 crisis. Also the results support the findings of Aysan et. al. (2016) for the other crises periods.

However, no differentiation emerged on long-term horizon. So, to conclude, the participation accounts bring an alternative on short-term horizon against deposits, yet it cannot sustain in long-term.

It can be implied that the participation banking business model has not been applied efficiently. The alternative structure on short-term shows the business model is efficient at performing financing first and offering profit share later. Long-term horizon has significant advantages to support our conclusive arguments when dividing the period into two since Islamic banks showed strong alternative characteristic in the pre-2006 period through their profit shares. Turkish Islamic financial institutions can be assessed as a short-term alternative in the pre-2006 period when special finance houses were active. A strong alternative structure rose on long-term horizon in the same period. To conclude we may say that for long-term further studies need to be performed with inclusion of inflation.
In the post-2006 period, conversion of special finance houses into participation banks ruined their alternative essence. Participation banks can be considered to have converged with commercial banks through Banking Act No. 5411, which went into effect on January 1, 2006. The regulative arbitrage that was exploited in the pre-2006 period can also be mentioned with the resulting effect. Also, different trends in inflation brought bidirectional causality. The results are parallel to Latiff and Halid's (2012) findings on regulatory changes but in opposite direction.

The effect of the legislative change shows that the secular regulatory structure has adversely affected the characteristics of Islamic banks. Developing separate legislation is a necessity for revealing the uniqueness of Islamic banks.

In addition, bidirectional causality is found during the period between deposit rates and profit shares, similar to findings of Latiff and Halid (2012), Yusoff (2013), Adewuyi et. al. (2016), Ata et. al. (2016), but contradict the results of Charap and Cevik (2011), Ito (2013; 2017) and Anuar et. al. (2014). The direction of inflation trend needs to be considered before reaching a concrete conclusion on causalities.

The results show that for Islamic banks to be able to sustain the claim of being the alternative, their distinguishing characteristic needs to reemerge strongly. Otherwise the findings imply that there is a gap between Islamic banking in theory and practice.

References


Abstract: The stability and resilience that Islamic banking (IBs) industry has shown during the current global crisis is based on the principles of Islamic economic laws that rest on equity, participation, and business ethics. The literature on Islamic corporate governance (ICG) is growing quite rapidly and the industry has emerged as an alternative to its conventional counterpart. This paper critically reviews the existing literature on ICG with a particular focus on the significance and functions of Shari’ah supervisory board (SSB), which differentiate IBs from CBs. This review describes ICG framework, elaborates and summarizes SSB functions, compares IBs with CBs and assesses the impact of SSB on IB’s performance. The key findings show that majority of the literature on SSB describes advising and monitoring as the two main functions of a Shari’ah board and past literature supports positive association between Shari’ah governance and the performance of IBs. This work might be helpful for scholars and practitioners approaching this field to study the role and functioning of SSB.

Keywords: Shari’ah Supervisory Board, Corporate Governance, Shari’ah Board Functions, Performance, Islamic Banks

JEL Codes: G2, G3

Introduction

Islamic corporate governance (ICG) has received much attention in the recent years. After the financial global crisis of 2008, Islamic banking and finance has emerged as an alternative to its conventional counterpart (Aebi et al., 2012; Pathan & Faff, 2013; Baki & Sciabolazza, 2014). The literature on ICG is growing quite rapidly and has attracted the attention of scholars and society. Islamic financial centres
are establishing throughout the world and universities and research institutes are arranging seminars on Islamic finance quite frequently. The fame that Islamic banking and finance is receiving as an alternative to its conventional counterpart lies in its foundation i.e. the Shari’ah laws. Islamic Shair’ah requires clear transparency in every transaction between trading parties (Alnasser & Muhammed, 2012). Islamic banking system is providing a variety of financial products and services, and has become an important part of global financial market which has extended beyond Islamic countries (Grassa, 2013; Khan & Bhatti, 2008). Islam is not just a religion but a way to live in which economy is seen as an area where profitable financial relations occurs (Ramadan, 2009). To deal with any sort of situation Islam has provided general principles for every sphere of life therefore, Islamic banking (IBs) is said to be performed when all the activities are aligned with Shari’ah laws. In an effort to ensure their continuous compliance with Shari’ah rules, an additional board composed of Islamic experts in jurisprudence with sufficient knowledge of contemporary finance emerged known as Shari’ah supervisory board (SSB). Choudhury & Hoque (2006) called it “Supra Authority”. They act as a constraint on operations of IBs as well as form an extra layer of monitoring and control in addition to the regular board of directors therefore; governance of IBs is referred as “multi-layer” governance.

In this study we review the growing literature on ICG of IBs focusing on SSBs. The SSB differentiate CG of IBs from their conventional counterparts. Many studies have examined the role of SSBs such as (Bhatti & Bhatti, 2008; Abu-Tapanjeh, 2009; Garas & Pierce, 2010; Ginena, 2014). Islamic doctrine contains four major Schools (1) Hanafii, (2) Malikii, (3) Shafii and (4) Hambalii with different opinions. These schools of thought differ in their interpretations of Shari’ah laws. Shari’ah board in its decision making is not allowed to combine different opinions in a particular single situation due to the risk embedded in the combination of doctrines resulting in “Haram output” (Ayedh & Echchabi, 2015) which is referred as “Fatawa fishing/shopping”. The members of Shari’ah board do not follow any specific doctrine, instead they reach their decisions by following the interpretations of Holy Quran and Hadith along with reassuring evidences of Fiqah councils, Shari’ah audit and most importantly through Ijmaa (where the scholars of Islam unanimously agree in their rulings), and Ijtihad (independent reasoning or exertion of jurists) based upon Qiyas (comparing teachings of Hadith with Quran).

To harmonize the industry’s practices, the Accounting and Auditing Organization for Islamic Financial Institutions’ (AAOIFI) regularly publishes Shari’ah standards
and Islamic Development Bank (IDB) Shari’ah board provides Shari’ah opinions by working closely with other international agencies. AAOIFI is working as an independent organization comprising of 200 members from IFIs worldwide, for providing IFIs standards on Shari’ah, accounting & auditing, corporate governance, and ethics. So far AAOIFI has issued eighty eight (88) standards out of which forty eight (48) standards are related to Shari’ah, thirty one (31) deal with accounting & auditing, seven (7) standards cover corporate governance and two (2) standards are on ethics (AAOIFI, 2015). AAOIFI defines SSB as:

“An independent body of specialized jurists in Fiqh-al-Muamalat (Islamic commercial jurisprudence) to ensure that IFIs are in compliance with Sharia principle”

The remainder of the study is structured into the following four core themes; (i) ICG framework is comprised of conflict of interest/agency problem, Shari’ah risk, appointment of Shari’ah scholars, regulatory model for Shari’ah supervision, and Shari’ah board independence (ii) functioning of Shari’ah board consisting of importance of Shari’ah governance, Shari’ah board activities, and disclosure level of IBs (iii) Islamic vs. conventional banks and (iv) Shari’ah supervision and performance.

**ICG Framework**

Extensive amount of literature has examined the issues relating to corporate governance and its optimal structure in conventional banking industry. In contrast the literature relating to ICG is at nascent stage but a growing stream of literature has contributed in the evolution of ICG framework. ICG framework, in compliance with Shari’ah rules and principle of Divine Unity of Allah, not only focuses on earning profits and increasing wealth but also safeguards the interest of all stakeholders and embraces the ethics. There are two frameworks or models of CG that have emerged from the literature that provides strong justification for stakeholders’ oriented ICG structure. In the first framework, for the achievement of “Divine Unity of Allah” the view is that Islamic corporations are the legal entities of shareholders (Choudhury & Hoque, 2006; Bhatti et al 2008; Hassan, 2012). And in second framework, interests of all the stakeholders are involved (Chapra & Ahmed, 2002; Iqbal & Mirakhor, 2004; Dusuki, 2006). In the context of ICG, the stakeholders’ oriented theory has gained strong roots in which organizations are managed to serve the interest of all the stakeholders based on the following three main assumptions: (i) in the process of decision-making all the stakeholders (being affected by the decision to be taken) are involved; (ii) it is the prime responsibility of manager to hold the stakeholders’ interest and (iii) organizational objective is
to promote the interest of all the stakeholders. Iqbal & Mirakhor (2004) argued that stakeholders’ oriented theory views the organization as a “nexus-of-contracts” between stakeholders, where wealth maximizing is their main objective. According to Chapra & Ahmed (2002) stable and sound financial system depends upon organizations that maintain the stakeholders’ confidence and protect stakeholders’ interest by showing fairness with transparency and accountability. Dusuki (2006) argued that CG in Islamic system holds “equitable manner” while protecting the stakeholders’ interest as well as social welfare.

**Conflict of Interest/Agency Problem**

Islamic Shari’ah considers conflict of interest as “haram” and is referred as a situation which creates doubtfulness for others therefore; it is not acceptable in Islam. Hadith about it narrates that: “Who keeps himself away from doubts, will highly exalt his religion and his integrity and whoever commits doubtful things, commits offenses (haram)...” (Al-Bukari I, p. 13). Rizk-Al Qazzaz (2008) defined it as:

“The impairment of decision maker’s objectivity and independence due to physical or emotional desire for himself or his relative(s) or his friend(s); or the changes in the person’s performance due to direct or indirect personal concerns or awareness of some information”

This definition highlights the impact of conflict of interest on decisions and performance relevant to the SSB’s work. Among Muslims Shari’ah members are the most regarded people. Therefore, Shari’ah scholars maintain their integrity and reputation by keeping themselves away from doubtful situations. However, it is hard for Fuqaha (representing more than one SSB) to give independent opinion to IBs during the development of new products by competitors that create conflict of interest or agency problem (Bakr, 2002). Garasa (2012) found that agency problem occurs when SSB holding executive position in Islamic Financial Institutions (IFIs), have membership in Islamic funds and when members of SSB establish relationship with BODs. Another study has determined a unique nature of agency problem in the IBs which revealed that lack in actual practices and agency structure give rise to trade-offs between Shari’ah compliance mechanisms and investors’ rights (Safieddine, 2009). Al Qari (2002) reported remuneration to SSB as an important factor in creating conflict of interest among SSB and has showed negative relationship between the remuneration paid to them and their independence. Similarly, Grais & Pellegrini (2006) argued that SSB serving as assessors of business’ operations and being paid by the same business could result in conflict of interest. However, in
contrast Rachdi & Ameur (2011) argued that SSB members can play an important role in reducing agency issues that ultimately lead towards improved performance.

**Shari’ah risk**

ICG is based on ethics and social welfare for achievement of Shari’ah objectives (Hasan, 2009). The depositors act like the backbone of banking system to a greater extent (Leventis et al., 2013) therefore, the success of banking system depends upon earning, maintaining and further strengthening their trust and confidence. Particularly maintaining their trust in IBs is very important as activities of IBs are supposed to be in compliance with the Shari’ah law (Archer and Haron, 2007). Most important risk to IBs is Shari’ah risk as they have to reassure that the claims of Shari’ah adherence made by them have no window dressing (Chapra & Ahmed, 2002; Mohd et al., 2018). Belz (2008) defines Shari’ah risk as: “the chance that an Islamic financing transaction is challenged on grounds that it does not comply with Islamic laws”

IBs are subjected to credible hazards due to the risk of Shari’ah non-compliance leading IBs towards failure (Ginena, 2014). Further, it is also an operational risk to measure monitoring losses that did not cover the non-financial risk and is defined as: “The risk of financial losses that an IFI may experience as a result of non-compliance with Shari’ah precepts in activities, as ascertained by the SSB or the pertinent authority in the relevant jurisdiction”

Shari’ah risk should be managed properly by the IFIs, otherwise the trust of depositors will shatter that may induce them to withdraw their deposits as a result. Shari’ah risk ultimately transforms into the credit risk leading banks toward failure (Ginena, 2014). According to Islamic Financial Services Board (IFSB, 2015), violation of Shari’ah results in the reputational risk as depositors and stakeholders lose their trust and in turn IBs lose their market position. To exalt transparency and to control Shari’ah risk IBs are required to submit Shari’ah governance reports to the supervisors regarding SSBs resolutions, as well as Shari’ah audited reports and any refinement to the Shari’ah governance (Ginena, 2014). In this way the supervisory authorities can find out the deficiencies where they lag behind and coerce the IBs to take cardinal measures to overcome the deficiencies within the stipulated timeframe.

**Appointment of Shari’ah scholars**

One of the important issues affecting the credibility of Shari’ah scholars is setting a benchmark criterion to recognize them as qualified (IFSB, 2006). Ullah (2014)
studied the compliance level of Bangladeshi IBs with *Shari'ah* laws and principles and found that IBs were weak in *Shari'ah* compliance. He attributed the weak *Shari'ah* compliance to the lack of knowledge, sincerity with compliance, and talented and skillful SSB, and not giving importance to *Shari'ah* audit, research and training. Al-Walidi (2013) discussed the practical and theoretical aspects of the *Shari'ah* supervision and concludes that SSBs should be formed with qualified and experienced *Shari'ah* scholars to increase efficiency and recommended that IBs should create departments specialized in *Shari'ah* training, research and marketing to strengthen the *Shari'ah* compliance practices. He further identified that some SSB members had not been rigorously performing their field supervision and training which caused loss of customer confidence. Therefore, IBs were recommended to put in place and follow strictly FPT “fit & proper test” criteria for their appointment. Further, BODs should ensure that recruited members have the capability to extend valuable contribution towards board (Ayedh & Echchabi, 2015). Table 1 shows the internal regulatory structure of SSB and has been built upon the work of Grais and Pellegrini (2006).

<table>
<thead>
<tr>
<th>Country</th>
<th>Composition *</th>
<th>Decision-making **</th>
<th>Appointment &amp; Dismissal</th>
<th>Fit and Proper Criteria</th>
<th>SSB Terms of Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>Specified</td>
<td>Unspecified</td>
<td>Appointed by Shareholders, dismissal is proposed by BOD and approved by shareholders (according to AAOIFI standards)</td>
<td>Specified</td>
<td>Yes</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>Specified</td>
<td>Unspecified</td>
<td>According to AAOIFI standards</td>
<td>Not disclosed</td>
<td>Yes</td>
</tr>
<tr>
<td>Brunei</td>
<td>Specified</td>
<td>Specified</td>
<td>Appointment or replacement of SSB members must be reported to Bank Indonesia and approved by the National <em>Shariah</em> board.</td>
<td>Specified</td>
<td>Yes</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Unspecified</td>
<td>Unspecified</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jordan</td>
<td>Specified</td>
<td>Specified</td>
<td>Appointed by the general assembly of shareholders, discharged only through a reasoned decision taken by 2/3 of the board of directors.</td>
<td>Unspecified</td>
<td>Yes</td>
</tr>
<tr>
<td>Country</td>
<td>Specified</td>
<td>Specified</td>
<td>Unspecified</td>
<td>Unspecified</td>
<td>Yes</td>
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<tr>
<td>Kuwait</td>
<td>Specified</td>
<td>Specified</td>
<td>Unspecified</td>
<td>Unspecified</td>
<td>Yes</td>
</tr>
<tr>
<td>Lebanon</td>
<td>Specified</td>
<td>Unspecified</td>
<td>Appointment for a renewable three-year period.</td>
<td>Unspecified</td>
<td>Yes</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Unspecified</td>
<td>Unspecified</td>
<td>Unspecified</td>
<td>Specified</td>
<td>Yes</td>
</tr>
<tr>
<td>Maldives</td>
<td>Not disclosed</td>
<td>Not disclosed</td>
<td>Unspecified</td>
<td>Unspecified</td>
<td>Yes</td>
</tr>
<tr>
<td>Oman</td>
<td>Specified</td>
<td>Unspecified</td>
<td>By the Central Bank</td>
<td>Unspecified</td>
<td>Yes</td>
</tr>
<tr>
<td>Pakistan</td>
<td>Specified</td>
<td>Unspecified</td>
<td>Appointment must be approved by State Bank of Pakistan.</td>
<td>Specified</td>
<td>Yes</td>
</tr>
<tr>
<td>Qatar</td>
<td>Specified</td>
<td>Unspecified</td>
<td>According to AAOIFI standards</td>
<td>Unspecified</td>
<td>Yes</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>Specified</td>
<td>Unspecified</td>
<td>According to AAOIFI standards</td>
<td>Based upon AAOIFI standards</td>
<td>Yes</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>Specified</td>
<td>Specified</td>
<td>According to AAOIFI standards</td>
<td>Not disclosed</td>
<td>Yes</td>
</tr>
<tr>
<td>Syria</td>
<td>Specified</td>
<td>Specified</td>
<td>According to AAOIFI standards</td>
<td>Not disclosed</td>
<td>Yes</td>
</tr>
<tr>
<td>Thailand</td>
<td>Specified</td>
<td>Unspecified</td>
<td>Approved by the Bank of Thailand</td>
<td>Specified</td>
<td>Yes</td>
</tr>
<tr>
<td>Turkey</td>
<td>Specified</td>
<td>Specified</td>
<td>According to AAOIFI standards</td>
<td>Not specified</td>
<td>Yes</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>Specified</td>
<td>Unspecified</td>
<td>SSB members must be approved by the Higher Shariah Authority</td>
<td>Unspecified</td>
<td>Yes</td>
</tr>
<tr>
<td>Yemen</td>
<td>Unspecified</td>
<td>Unspecified</td>
<td>According to AAOIFI standards</td>
<td>Unspecified</td>
<td>Yes</td>
</tr>
</tbody>
</table>

*Specified = at least three members, **Specified = By unanimous or majority vote & Unspecified = To be decided by shareholders

**Regulatory models for Shari‘ah supervision**

SSB serves as an independent body in the IBs without being influenced by the authority of management, board of directors or shareholders (Garas & Pierce, 2010). There exist two regulatory models of Shari‘ah governance namely national regulatory model and institutional regulatory model (Grassa, 2013). The national regulatory model provides nearly every element of regulation for Shari‘ah practices with more participation of regulatory authorities. While, institutional level provides regulatory framework for Shari‘ah supervision with little participation of regulatory authorities. Malaysian IBs are progressing very fast (Laldin, 2008) therefore; other countries should set Malaysian model as the benchmark to be successful in pro-
viding Islamic banking services. Findings of Ayedh and Echchabi (2015) support the notion that IBs still lacks regulations and standards, as the Yemeni IBs are still just following the minimum requirements and compulsory standards. Further, for fatawa issuance the SSBs refer to different Mazhabs’ which is not allowed in Islam. Table 2 shows the external regulatory structure of SSB and this table is an extension of the work of Grais and Pellegrini (2006).

### Table 2. Regulations on external Shari'ah supervisory board

<table>
<thead>
<tr>
<th>Countries</th>
<th>Regulatory Models</th>
<th>Centralized Ssb or High Shariah Authority or Fatwa Board</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>National Regulatory Model</td>
<td>Institutional Regulatory Model</td>
</tr>
<tr>
<td>Bahrain</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Brunei</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Jordan</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Kuwait</td>
<td>No</td>
<td>Yes</td>
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<tr>
<td>Lebanon</td>
<td>No</td>
<td>Yes</td>
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<tr>
<td>Malaysia</td>
<td>Yes</td>
<td>No</td>
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<tr>
<td>Maldives</td>
<td>No</td>
<td>Yes</td>
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<tr>
<td>Oman</td>
<td>No</td>
<td>Yes</td>
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<tr>
<td>Pakistan</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Qatar</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Srilanka</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Syria</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Thailand</td>
<td>No</td>
<td>Yes</td>
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<tr>
<td>Turkey</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>UAE</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Yemen</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Shari’ah board independence

As it is argued in ICG framework that the decisions taken by the SSB will be biased if they are influenced by BODs or any other stakeholders, Bin Ibrahim (2010) shows the importance of independent SSBs and emphasizes that BODs should appreciate SSBs to work independently without any influence for the protection of long-term interest of IBs. Moreover, their uprightness, trustworthiness, and nobility is realized when they discharge their responsibilities independently, that in turn fortify IBs’ integrity and reliability. In the ICG structure of IBs, SSBs should be strong and independent in decision making process for getting efficient and effective results. Hamza (2013) compared decentralized and centralized model of Shari’ah governance and found that IBs having centralized governance system are more effective and the principal component of the effectiveness was SSBs’ independence. Moreover, Malaysian IBs provide a big amount of profit as Shari’ah governance system is working freely and independently.

Functions of Shari’ah Supervisory Boards (SSBs)

The functions of SSBs have been described by various regulatory institutions and researchers from time to time according to the needs of SSBs and based upon their activities. Their functions have been categorized. For instance, Fayyad (2004) categorized the Shari’ah supervision functions in to five categories: (1) moral function; Shari’ah scholars achieve depositors’ confidence in the activities of IFIs by ensuring that they are compliant with Shari’ah laws. (2) Practical function; they provide fatwas on newly developed products/services for strengthening the depositors’ confidence. (3) Consulting function; they guide CG bodies based upon Islamic canons and laws. (4) Administrative function; attending meetings of BODs to discuss the issues pertaining to them and intimate their opinions regarding annual reports. (5) Control function; auditing all the transactions performed by the IFIs.

Similarly, Hammad (2009) categorizes their functions into two categories: (1) Academic function; it involves research for strengthening the Islamic theory based upon issues that Shari’ah scholars face in their day-to-day operations and from review of Shari’ah non-compliant activities. Training of employees on Shari’ah matters so that employees becomes able to answer the questions raised by their customers. (2) Executive function; it is further categorized into three sub categories: (i) Preventive function; complete assessment of all the transactions/operations of IFIs and reviewing policies, products/services and articles of associations prior to their publication to assure that they are Shari’ah compliant. (ii) Remedial function;
all the transactions are audited during their execution for assuring the proper implementation of issued fatawas. (iii) Complementary function; intact enquiry for all the transactions accompanying internally audited Shari‘ah report.

According to Hassan (2001) it has two main functions: (i) Guiding function; they amend the contracts, policies and agreements in light of Shari‘ah laws and undertake research for solving the problems they face in their day-to-day operations. (ii) Controlling function; they give fatawas and take the ultimate decisions by ensuring that all the transactions and operations are compliant with Shari‘ah laws.

Garas and Pierce (2010) argued that they perform two main functions: (1) Supervisory function; issuing fatawas prior to the execution of transactions, sanction or veto any proposal in the light of Shari‘ah, intact enquiry for all the transactions accompanying with Shari‘ah internal audited reports, audit of annual reports and approval to distribute net income among the shareholders. (2) Consultation function; proposing Shari‘ah compliant solutions, describing ways to calculate the zakat payments, directing management to allocate non-Shari‘ah income for charity purposes and arrange trainings for management and investment account holders (IAHs).

While, institutional definitions regarding Shari‘ah board functioning are as under:

AAOIFI defines SSB as: “An independent body of specialized jurists in Fiqh-al-Muamalat (Islamic commercial jurisprudence) to ensure that IFIs are in compliance with Sharia principle”

State Bank of Pakistan (SBP) in its Shari‘ah Governance Framework (SGF, 2016) describes the role of Shari‘ah board as: “The SB shall ensure that all the procedure manuals, product programs/structures, process flows, related agreements, marketing advertisements, sales illustrations and brochures are in conformity with the rules and principles of Shari‘ah”.

Bank Negara (2013: 1) declared that, “The Shariah Committee is expected to advise the board and provide input to the IFI on Shariah matters in order for the IFI to comply with Shariah principles at all times and is expected to endorse Shariah policies and procedures prepared by the IFI and to ensure that the contents do not contain any elements which are not in line with Shariah.”

IFSB (2006) also highlighted facilitation aspect of SSBs stating that, “Some Shari‘ah scholars acting in advisory or monitoring roles to IIFS need to use their
Based on the discussion above, we have summarized the following functions of the Shari’ah boards as proposed by many authors and institutions:

- That they (Shari’ah supervisory board) approve the official documents in light of Shari’ah laws derived from sources that involve reasoning based upon interpretations of Quran and Hadith.

- That they approve the transactions being performed by IBs to ensure their compliance with Shari’ah to achieve the confidence of stakeholders as well as the credibility of industry.

- That they comprehensively review and audit the transactions fulfilled or completed by the IBs to ensure that they have been performed without any window dressing and were compliant with Shari’ah laws.

- That when the activities performed by IBs are non-compliant with the Shari’ah they provide solutions to take corrective actions.

- That for the rapid growth of industry, they should significantly contribute towards creating new products and approve them in the light of Shari’ah. Moreover, for harmonizing the industry practices instead of completely rejecting the products they suggest to make some alterations in the products under the grounds of Shari’ah laws.

- That they provide fatwas on newly developed products and services to ensure that they are according to the teachings of Islam and are not based upon any activity that is considered as offensive in Islam.

- That they audit the financial statements of IBs to ensure their compliance with Shari’ah and give their independent opinions that ultimately reflect the true picture of the industry.

- That they ensure that the income or profit generated by the IBs is in compliance with the Shari’ah.

- That they establish and comprehensively explain the way for the calculation of zakat.

- That they provide Shari’ah legislations.
• That they answer the issues or questions raised by the stakeholders, depositors and public at large, and consider them in their meetings to clarify the issues and provide *fatawas* where appropriate.

• That keeping in view the current rapid growth of IBs they should be engaged in more research and development activities regarding Islamic banking.

In theory, the role of SSBs involves providing *fatawas* (on newly developed financial products), conducting *Shari'ah* audit (to ensure that products are in line with *Shari'ah* laws), calculating *zakat*, disposal and distribution of *Shari'ah* compliant income to investment account holders and guiding banks on their wider social role, hence acting as the backbone for IBs. Their ultimate goal is to preserve the credibility of Islamic industry and to enhance the confidence of stakeholders in products and activities of IBs. However, in practice their role varies significantly from one country to another. They are facing double pressure i.e. for commercial reasons and to preserve their reputation by ensuring strict *Shari'ah* compliance.

**Importance of *Shari'ah* governance**

*Shari'ah* governance is referred as the system that provides conformity of all commercial transactions and activities of IFIs with *Shari'ah*. Its significance is procured from religious, social, economic and legal resources. An important pillar on which Islamic banking rests is *Shari'ah* governance, as all the activities and operations of Islamic banks have to be in compliance with *Shari'ah*. Ali (2002) highlighted the importance of *Shari'ah* governance and reported that *Shari'ah* non-compliance results in deposits withdrawals leading banks toward failure. He further suggested that for assurance of *Shari'ah* compliance IFIs should upgrade their products, designs and structures. Similarly, the study of Chapra and Ahmed (2002) conducted an empirical survey based on questionnaire at three different levels: regulators’ level, institutional’ level and depositors’ level to find out the impact of CG on IFIs. The results at depositors’ level indicated that if the activities of IBs were not in compliance with *Shari'ah* IBs’ depositors in Bahrain (84.6%), Bangladesh (66.8%) and Sudan (94.6%) would shift their deposits to other banks. SSBs hold very respectable position and provide *fatawas* on newly developed products and services; as a result stakeholders’ conviction about the validity of transaction is achieved. Product and services on which SSBs do not give *fatawas* will be vetoed by the depositors (Omar, 2002). Further, doubts of depositors are eliminated due to the presence of SSBs (Zighaba, 2009) as they assure the compliance of *Shari'ah* laws and principles. Collectively, these studies suggested the presence of *Shari'ah* governance at appropri-
The participatory mode of financial intermediation with risk sharing by the depositors requires IBs to maintain a greater level of disclosure as compared to conventional banking. The SSBs can play pivotal role to ensure appropriate level of disclosure. In this regard, Wan et al. (2013) reported that SSBs having background of contemporary finance in addition to Shari'ah have a significant positive impact on the disclosure by the IBs. Similarly, large board exercises, better monitoring as the level of expertise and information increases, uncertainty and information asymmetry decreases, and collective knowledge and experience of SSB will lead to greater disclosure (Singh et al., 2004). However, Hussainey et al., (2016) found insignificant relationship between board independence and level of corporate disclosure.

In IBs, level of disclosure has increased with the presence of SSBs as they discharge their duties according to Shari'ah principles with the prime objective to protect the shareholders’ interest (Farook, et al., 2011). Therefore, Shari'ah matters should be transparent and disclosed properly so that stakeholders become informed about the activities of Shari'ah scholars and immediately concede the Shari'ah contravention. Otherwise there is the possibility for the existence of Shari'ah risk that ultimately leads towards banking distress and financial crisis. However, Hasan (2012) stated that IBs’ annual reports are not standardized as Shari'ah matters and important information through which stakeholders’ confidence is achieved like the issued fatawas, numbers of meetings held during a year etc. are not disclosed. According to Haniffa and Hudaib (2006) mostly IBs didn’t publish the issued fataws or any such documents on the websites so it is predicted that they are hiding things from general people. It is anticipated that IBs should disclose the SSB related matters to a greater extent, so that stakeholders become confident that the resources managed by the banks are in conformity with Shari'ah laws.

**Shari’ah board activities**

Sometimes Shari’ah scholars without giving due consideration issue fatawas and as a result IBs are encountered with losses (Hammad, 2007). Therefore, it is cardinal to arrange meetings between key personnel of relevant departments, so they can accurately and comprehensively understand the matter and provide flawless fatawas. The SSBs members are specialized more in Shari’ah than other fields the-
Therefore; it is preferred to have periodic meetings between SSB members and the management of banks to ensure that all the practices are aligned with Shari‘ah (Ghayad, 2008). Through periodic meetings, management of bank will be able to present the questions arising from their clients and disclose problems from their day-to-day operations which are not in compliance with the Shari‘ah. Furthermore, SSBs’ meetings are important for clarifying Shari‘ah non-complaint issues as SSBs are not always available to the banks. Moreover, with proper understanding of commerce, economics and finance, they are able to resolve the banking issues efficiently leading towards improved performance (Bukhari et al. 2013; Ghayad, 2008).

Ownership over applicable information and aptitude empower the members to comprehend the nature and ramifications of product(s) submitted for fatawa. Khan et al, (2017) found that SSB members having knowledge of accounting and finance in addition to the Shari‘ah have significant positive impact on the performance and profitability of IBs. Similarly, Ghayad, (2008) and Kolsi & Grassa, (2017) reported that increase in IBs profitability is associated with members of SSBs having accounting background.

**Islamic vs. Conventional Banks**

Islamic banking and governance reforms significantly contribute towards stable and credible financial markets internationally (Wilson, 2010). IBs remained resilient and stable during financial crisis (Chapra, 2009; Green, 2010), and showed better growth than conventional banking (CBs) during global financial crisis (Phulpoto, et. al. 2012). Many researchers compared the Islamic and conventional banks on the grounds of stability, efficiency, profitability and their business orientations to find out the differences and similarities between them (Hutapea & Kasri, 2010; Mollah & Karim, 2011; Wasiuzzaman & Gunasegavan, 2013; Grassa & Matoussi, 2014; Khan et al., 2017; Mollah & Zaman 2015; Mollah et al., 2017; Bitar et al., 2017). According to Beck et al. (2013) business orientations of IBs and CBs don’t have any significant differences. However, Dridi and Hasan (2010) indicated that their business orientations are significantly different that minimized the effect of crisis on the profitability of IBs. Although CBs are cost effective compared to IBs but IBs have higher intermediation and capital-to-asset ratio, suggesting that IBs are adopting orthodox and cautious approach towards risk taking (Beck et al., 2013; Bourkhis & Nabi, 2013). Thus IBs appeared to be cost effective during crisis and made high profits (Abedifar et al., 2013; Olson & Zoubi, 2008). Ayub et al.,
argued that IBs performed better in capital adequacy and liquidity position while management and earning ability of CBs is better than IBs.

Since, non-PLS modes of financing are supposed to reduce the level of compliance with the Shari’ah and are used by the CBs as a benchmark, therefore, it is suggested that similarities exists between IBs and CBs (Abedifar et al. 2013; Beck et al. 2013; Mollah & Zaman, 2015 and Bitar et al., 2017). Therefore, it is considered important to investigate how IBs compared to CBs are affected by these financing modes (Bitar et. al. 2017). Firstly, some instruments of IBs are based on PLS principles, thus are considered to be better capitalized compared to CBs. Secondly, IBs have more liquidity buffers and are safeguarded for liquidity shortages as they do not offer short term liquid instruments and debt instruments to CBs. Moreover, central banks act as “the lender of last resort” still IBs don’t borrow from them. However, it put negative impact on their stability and performance. Still, IBs are contemplated as more liquid compared to the CBs. Thirdly, leverage investment accounts being used by the IBs are backed by IAH. Therefore, Islamic banking investments don’t accord to “financial bubbles” as compared to the CBs (Bitar et. al., 2017). Lastly, for financing, IBs use investment accounts instead of equity therefore, they are considered to yield increased profit as compared to CBs (Olson & Zoubi, 2008). Leon & Weill (2017) examined the effect of IBs expansion upon access to credit and didn’t found any impact of IBs’ expansion on credit constraints in contrast to CBs’ development that creates hurdles to financing.

**Shari’ah supervision and bank performance**

Shari’ah supervision is one of the critical areas in Islamic finance for being the part of overall ICG of IBs. Shari’ah supervision is an additional layer as compared to the conventional banking governance system to implement Shari’ah financial laws.

The literature on Shari’ah supervision’s association with firm performance is limited, however rapidly growing. Abdullah et al. (2012) analyzed that CG plays a vital role in IBs as CG helps SSBs to perform their work in the best way to connect to Islamic banking. Grassa and Matoussi (2014) described the differences and similarities between Gulf Cooperation Council (GCC) and Southeast Asian countries. They found big differences because in different countries CG of IBs is influenced by different laws and regulatory frameworks and to overcome these weaknesses it needs some positive changes and improvement. Further, the composition of BODs and SSBs is affected by culture, economy, regulatory environment and social contexts under which these banks operate. Wasiuzzaman and Gunasegavan (2013)
found that average assets, board size and bank size of IBs were lower as compared to CBs. While assets quality, operational efficiency, liquidity, board independence and capital adequacy were higher for the IBs. Kolsi and Grassa (2017) examined the effect of ICG on earnings management through discretionary loan loss provision (DLLPs) and reported that larger Shari'ah board size in IBs manages less DLLP and AAOIFI member banks have higher expertise in accounting, financial markets and Shari'ah prescriptions than non-members. Therefore, SSB members having knowledge of finance are very important in improving the performance of IBs. Furthermore, a negative relationship has been found for director's independence and the range to which IBs manage DLLP. The presence of block-holders has positive impact on earnings management and there is no impact of bank size and institutional ownership on earnings management through DLLPs. Quttainah (2013) found that in IBs, earning management is not affected by the presence of SSBs. Grassa et al. (2010) did not find any significant relationship between SSB characteristics and financial performance. However, Shari'ah governance attributes are efficient in terms of Shari'ah compliance transactions. Bukhari et. al., (2013) investigated the perceived importance of management of IBs and Islamic banking windows of CBs regarding different dimensions of CG in Pakistan. Results revealed that CG of IBs is affected by BOD and SSB whereas for the CG of Islamic banking windows, all dimensions were important. Mollah and Zaman (2015) found positive impact of SSB and role duality on the performance during crisis, which shows that Shari'ah supervision significantly impacts performance as it ameliorates the dissenting impact of additional risk taking. Mollah et al., (2017) concluded that due to the Shari'ah compliant products and complex nature of transactions of IBs, the CG structure of IBs allowed them to undertake high risks and improved their performance. Moreover IBs compared to CBs maintain high capitalization.

**Concluding Remarks and Future Direction**

The Islamic corporate governance has received much attention in the recent years, partly due to the global financial crisis of 2008 that severely hit the conventional financial system and partly due to the stability and resilience that the IBs have shown during that period. The fame that Islamic banking and finance has received worldwide is because of its reliance on the principles of Islamic financial laws that rest on equity, participation and business ethics. The literature on Islamic banking and finance is growing quite rapidly and has attracted considerable attention of the concerned bodies. This paper surveyed the existing literature on ICG and focused on the
characteristics of SSB that differentiate the IBs from CBs. The research is structured in four main themes that are thoroughly explored in the recent literature.

Islamic banking is said to be done when all the activities carried out by them are aligned with the Shari'ah laws as Islamic Shari'ah requires transparency in every transaction between trading parties (Alnasser & Muhammed, 2012; Thomas et al., 2005). Therefore, to ensure Shari'ah compliance in IBs, the ICG has incorporated an additional board called SSB which is comprised of Shari'ah scholars having expertise in Islamic jurisprudence as well as contemporary finance. These Shari'ah scholars are generally of good reputation in the Muslim community that enhances the reputation and credibility of IBs in general public. The SSBs have shown a significant role in improving the quality of ICG in IBs and their performance.

This paper has explored the optimal structure of ICG framework and concludes that the extant literature provided strong foundations to label it as stakeholders’ oriented. It involves showing fairness with transparency and accountability to all the stakeholders in an equitable manner. Islamic Shari'ah considers conflict of interest as offensive i.e. “haram”. In the light of Shari'ah it is referred to as a situation that creates doubts for others, therefore, it is not acceptable in Islam. The most important risk to IBs is Shari'ah compliance risk as they have to reassure IAHs that the claims of Shari'ah adherence made by them involve no window-dressing (Chapra & Ahmed, 2002). However, one of the important but uncertain issues affecting the credibility of Shari'ah scholars is the non-availability of standard criteria to recognize them as qualified.

This study has also examined the role and functions of SSBs. Different researchers defined the SSB’s functions differently. Based upon prior findings it is concluded that key functions performed by SSBs involve providing fatawas, conducting Shari'ah audit, calculating zakat, disposal and distribution of Shari'ah non-compliance income to investment account holders and guiding banks on their wider social role on the basis of Shari'ah laws and principles hence, act as backbone for IBs. Their ultimate goal is to preserve the credibility of Islamic industry and enhances the confidence of stakeholders in products and activities of IBs. For stable financial system, it is necessary to gain the confidence of depositors by constituting Shari'ah supervisory boards (Ali, 2002) as Shari'ah non-compliance will result in deposits withdrawals leading banks toward failure.

Furthermore, we compared the Islamic and conventional banking system and concluded that IBs performed better during financial crisis as the business orientation of IBs and CBs is different and IBs appeared to be cost effective (Beck et al.,
We also studied the empirical impact of Shari'ah supervision on firm performance. Furthermore, many studies confirmed that the impact of Shari'ah supervision on firm performance is positive and significant.

The survey of the literature suggests few important future research directions such as (i) more research is needed to improve the quality of the present work by using primary data sources especially conducting interviews with the Shari'ah board scholars regarding the contemporary issues in Islamic finance, their selection, education, and gender diversity, (ii) the extant literature lacked in exploring the diversity factor of SSB and its implications, and (iii) the future research could also consider the experiences of IBs in the non-Muslim majority countries so that comprehensive and generalized implications could possibly be drawn.

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The book was first published in 2016 by Routledge. It has 12 chapters and 260 pages. The author of the book, Professor Masudul Alam Choudhury, is a very famous academic scholar in the field of Islamic economics and finance, especially in addressing the epistemological underpinnings of Islamic economics and finance. He has published numerous books and articles in the field of Islamic economics and finance. Moreover, he has lectured and did research in many prestigious universities including Harvard and Oxford. A brief summary of the book is given in the following paragraphs.

The author tries to constitute an epistemological framework for Islamic economics by introducing Tawhidi methodology in the book. For this purpose, he argues philosophy of knowledge in Islam and touches upon the relationship between religion and social economics. He then tries to employ the concept of Maqasid al-Shariah to evaluate the financial tools used currently in Islamic finance. Therefore, it could be stated that the author places the Tawhidi methodology at the center of his arguments/methodology in the book in order to introduce a theoretical framework for an economic system based on Qur’an and Sunnah.

Let us look at the arguments he has presented in the book. According to him, there can only be a unique economic system if it is based on Tawhidi methodology, which means Oneliness, unity of God, in the light of Qur’an and Sunnah. Accordingly,
the economic system derived from Qur’an and Sunnah in compliance with the concept of Tawhidi methodology is applied to the world system. It is then reconsidered in compliance with the IIE (Interaction, Integration, and Evaluation) process by taking into account time and space dimensions which takes us to unity of knowledge.

He concludes that current Islamic economics and finance are not on the true structure since they do not take into consideration the Maqasid al-Shariah. To him, the concept of realism in the mainstream economics is a false concept and needs to be replaced with Tawhid leading Islamization of knowledge. Consequently, he argues that ethical values must be included to economic theory to solve the current problems of economic system that are caused by mainstream economic approach.

As far as the critique of the book is concerned, firstly, we should express that we were sometimes lost while reading the book due to the lack of connection between some chapters and density of technical terms such as Maqasid Shariah, unity of knowledge etc. As we understand, most of the chapters of the book were written as individual articles or are chapters from other books and have been brought together in this book. Therefore, at the beginning of almost every chapter there are repetitive expressions about some terms such as Maqasid Shariah, which is a broad concept. It needs to be explained carefully and in details since the author ties almost everything to this concept, or unity of knowledge and to some verses from the Holy Qur’an. Hence, if the author had penned the chapters in an easy-to-follow method for readers, it could have been better for readers to understand the arguments of the author. There could also be a part containing conceptual framework regarding abovementioned terms at the beginning of the book. For instance, the author refers to Tawhid methodology in all chapters which is both unnecessary and uninteresting for the readers. Instead of doing this, he could have handled this theme at the beginning of the book in details.

Another criticism could be the fact that this book was written for scholars of Islamic economics and finance as well as for economists. Therefore, in the prologue of the book, the author could have shed some light upon basic concepts for readers with limited knowledge of economics and Islamic economics and finance.

On the other hand, there are some printing mistakes in referencing of several Qur’anic verses as is the case of the verse given as a reference in the prologue i.e. it has been referenced as 51:53 mistakenly and instead should have been 41:53).

In addition, some comments by the author are hard to understand and are not clear which lead to confusion. For instance, to him, murabaha financing model does
not comply with the idea of *Tawhid* but in the next chapters he proposes a model called MMM which includes *murabaha* financing. Another example may be given from the usage of the term *Tasbih*. We could not understand the concept of *Tasbih* in economics. It seems that he uses this term in a different meaning. As known, *Tasbih* generally means remembrance of *Allah* (*dua* or *zikrullah*). So, to us, its connection with application of *ijtihad* is not clear. One more example of the confusion can be given from chapter 7 (A Generalized Islamic Development-Financing Instrument). In this chapter, verses 2:164-167 from *Qur’an* have been given as the source of development policies. However, when we look at these versus, we see that these verses are related to the believing in *God*, therefore, we could not understand the connection of these verses with *musharaka* or development policies as indicated by the author. Finally, the relationship between increase in labor force participation rate and decrease in structural unemployment rate is not clear. Had he clarified the aforementioned sections and arguments, it would have been more understandable for the readers. Finally, we may say that the issues handled in this book are too broad for a 260 pages book hence create a lot of confusion.

Our last criticism about the book is related to its title “Islamic Financial Economy and Islamic Banking”. Frankly, we were a little bit confused after reading the book since the book is about Islamic economics. Hence, to us, the title of the book does not fit to its content.

To conclude, we may state that the author tries to put forward something in the field of Islamic economics and finance theoretically which is a valuable effort in context of the existing deficiency in the field. Therefore, the author’s commitment towards Islamic economics and finance by introducing a methodology to improve or introduce new financial tools under the concept of *Tawhidi* methodology and *Maqasid al Shariah* to improve financial engineering in Islamic finance is substantial and his efforts deserve appreciation.

According to the author, since current instruments in Islamic finance are far from the *Tawhidi* methodology, Islamic finance and economic faces challenges and criticism. As said by the author, this study presents a different approach to the mainstream Islamic financial economics. Therefore, to us, it is worth reading. Last but not least, one as a reader may be lost while reading the book since it requires a prior knowledge of economics as well as of Islamic economics and finance.
Abdu Seid Ali

Individuals interact with different members of the society in their day to day life. These interactions are mostly governed by a set of behavioral standards that in turn determine what is good and bad. Honesty, integrity, truthfulness, transparency, reliability, faithfulness and the like are some of the virtues of ethics. In the same manner, companies also practice a set of values that guide business transactions and their relations with employees, customers, suppliers and government bodies. All in all, ethical values enable us to be vigilant in our relationship with others and create auspicious environment for us and others.

The two renowned personalities in their contribution to Islamic economics and finance, Zamir Iqbal & Abbas Mirakhor, authored a book titled “Ethical Dimensions of Islamic Finance: Theory and Practice” as part of Palgrave Studies in Islamic Banking, Finance, and Economics. The authors address the significance of ethics in economic activities, business dealings and financial transactions in achieving an overall development without causing damage to any particular group of the society. The authors elaborate ethics from the perspective of conventional as well as Islamic economics and finance, business practices and development. They lay emphasis on risk sharing as a favored method of financial and economic transactions.

The first part of the book discusses the prominence of ethics in finance and cites recurrent financial predicaments, broadening income and wealth dispropor-
tions, financial wrongdoings, lack of emphasis on coping with unethical and immoral financial transactions, augmented intricacy of financial transactions and financial markets, deleterious impact of overlooking ethical practices on investment and the growing importance of ethics in academic curriculum as the essential dynamics to study ethics. The authors denounce the mainstream financial economics which tries to pay no attention to the role of ethics in finance and economics. Repeated financial crises and crimes, expropriation of values, failure in corporate governance, unethical business leadership, lack of due care, honesty, and transparency in financial sectors’ ethics are part and parcel of finance and it is impossible to isolate the two from each other.

In addition, the book blames the capitalist economic system for splaying inequality, sluggish income growth, huge unemployment, frequent crises, market crashes, enormous growth of personal and sovereign debts and other ills related to the overall performance of the system. The widespread forms of immoral and unethical behaviors such as self-centeredness, greediness, and detrimental business activities obliged the authors to ask whether the moral failure is in the system or of the people. They contended that it is the system that gives a free rein to the stated unscrupulous conducts in the market by eradicating some restrictions that guide the finance and business environment. The other point was financial repression that harms the borrowing class through innumerable forms of manipulations and biased monetary policies. They have concluded that given the seriousness of lack of morality and ethics in the global financial and economics arena, there ought to be a collaborated effort to avert, treat, reinstate, shape and practice universally applied morality.

The second part deals with the pursuit of worldwide moral code and its application to economics and finance. “Do to others as you would have others do to you” is acceptable to primordial or modern, spiritual or secular system of thought and it is universally agreeable to avoid harm from someone. Moreover, though there are a number of principles of morality and ethics from philosophical point of view, their application to business is a recent phenomenon. Among the three widely used business ethics theories namely teleological, deontological and virtue ethics, the third one is more relevant and rotates “around individual character, attitudes, and other dispositions and preferences, including values and guiding norms.”

The core moral characters which are indispensable in business ethics are covered in the third section of the book. The authors discuss the most crucial ethical manners as embracing the unity of creation, being unbiased and endeavoring for justice, safeguarding the rights of others, inviolability of contracts, reliability and
integrity, trustworthiness, goodness and excellence, consideration and kindness, far-sightedness and modesty, honesty in business dealings and collaboration and solidarity. These moral conducts constitute both philosophical ones and those that can be applied specifically to economics and business.

The fourth section suggests the implementation of business ethical manners and establishes a scheme to overcome the challenges in various financial and economic markets. Market conducts are vital since their very existence doesn't guarantee to have just and fair exchanging, selling and buying activities. The moral characteristics of market participants along with enforcement of proper rules are essential to have a favorable market conduct. Work is one of the religious duties in Islam and the ethics on it embrace justice, responsibility, fairness, solidarity, perfection and trustworthiness which are supposed to be practiced both by employers and employee. Moreover, proper ethical manners on production, consumption and distribution phases can produce a stable community with an inclusive prosperity.

The fifth and sixth parts focus on risk sharing and the ethical manners and purifying finance through risk sharing model. The authors are of the opinion that sharing risk contributes a lot to vigorous flow of wealth in the economy and discourages to accumulate the risk to one party. However, risk transfer or risk shifting, financialization, information problems and mispricing of resources are condemned. Hence, economic, social and redistributive justice should be placed to create equal opportunities in the economic and financial atmosphere. The risk sharing system promotes productivity since all contracting parties have “skin-in-the-game” which is supposed to diminish agency problems in addition to reducing transaction costs. Furthermore, this system empowers enterprises and households to widen their business for the former and branch out their resources by investing in productive sectors. Finally, risk sharing also has barakah, which is a bounty that Allah (swt) bestows upon people or contracts who/which follow righteous dealings.

The last part highlights the significance of ethical practices in development. Development from Islamic point of view constitutes three interconnected facets that are individual, physical and humanity at large. In order to achieve inclusive development, ethical manners are essential in enhancing social and economic justice, justifiable and reasonable wealth distribution and reallocation to boost financial involvement.

The strength of the book is that it has argued that most of the business, finance and economic complications such as poverty, income and wealth and imbalances,
all forms of crises, corruptions, stakeholders’ conflicts, and environmental degradations are the result of the absence of virtues and appropriate moral values. In addition, the authors refer and utilize a great deal of evidences to corroborate their main thesis and challenge the interest-based economic and financial system that is the bedrock of the capitalist system of economy.

Among the weaknesses of the book, it has duplicated some ethical virtues in distinct chapters. In my humble opinion, chapter three and four could have been merged since both point out business ethics in Islam. Moreover, chapter five and six which expound risk sharing and its ethical aspects could have been treated in the same manner. The book has extensively discussed the importance of ethical values in Islam and has recommended risk sharing as an ideal way of economic structure; however, it overlooks the institutional mechanisms that are requisite for practicing and following up ethical defilements that arise in our business dealing and financial and economic transactions. Besides, the book fails to indicate the challenges in authorizing those ethical virtues both locally and on global level since there are numerous ethical standards issued by governments and international organizations. As Ahmed (2011) asserted that Islamic banks have challenges in applying ethical values in a highly rival market environment. Some studies revealed that there is a gap in ethics from Islamic point of view and the reality in today’s Islamic banks' practices (Pesendorfer and Lehner, 2016; Mansour et.al., 2015; Al-Jarhi, 2010) whereas other studies suggested that some Islamic banks function based on ethical guidelines (Gilani, 2015; Slimene et.al., 2014). Though not conclusive, most of the studies illustrate that Islamic banks are deviating from some ethical practices and this situation needs due consideration from Shariah advisory committees and regulatory bodies.
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Muhammad Al Bashir Muhammad Al Amine. *Islamic Finance and Africa’s Economic Resurgence*  
London: Palgrave Macmillan, 2016, 395 Pages

Rukayya Muhammad Ahmad

Islamic Finance and Africa’s economic resurgence delivers a substantial account and a solid perspective on Africa’s untapped investment opportunities and pattern of economic growth. This work is a useful resource to investors, students, educators, and Islamic finance enthusiasts.

The book structure and the contents are simple and straight to the point. The author starts by educating the reader about the basic principles and concepts in Islamic finance making it much easier to understand the book even to those who are less familiar with the terms or have less knowledge of Islamic finance. In chapter one, the author tries to explore the position of Islamic finance in Africa compared to the rest of the world, and gives a general background of the study. The author also highlights some of the challenges hampering implementation of Islamic finance, general challenges facing Islamic banking industry which relate to sustainability of current growth and challenges peculiar to African continent such as perception, media propaganda and negative reporting e.g. Islamic finance supports terrorist organizations or is trying to impose shariah on non-Muslims. The author also emphasizes on the need to address such challenges in order to ensure smooth penetration of Islamic finance into African markets.

Chapter two is dedicated to explaining the basic principles of Islamic finance as well as its evolution and development in some parts of the world. This chap-
ter also elaborates on resilience demonstrated by Islamic financial system throughout the 2008 financial crises i.e. the importance of interest prohibition beyond tackling exploitation and injustice. The implication of excessive leveraging and its negative effects are covered under prohibition of “Gharar and Maysir”. The author also explains in detail the importance of risk management, explicit disclosure and transparency in Islamic financial contracts. Prohibited activities in sharia are also discussed, such as those relating to the consumption of alcohol or pork and the development of weapons of mass destruction or any other activity that is considered harmful to health or society at large. Contractual exploitation, debt-based financing and securitization of debt are also discussed under this chapter. An account of Islamic banking’s global development and growth rate as well as growing interest and recognition by some key players is also highlighted, for instance; the issuance of Sukuk by the International Finance Corporation (IFC), several leading conventional banks offering Islamic windows such as Hong Kong and Shanghai Banking Corporation (HSBC) through their brand Amanah, Standard Chartered through Saadiq, or Citicorp Group through their full-fledged subsidiary Barclays ABN Amro, American Express Bank, ANZ Grindlays, BNP Paribas, and Union Bank of Switzerland (UBS) are pursuing this market.

In chapter three, the author tasked himself to give a comprehensive description of Africa not only in terms of economic development and investment opportunities but also its geographical, political and cultural affinities which adds enormous value to the work. Through this master piece the reader will receive first-hand information about African economic development region after region, one country after the other in each region, enticing the reader with the level of economic growth, gaps created or left by conventional financial system and consequently opportunities awaiting the risk takers. The study also supplies an in-depth analysis of opportunities and challenges that exist in various economic sectors in Africa and the risk involved in each of those sectors such as natural endowment, consumer sector, expanding labour force, infrastructure needs, healthcare needs, urbanization and foreign direct investment. The author also highlights the reason for success of Islamic finance in Africa, such as Muslim population and the need for financial inclusion and sharia compliant ways of investment.

In the later part of the work the author discusses Africa’s economic relationship with rest of the world and the reason behind their interest in Africa. China is Africa’s second largest trading partner after the USA and is on the track to move into the first place. China obtains about one-third of its total oil imports from Afri-
ca while exports to Africa have also risen as its imports from Africa, as such China has become an important driver of Africa’s resource sector growth.

Another important partnership is that of Africa-India relation, new Indian corporate is establishing its presence in Africa. Indian companies have a vast and long presence in the African continent. India’s economic partnership with African countries has been extending beyond trade and investment to technology transfers, knowledge sharing, and skills development. Brazil’s trade with Africa increased tremendously by six-fold from 2000 to 2008, from US$4.2 billion to US$25.9 billion. In 2009, this volume of trade decreased to US$17.1 billion as a result of the global crisis.

Challenges facing Islamic finance in Africa are also discussed, and the author also elaborates on how cooperation with multinationals; such as IDB, World Bank, IMF and Africa Development Bank will help curb such challenges.

The book is well structured and delivers itself successfully to the readers especially in context of investment opportunities present in different parts of Africa. Each chapter is broken down into subheadings which fit logically into the topic of the chapter. Unfortunately, the study falls short of graphics, charts or tables which could simplify some given statistics. This can also render it difficult to the reader. Each chapter has rich citations and is concluded with a thorough bibliography. The book is well-referenced, making skilful use of first-person sources.

The author also provides definitions of some key terms and abbreviations at the beginning of the work but could not find it worthy to provide a sizable preface to attract readers’ interest. While editing errors and organizational incongruities were found in some of the chapters, many of the shortcomings of this first edition will likely be removed in the later editions. For example, in chapter 3-page 54 paragraph 2, “Africa as the next Islamic finance haven” instead “heaven”. These problems are only a minor distraction from the main aim of the study. Although the book is systematically divided into chapters, in the table of contents there is no indication of contents of the chapters making it a bit tedious for the reader to search through the work.
Rania Abdelfattah Salem. *Risk Management for Islamic Banks*
Edinburgh: Edinburgh University Press, 2013, 222 Pages

Ahmet Suayb Gundogdu

The eight chaptered book entitled “Risk Management for Islamic Banks” is kind of a review of literature on the subject of risk management in Banks, particularly Islamic banks. Chapter 5 and chapter 6 are the main parts of the book. In chapter 5, the book supposedly introduces various risk mitigation methods for Islamic banks. However, this chapter is primarily a review of existing literature. In chapter 6, the book supposedly demonstrates how to adopt an integrated risk management framework to fit Islamic banks, by presenting a hypothetical case of an Islamic bank and adopting suggested risk management procedures. While developing the argument, the book assumes, with reference to the literature, that Islamic banks’ business models and products are homogenous. While such assumptions are made in conventional economics and finance and any results can be derived with these assumptions, they are not deemed scientific and acceptable in Islamic economics and finance which looks for reality instead not assumptions in order to have scientific inferences. For example, conventional economics and finance assumes that Riba is same as mark-up in trade transactions and such an assumption is reprimanded in the Holy Qur’an.

*Aim*

The book aims to bridge the existing risk management gap between conventional and Islamic banks. However, the book assumes that Islamic banks are different due to ownership risk and such risk necessitates modification of conventional risk
management practices. The book assumes that Islamic banks expose themselves to price fluctuation risk since they don’t transfer such risk to their loan seekers. The book’s assumption pertaining to ownership risk is unjustified in real life, so do the results.

**Interpretation**

The treated subjects are not well connected. The book claims that Islamic banks have different risks, yet, it proposes a framework that is equally applicable to conventional and Islamic banks. The book’s statements are not reasonable and consistent. In order to avoid logical fallacy, the book should either consider that Islamic banks are not different from conventional banks in practice or propose a different risk management framework for Islamic banks. There are major wrong statements in the book which would mislead those who are not familiar with Islamic finance. For example, the book claims “non-existence of a lender of last resort” function for Islamic banks. Besides, the book claims, pertaining to liquidity risk, that “there is no interbank market for Islamic banks”. In practice, Islamic banks have access to such non-Shari’ah compliant platforms. In another part, the book mentions the availability of organized Tawarruq and Liquidity Management Company for Islamic banks and contradicts with the previous statements. The book refers to literature, yet, does not verify the authenticity of such information. Besides, the book even makes untrue statements without any reference: “conventional banks heavily depend on rating systems, specifically external rating, Islamic banks have limited access to external ratings. Therefore, in the absence of rating agencies, Islamic banks depend on internal rating systems, in which a client’s creditworthiness is assessed through historical data – by evaluating past performance measures of the client’s track record”.

**Context**

The book assumes complying with government regulatory framework and BASEL system is enough to develop a risk management framework for Islamic banks. There is no out-of-the-box thinking. Hence, the ideas and facts expressed are not put into a wider context. The book does not adequately concentrate on the proposed subject. The book’s perspective provides an understanding of existing bank risk management habitat to the reader. However, the book does not question the soundness of the BASEL system, neither does it mention the convergence of Islamic banks to conventional. Should conventional banks and Islamic banks fail in the next global financial crisis, the book would totally be irrelevant.
**Silence**

The book does not dwell on the practice of Islamic finance and instead conveys the reflection of other researchers regarding the theory of Islamic finance. The book’s claim of Islamic banks having financing facilities backed up by physical assets is untrue. The financing of Islamic banks is not actually backed by real assets and in many instances, there does not even exist any asset-based financing in real life. The book is silent about non-Shari’ah compliant liquidity management practices of Islamic banks vis-à-vis liquidity risk management. Such silence takes away from the book’s appeal and casts doubt about the soundness of the models proposed by the book. Nevertheless, the book broke the silence, to some extent, towards the conclusion and highlighted the importance of central Shari’ah board for Islamic banks to avoid Shari’ah compliance risk. The book also rightly identifies the fact that having central Shari’ah board is not enough to avoid Shari’ah compliance risk and central Shari’ah audit function is needed as well.

**Form**

It might be discerned that the book is written in a Ph.D. thesis format but lacks the quality of a book as the author refrains from expressing his personal opinion and instead refers to other researchers without checking the accuracy of information. For example, on page 87, the book states that “It is known that Islamic Principals agree with conventional finance in terms of the risk-return principles, highlighted by Markowitz, where an increase in the expected return can only be released with an increase in the portfolio risk”. Markowitz theories stemmed from Bachelier’s book entitled “Theory of Speculation”. The very basics of Islamic finance relate to the prohibition of such practice of speculation based financial engineering. Such fundamental mistakes alongside literary style do not add to the book’s appeal and it is misleading for those are not familiar with Islamic finance.

**Sources**

The book refers to miscellaneous material related to Islamic finance. The major sources are mentioned, yet, due to silence on real-life examples with interviews, the authenticity of the information in the literature is not verified. Hence, the book is disconnected from real life. The book is rather a compilation of literature and could not bring the subject to life.
**Literature**

The book is another academic endeavor relating to other academic works in the field. It does not break new ground and/or modify the general perspectives, it rather locates itself within the established perspectives. It would be an overstatement to claim that the book introduces a novel methodological or theoretical approach and/or raise controversy. The book was published in 2013 and could not lead a debate following its publication since finance practitioners would immediately discern its disconnect from the real life.

**Background**

The structure and the style of the book imply that the origin of the text is a Ph.D. thesis. It is clear that the book is written by an academician with no substantial Islamic banking experience.

Overall, the book is misleading due to material information mistakes. Hence, it is neither appropriate as a textbook for any course in Islamic finance nor for casual reading. The reliance on official regulatory framework and the BASEL system suggests that the author has full confidence in the established system. The future of the established system might reveal the weakness of the book by itself in due course.
Mustafa Yıldız. Bir İslamciya Göre Kapitalizm ve Sosyalizm: Eşref Efendizâde Şevketî’nin “Sa’y ve Sermâye Mücadeletâının Dînen Sûret-i Hallî” Risalesi (Capitalism and Socialism for an Islamist: Eşref Efendizâde Şevketî’s Treatise on “Resolution for the Conflict between Labor and Capital”)

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Notion of Islamic economics, although a twentieth century phenomenon, has its origins in the time of our Beloved Prophet ﷺ and His Rightly Guided Caliphs as well as in the writings of Muslim scholars. Throughout the history of Muslim Economic Thinking (MET), Muslims experienced various political, economic and social threats and opportunities that formed the basis for the transformation of MET on one hand, as these threats and opportunities triggered the formation of a historical consistency in MET on the other. Regardless of time, space, context, and actors, each development revealed the different aspects of consistent stance against the transformations. Thus, consistency, transformations and disintegration, in that sense, are vital to understand to what extent the contemporary Islamic economics literature constitutes consistency and integrity — in terms of Shari’ah legitimacy and methodology — with its roots formed by the Prophet ﷺ and advanced by His Rightly Guided Caliphs, as systemized and elaborated throughout the history.

As a continuation of the historical adventure of MET, late Ottoman period — mainly constitutes the second half of the 19th century and the early 20th century —

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was one of the breaking points for transformation and disintegration of the MET throughout its history. This period witnessed some unprecedented socio-economic changes in the world history, which were triggered by the events such as industrial revolution, French revolution, so-called enlightenment movement, colonization, increasing number of pitched battles, emergence of various ideologies through which the masses conflicted with each other. Nevertheless, Mehmed Eşref Efendizâde Şevketî’s treatise on the conflict between labor and capital (Sa’y ve Sermâye Mücâdelâtının Dînen Sûret-i Halli Risalesi) was one of the important signs of such consistent stance during the late Ottoman period.

In the early 20th century, had the Ottoman Empire disengaged from its classical economic paradigm which was an extension of Islamic economic tradition, there had been a severe conflict between capital and labor, which would have lead a class struggle between capitalists and their laborers in Ottoman lands. There emerged some demands and labor movements, however they were not as significant as in the west. It might be said that Islamic values and culture had prevented the emergence of such conflict to a significant extent. Thus, in the Ottoman society, we cannot trace back the existence of capitalist or socialist tendencies to the extent that class struggle might have emerged as a result of them.

As a representative of ‘ulema at his time, who improved himself and gained insight into different branches of Islamic knowledge and various western disciplines, Şevketî set an example in terms of using these intellectual formations by being loyal to Islamic values and principles. He was a member of Darü’l-Hikmeti’l-İslâmiyye, which was an Islamic academy that operated under the Şeyhülislâmîk during 1918-1922, a müderris and dersîâm in Süleymaniye Medresesi and Bayezid Medresesi on ‘ilm-i nefs and ahlâk, and also one of the founders of Cemiyetü’l-Müderrisîn. As a response to two letters from the Anglican Church to Darü’l-Hikmeti’l-İslâmiyye written in 1918 and 1921, in which the church requested a brief introduction about Islam and the Islamic stance against the prevention of class conflicts which had threatened the social order in the Europe from competent ‘ulemâ, Şevketî wrote a treatise on the solution for the conflict between labor and capital (Şevketî, p. 6).

Ever-mounting magnitude of this conflict, which had also been driven by Bolshevik revolution in Russia, rising socialistic tendencies among the masses and negligent attitude of capitalists, was increasingly felt in Europe to the extent that the Anglican Church requested to learn the Islamic stance against the issue. The interest of the church about the Islamic position against the conflict and their effort to learn from a government agency of the Ottoman Empire are remarkable points
in terms of their perceived mentality as well. Şevketi addressed the first request in his reply, by touching upon a brief description and explanation regarding Islam, classification of ahkâm, pillars of akâid and ahkâm-ı ameliyye and ahkâm-ı vicdaniyye by referring to some Verses of the Holy Qur’an and Sunnah of Rasulullah ﷺ. For the second request, he wrote his reply under five chapters that are İki nev’-i tarz-ı hayat ve netâici (Two kinds of lifestyle and their consequences), Garbdaki mes’elenin esbâb-ı hudâsu (Reasons that arose the issue in the west), Mes’elenin hall-i ihlimâtî (Possibilities for solving the issue), Mes’elenin yegâne çâre-i halli (Sole remedy for the issue) and Âkıbet-i hâl (State of the denouement). Under the first chapter, İki nev’-i tarz-ı hayat ve netâici, Şevketi briefly explains the two kinds of worldviews, one of which believes and knows the reality of Hereafter and the other assumes that the life is about the worldly life as it does not accept the Hereafter, and the economic consequences of these worldviews, by referencing to the lives of Prophets and features of Islamic civilization. In the second chapter, Garbdaki mes’elenin esbâb-ı hudâsu, he explains the three reasons behind the conflict between labor and capital in the west, one of which points out the denial of Tawhid and belief in trinity, as Christian scholars distorted and garbled Christianity as a result of which masses were alienated from the religion and sought other ways for salvation. The second reason is the inequality in resource allocation and distribution, as well as in inheritance, as it formed the basis for the formation of social classes and the conflict between them. Lastly, the third one is the increasing international competition between states, as it triggered the formation of regular armies on a vast scale, subsequently the need for financing these military powers emerged and it consequently increased the tax burden on the public.

In the third chapter, Mes’elenin hall-i ihlimâtâti, Şevketi evaluates some possibilities regarding the solution for the conflict. Firstly, he mentions the possibility that those who were satisfied with the status-quo would tend to use legal power, instead of taking the complaints of poor classes into account. Secondly, he points out that, the main causes of the conflict were individual and external differences which formed the classes. In this regard, he emphasizes the point that existence and continuation of the individual and social differences is a natural consequence of the Divine Wisdom, as Allah Ta’ala states “… It is We who have apportioned among them their livelihood in the life of this world and have raised some of them above others in degrees [of rank] that they may make use of one another for service. But the mercy of your Lord is better than whatever they accumulate” (Qur’an, 43:32). In addition, he accentuates that efforts for abolishing these differences are vain and against the Divine Wisdom, as the Prophet ﷺ states that
“...Verily your blood, your property and your honor are as sacred and inviolable as the sanctity of this day of yours...”(Sahih al-Bukhari 3:9; Sahih Muslim 28:43) in the Last Sermon. In that regard, as neither preserving the status-quo, nor abolishing the differences completely would solve the problem, Şevketî suggested that the solution for the conflict is *islah* in the sense of improving, bettering and restoring the situation.

In the fourth chapter, *Mes’elenin yegâne çâre-i halli*, he remarks the importance of instinctive desire to him or for human beings by explaining the Verse of Surah Ali ‘Imran, (Qur’an 3:14). In that sense, while the rich live in a self-indulgent manner, the poor cannot be supposed to control their desires for worldly possessions. However, if the ruling class and scholars live in a pious and contended way, the poor can prefer the life of Hereafter and feel a contentment by controlling their desires. Such contentment can be merely attained through believing in the right religion, which gives to hearts a sense of fulfilment, and following the way of Prophets. Thus, the sole remedy for the conflict is to believe in Islam and accept the lifestyle that Islam conveys. In addition, Şevketî views the conflict as a result of the animosity and hatred put among the Christians because of forgetting their covenant with their Lord, as Allah Ta’ala in Surah Al-Maidah states that “…but they forgot a portion of that of which they were reminded” (Qur’an 5:14). Hence, as the animosity and hatred among them are the results of denying the Prophethood of Muhammadﷺ, believing in Hisﷺ Prophethood will remove the animosity and hatred among them, thus solve the conflict. He explains this truth in a detailed way, and makes its connection with the conflict between labor and capital.

For the last chapter of the treatise, *Âkıbet-i hâl*, Şevketî indicates that while Islam is a remedy to many problems of the west, he thinks that the west will not be likely to accept Islam because leaving their attractive lifestyle and preferring a simple and plain one is hard for the westerners. He adds that where and when an intellectual reform starts to take place within the minds, this reform might come to fruition by eliminating the barriers. In that regard, he emphasizes the importance of capitalists’ arrogant attitude against the poor by referencing the parable of Qarun in Surah al-Qasas in the Holy Qur’an (28: 76-83). For the denouement of the conflict, he predicts that the conflict will not come to an end, as Allah Ta’ala

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1 “And from those who say, ‘We are Christians’ We took their covenant; but they forgot a portion of that of which they were reminded. So We caused among them animosity and hatred until the Day of Resurrection. And Allah is going to inform them about what they used to do” (al-Maidah 5:14)
states that the animosity and hatred put among them will last until the Day of Judgement in Surah al-Maidah (Qur’an 5:14). In conclusion, Şevketi admits that resolving this conflict is a quite difficult issue for all the easterners and westerners. He accentuates that both of them should think over the conflict more, and while westerners would understand to what extent they strayed from the way of the Prophets, Muslim easterners would realize the desperate consequences of devoting themselves to the worldly life in order to protect their political existence along with the developed states. He finishes the treatise by considering that solely devoting to worldly life leads to desperate consequences whereas leaving it harms both the world and the Hereafter, hence it requires the reconciliation between these two lifestyles, as he asks a question towards the end: “How can it be possible?” (Şevketi, p.32). Answering this question is quite hard according to Şevketi, as this question has remained unanswered since it emerged. He concluded his treatise by pointing out the challenge to answer this question and content himself with the explanations that he made throughout the book. Notwithstanding he could not answer the last question and propose a solution, his treatise is an important instance which was written in the early 20th century, addressing the conflict which had been stemming from the modern phenomena from the consistent perspective in terms of the heritage of MET.

Furthermore, the impressive style and expression are other outstanding points of this book. It reflects the richness and depth of the late Ottoman Turkish in terms of both vocabulary and manner of discourse. It reflects the level of politeness — in terms of linguistics — in the late Ottoman period as well. These linguistic features of the book make it more impressive and attention taking for the audience who are familiar with Ottoman Turkish.

Mustafa Yıldız published the Şevketi’s treatise by latinizing its original manuscript without any interference for the contemporary Turkish audience and added a brief summary regarding the content of the book. However, it should be noted that the name of this edition does not seem to be coherent with the content of the treatise, as Şevketi did not directly speak of capitalism and socialism as economic systems. Rather he mentioned the class struggles among the poor and the rich that emerged in the west, the underlying reasons behind them, and evaluated the conflict and its reasons in the context of Islamic texts and evidences. Hence, it seems like it would be better to prefer the original name of the treatise.

2 We are also indebted to Mustafa Yıldız for this brief summary, as we benefited from it in this review.
Moreover there were previous editions which were published before this book, as the first edition of the treatise was published in 1924 by Matbuat-ı Osmaniyye in Ottoman Turkish, then its summarized edition was published by Hedef Yayınları under the name of İslam’da Emek ve Sermaye (Labor and Capital in Islam) in 1964 (Yıldız, p.10). Although there are some typos regarding the latinized text, as well as problems related to general layout and punctuation marks, the book constitutes an important milestone for the consistency of MET in the late Ottoman period, as it must be read for the researchers in history of Islamic economic thought and Islamic economics. For those who want to read it from the original manuscript, it is available in some online databases, such as ISAM’s Treatise Database in Ottoman Language.

Briefly, Eşref Efendizâde Şevketî’s treatise constitutes a milestone for the MET in the late Ottoman period, through which the consistency of it can be understood in a more accurate way and some of important problems of contemporary Islamic economics literature can be addressed too, as it might provide crucial insights to establish a healthy relationship with the roots and heritage of MET. Instead of evaluating it just as a historical document, it might be considered as a part of the two centuries-long struggle of Muslims for developing through being loyal to Islamic values as well. Notwithstanding, he did not propose an exact solution for that, Şevketî’s treatise should maintain its importance in the sense of historical consistency of MET.

References