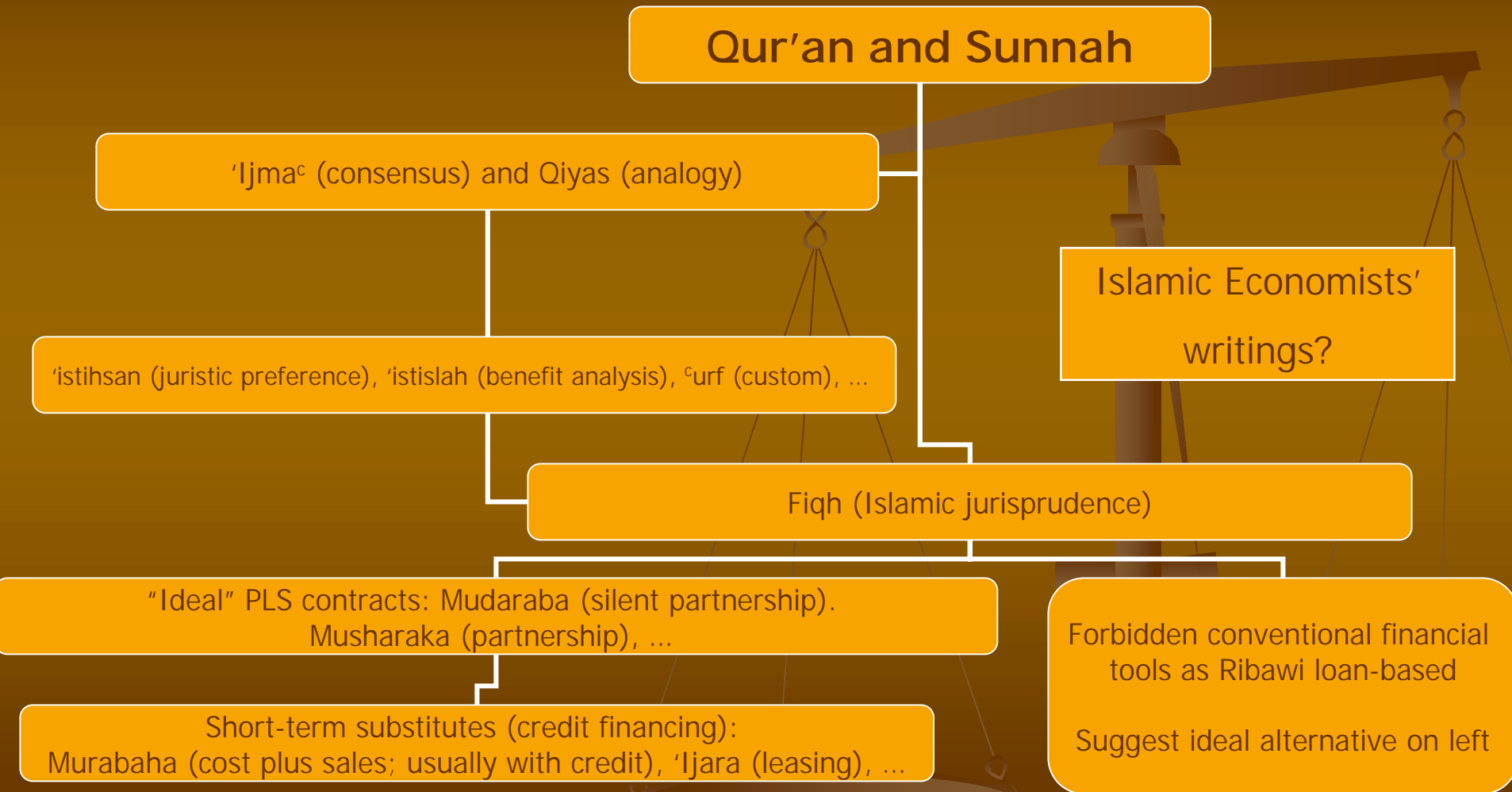


# Reviving the roots of Islamic economics & finance



Mahmoud Amin El-Gamal  
Rice University


# Muslims' mental image of Islamic finance



# The role of Islamic economists

- Influenced jurist perceptions of the ④ (instigating factor) and (wisdom/ objective) of certain prohibitions
  - e.g. myths regarding the prohibition of Riba
    - “fixed rate of return” – what about leasing and credit sales?
    - “return without risk” – what about credit risks and others?
    - “exploitation of the poor” – is still possible.
  - In fact, it appears that the prohibitions of Riba and Gharar are built-in prudential financial regulations
    - Prohibition of Riba enforces “marking to market”; see <http://www.ruf.rice.edu/~elgamal/files/riba.pdf>
    - Prohibition of Gharar enforces optimal “risk-sharing”; see <http://www.ruf.rice.edu/~elgamal/files/gharar.pdf>
- Convinced jurists that there is a viable radical “Islamic” alternative (e.g. various types of “Islamic bonds” via *Ijara*, *Mudaraba*, etc.)
- Frustrated the attempts of practitioners

# Case study: Government bonds (a form of money)

- Solicited *fatwas* clearly illustrate banker and government disagreement with jurist views
- Jurist views are self-contradictory:
  - Claim that fiat money is not a commodity, while commodifying it by analogy to gold & silver (various OIC FA decisions)
  - Treat different currencies as different genera (KFH fatwa #164), but do not permit issuance of multiple monies with different seignorage (contrary to bi-metallic standard)
  - Frequent use of , and excessive classification of modern instruments under known contract forms

# Some interesting solicited Fatwas I

- Kuwait Finance House *fatwa* # 361: exchange or redemption of bonds in a different currency; forbidden
- Rajhi decision # 12: how can Rajhi help with the fiscal deficit; opinion listed suggested alternatives from Islamic financial engineering literature
- Rajhi decision #101: Platinum exempt from gold & silver exchange (☒☼☛) requirements!

# Fatwas II:

## Fiqh Acadmy 6/1 1/62

- 1989 following joint conference with IRTI and Moroccan Awqaf Ministry:
  - Positive coupon bonds are forbidden *ribawi loans*, regardless of labels
  - Zero-coupon bonds are also forbidden since they are loans sold at a discount
  - Bonds that pay [unpromised] prizes are also forbidden as loans that benefit the lender
  - Recommend bonds that are tied to specific projects through "PLS" Mudaraba

# Fatwas III

## The late Sheikh Dr. Mustafa Al-Zarqa' opinion on Treasury Bills (2000)

- A treasury-bill "cannot be classified" except as an interest bearing loan to the government, regardless of labels
- All other bonds have the same loan status
- Major contemporary jurists are in consensus that interest = *riba* + reference to Dr. Chapra's book on a "Just Monetary System"
- Scathing attack on Dr. Tantawi's *fatwa* that "raised doubts about his knowledge and faith"
- recommends *Musharaka* and *Mudaraba*

# Economists & jurists I

- Jurists have adopted the worst traits of Economists:
  - Treating new inventions (e.g. money, c.f. Goethe's Faust) like known historical entities
  - Seeking temporary solutions to permanent problems, then defending them stubbornly
- Economists have adopted the worst traits of jurists:
  - Legalistic "form over function" thought
  - Absolutism in the definition of "Islamic"



# Paradoxes in Islamic Finance

- Rift between “Islamic economic/financial system” writings and the practice of Islamic finance (the supposed *PLS* ideals?)
- Highly segmented Islamic finance markets
- A small number of active jurists in the Islamic finance industry
- Jurists permit contracts, and then criticize their over-usage instead of the *PLS* “ideal”

Equity



Ethical/Islamic  
Jurist Preferences



Juristic-Islamic  
Permissibility  
Frontier

Secular/Banker  
preferences

Different  
Financial  
technologies

Efficiency

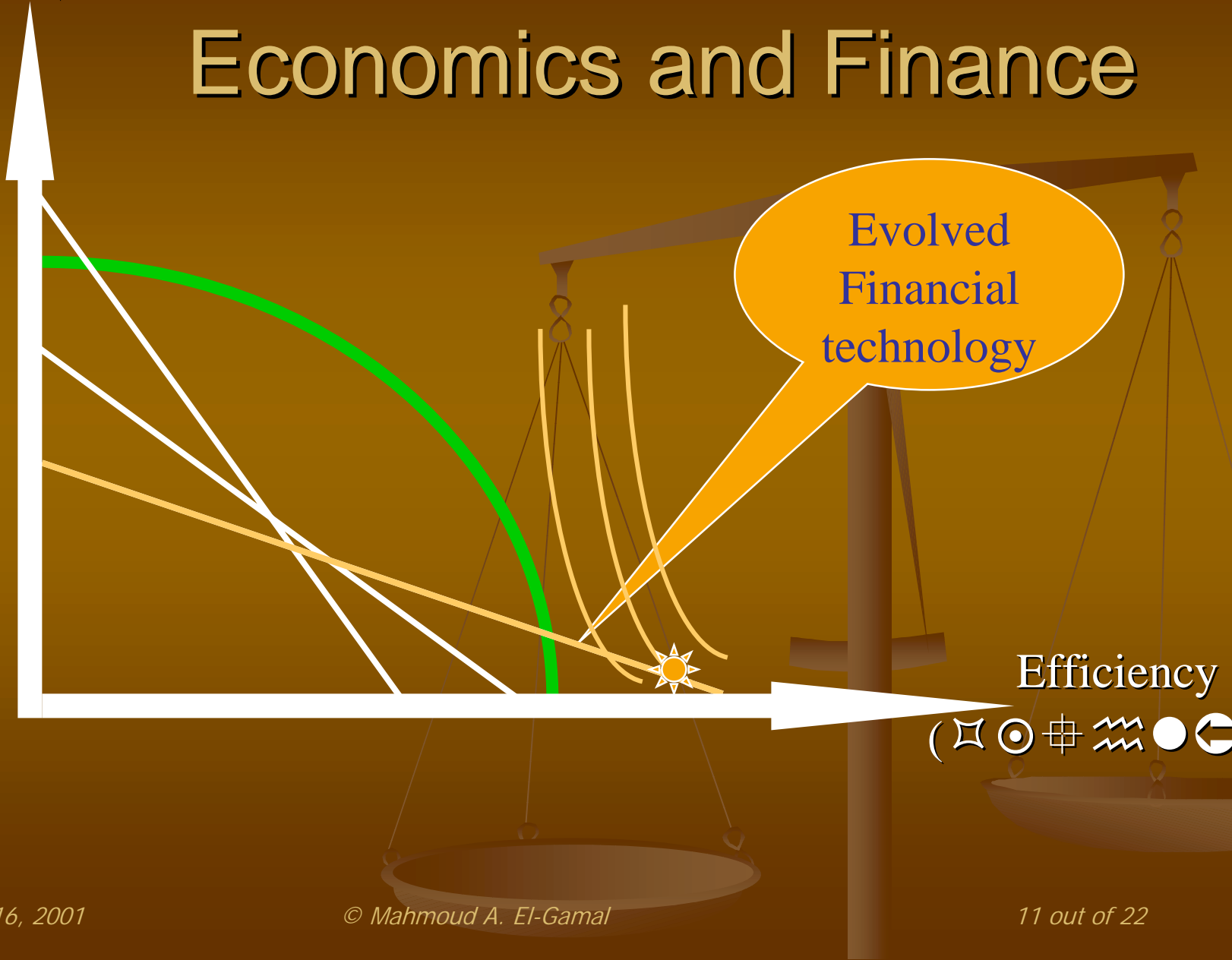


Model to explain paradoxes

Equity

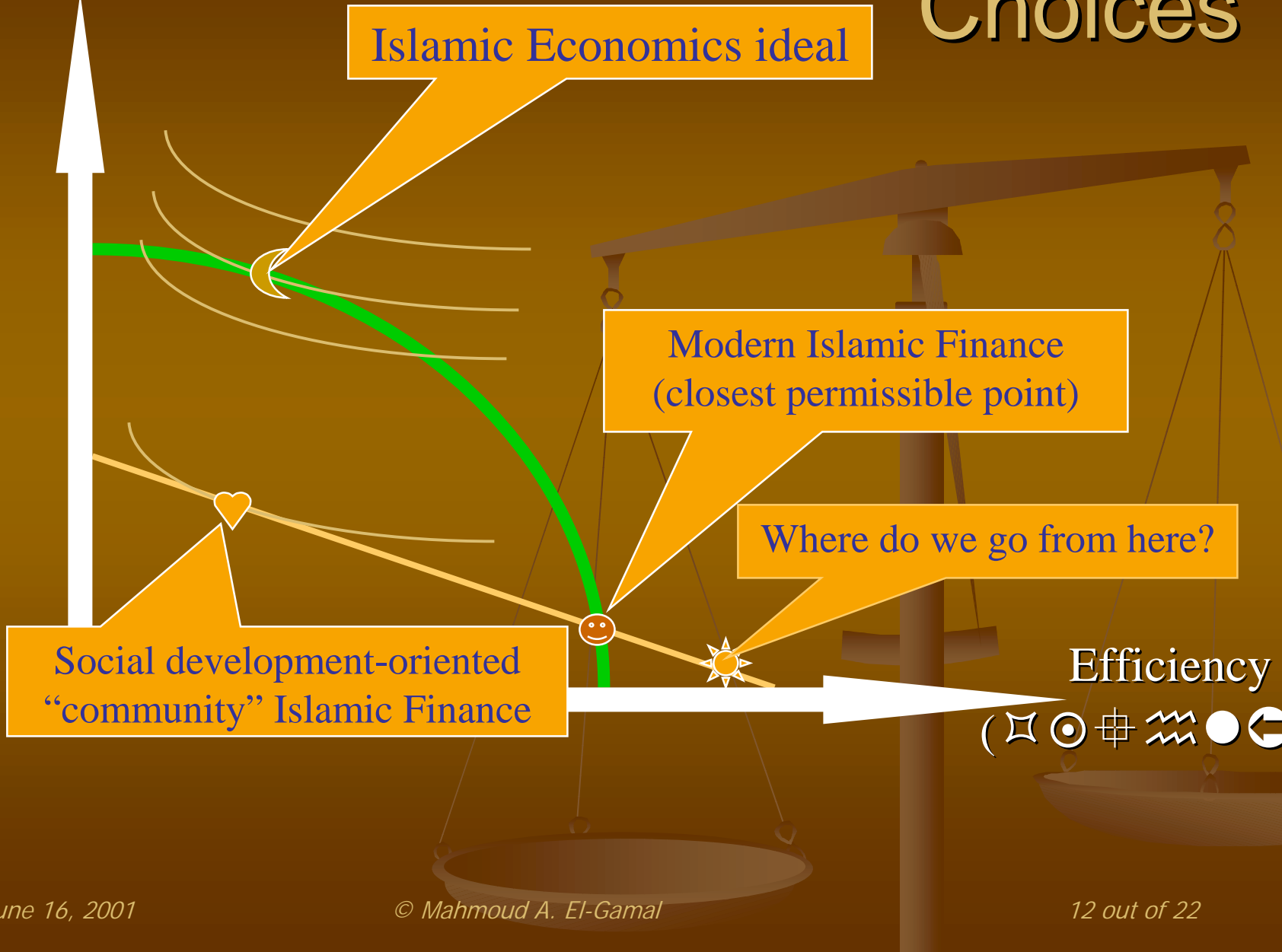


# The need for an Islamic Economics and Finance



# Common Choices

Equity  
(↔ ⌚ ⌘ ↺ ✨)



Islamic Economics ideal

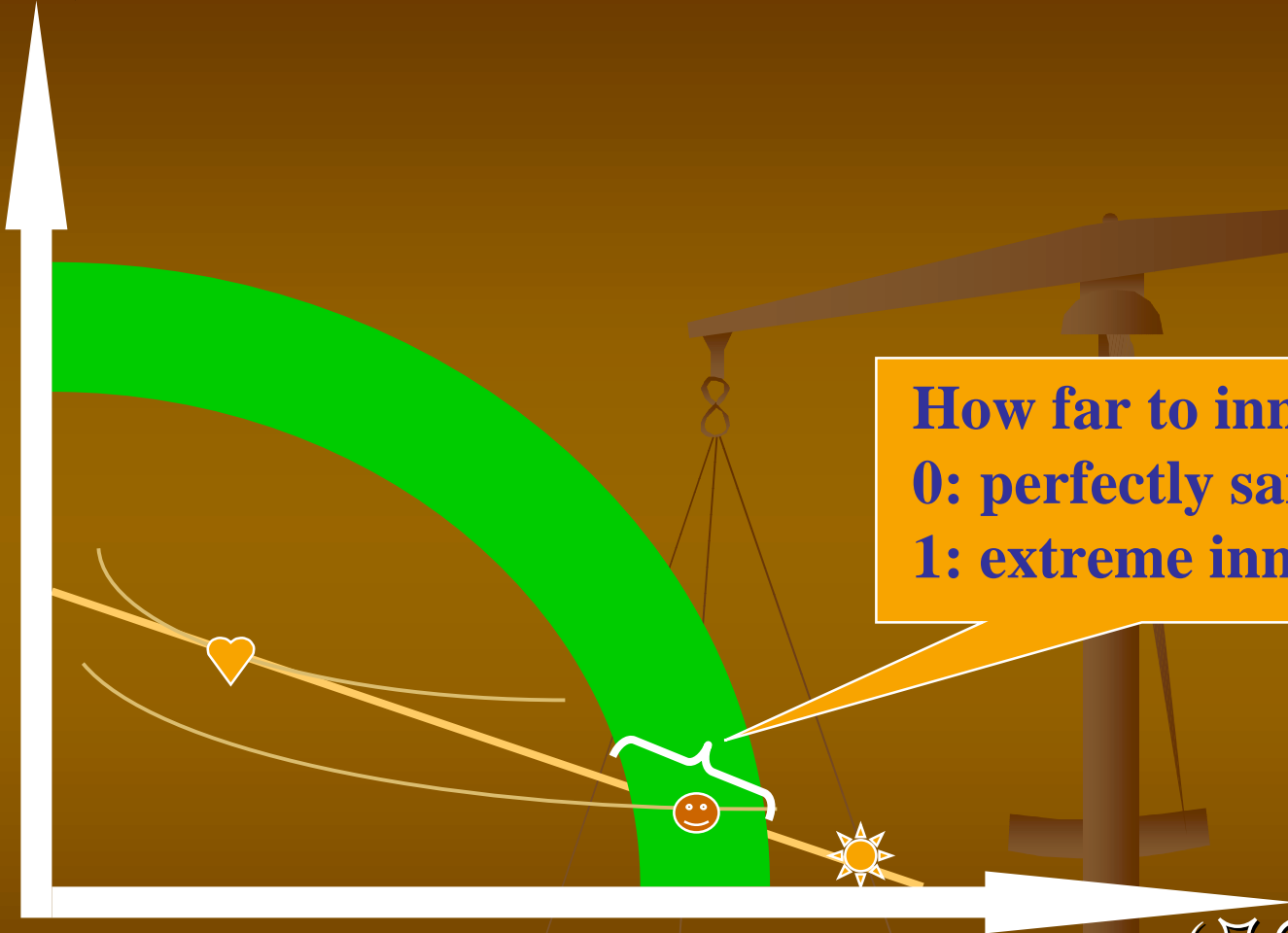
Modern Islamic Finance  
(closest permissible point)

Where do we go from here?

Social development-oriented  
"community" Islamic Finance

Efficiency  
(◻ ⊙ # ≡ ● ↺)

Equity



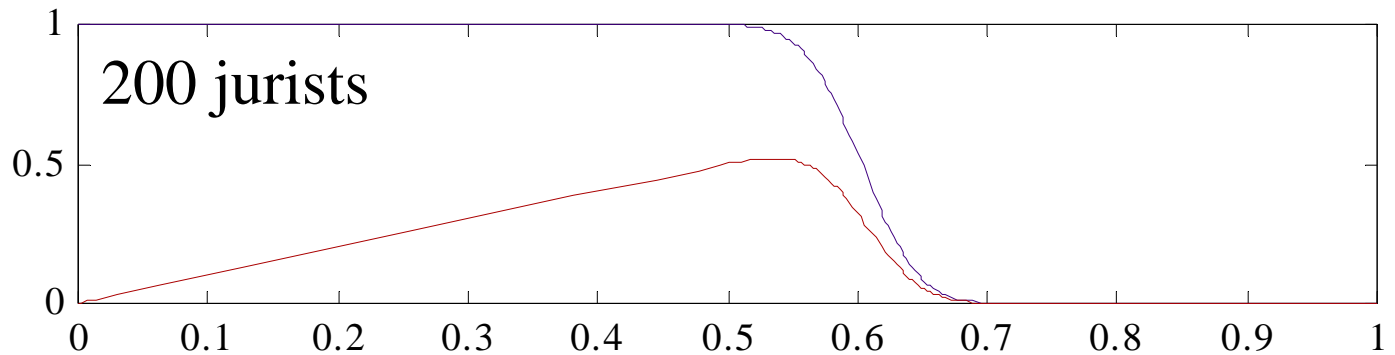
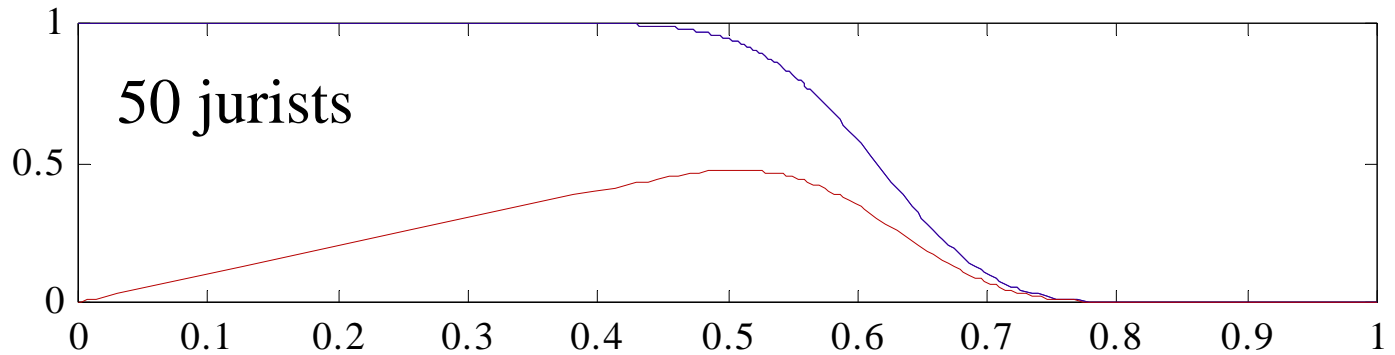
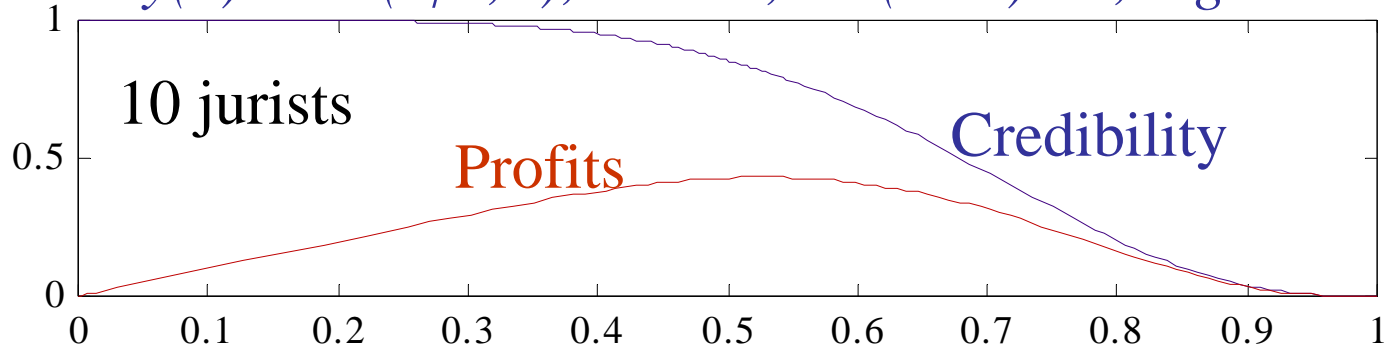
**How far to innovate?**  
**0: perfectly safe**  
**1: extreme innovation**

Efficiency



# Model: basic components

$Credibility(x) = 1 - B(x/\alpha, \lambda)$ ;  $\alpha = \pi n$ ;  $\lambda = (1 - \pi)n - 1$ ; e.g.  $\pi = 0.6$



$Profit(x) = x \cdot Credibility(x)$  Degree of innovation

# Competition

Given one bank's level of innovation, second bank can:

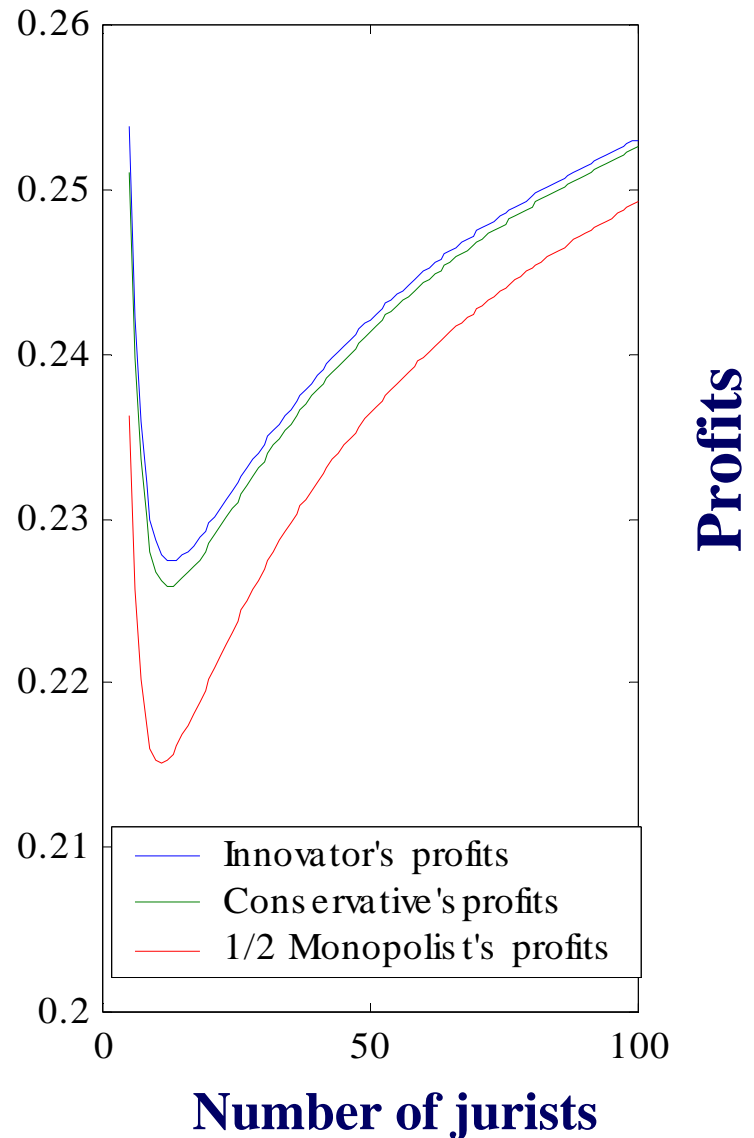
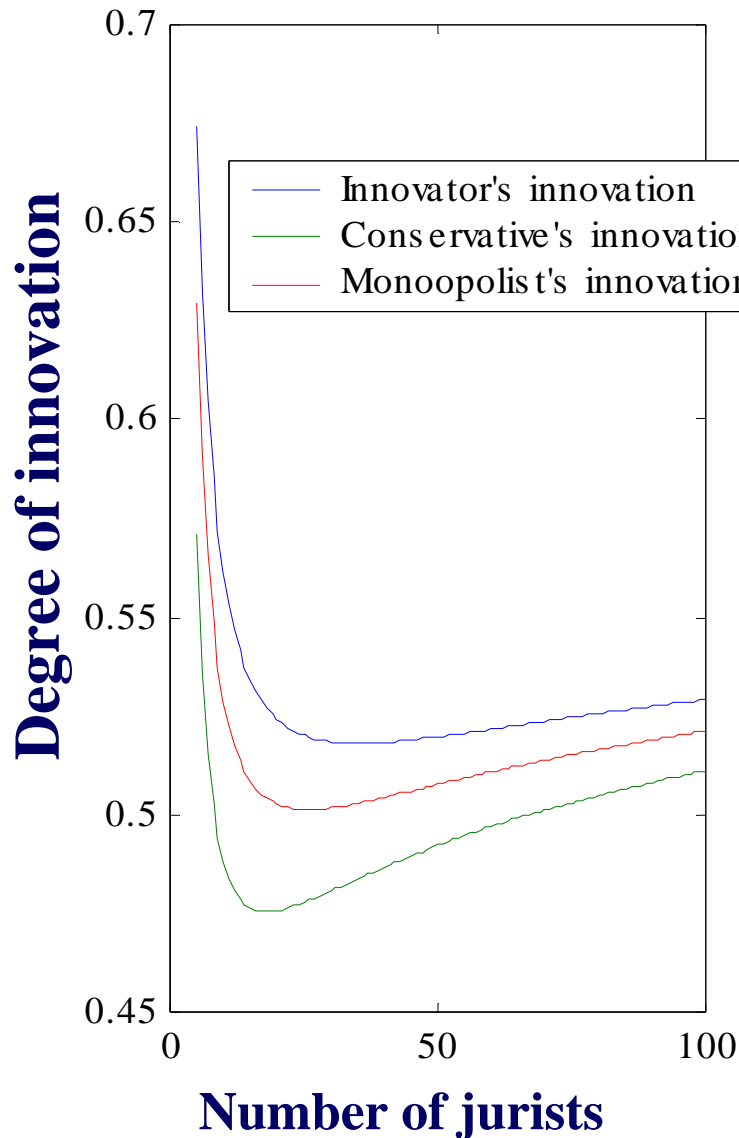
1. **Share** monopoly profits,
2. **Innovate** further, or
3. **Challenge**: discredit first bank to take his business

Innovator's profits:  $\pi_1(x_1, x_2) = x_2 \frac{(1 - F(x_1))^2}{2 - F(x_1) - F(x_2)} + (x_1 - x_2)(1 - F(x_1))$

Conservative's profits:  $\pi_2(x_1, x_2) = x_2 \frac{(1 - F(x_2))^2}{2 - F(x_1) - F(x_2)}$

**Solve for Cournot-Nash equilibrium (fixed point)**

# The Economics of Jurisprudence





# Explaining the paradoxes

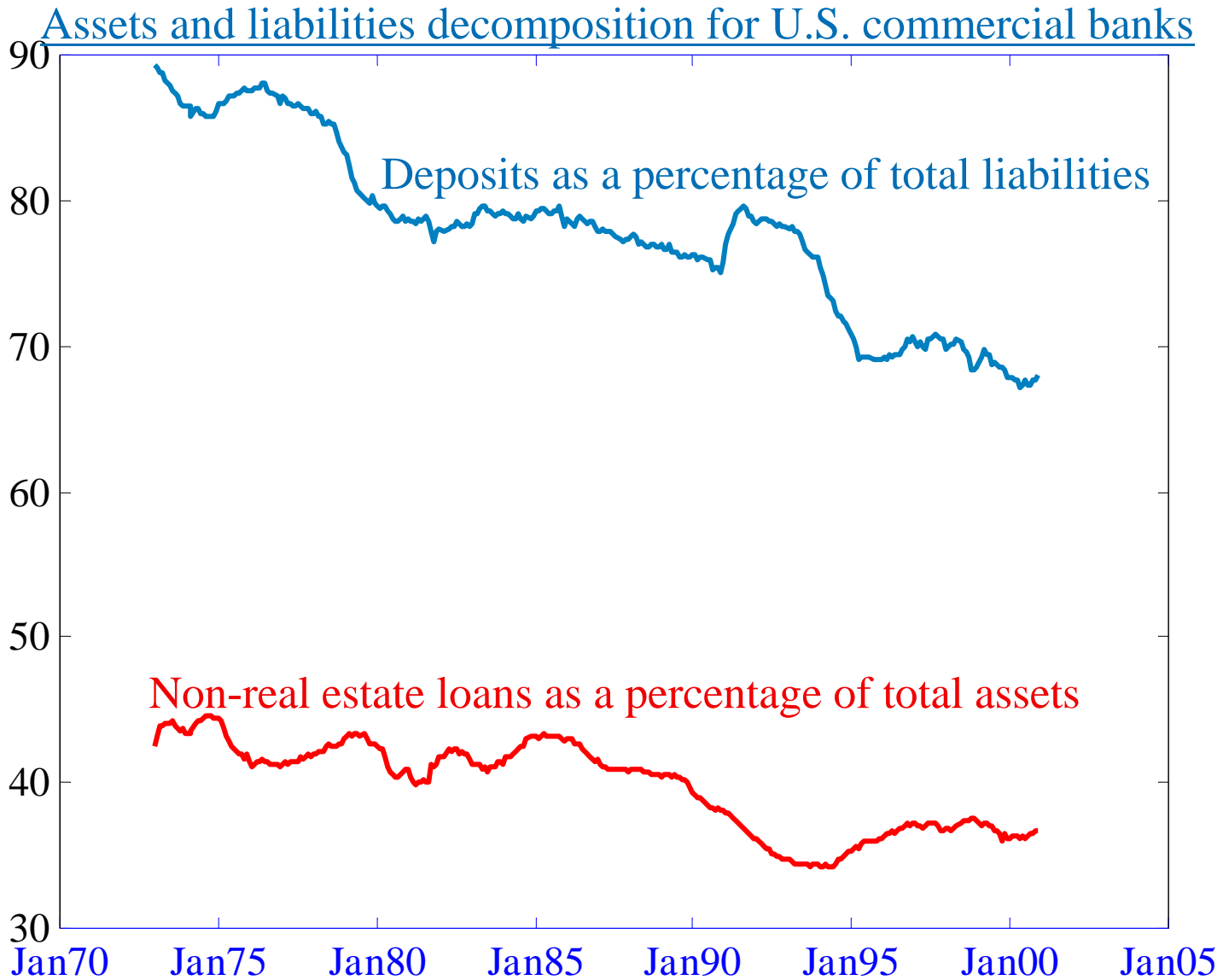
- As more jurists get involved:
  - At first, the industry sees more conservatism
  - Then, beyond some point, more innovation
- Despite the rhetoric, banks benefit from jurist-supported market segmentation
- If jurists cared only about perceived    : quit at minimum “innovation” (proximity to conventional finance)

# Outstanding questions



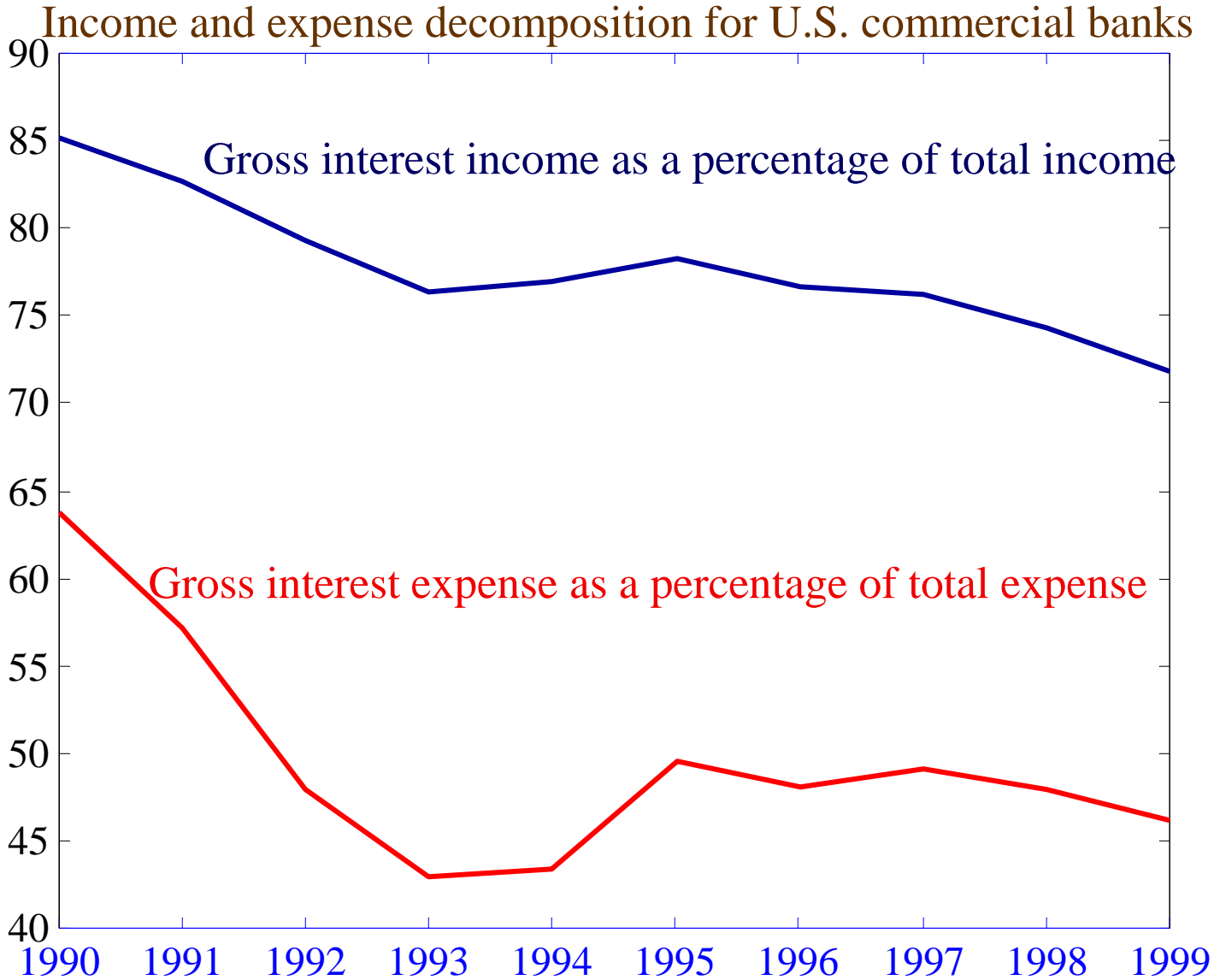
- Can we recognize as “probable” what is now treated as a “certainty” (virtual consensus)?
- Can we overcome outdated suspicions of “western” economics and financial products?
- Can we overcome the urge to come to hasty conclusions regarding the understanding of the Islamic Legal Texts?
- Can we be more careful and less apologetic for historical jurisprudence based on outdated thought

# Opportunity: Islamic & conventional banking convergence?



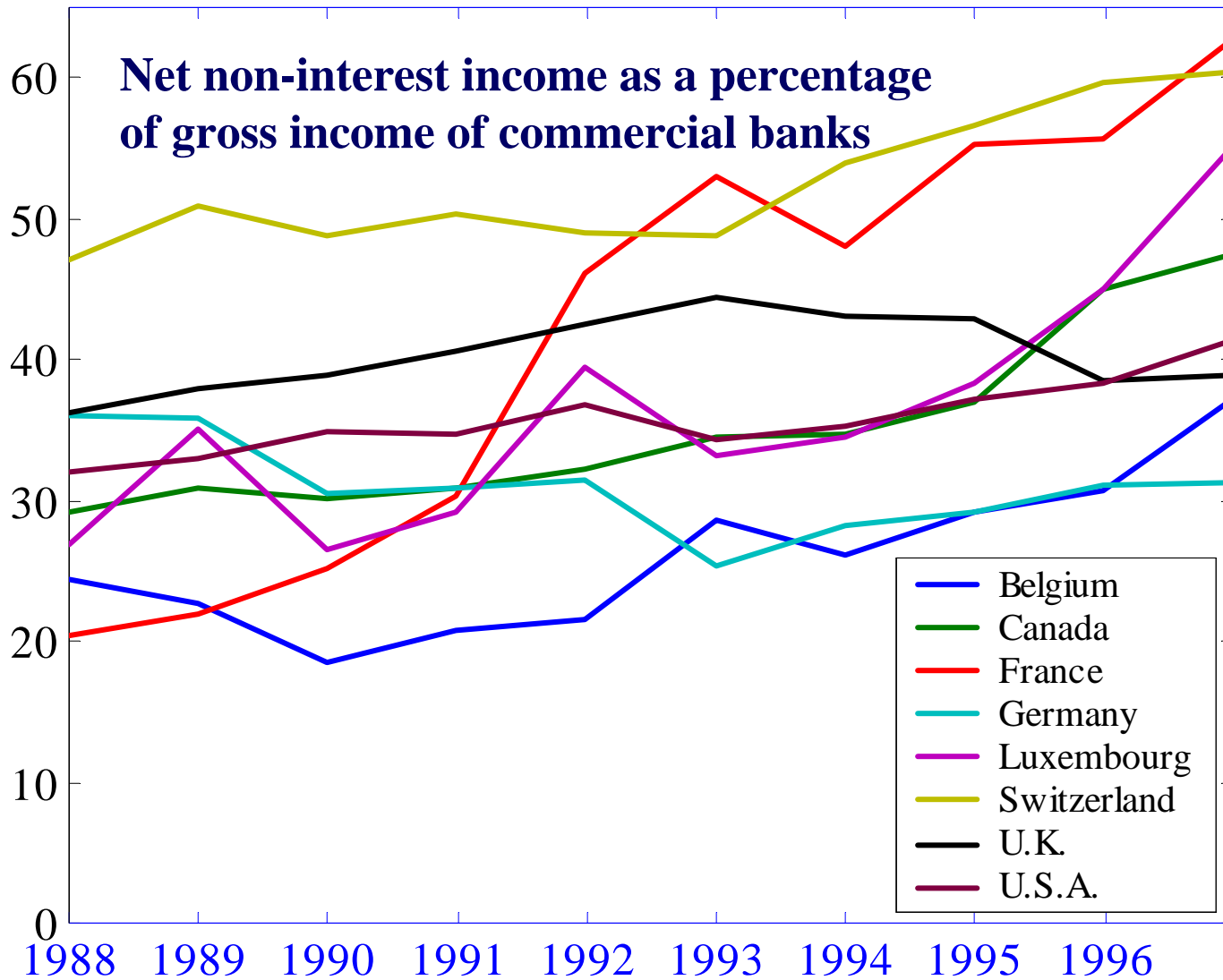
Source: Federal Reserve Statistical Release – H.8, Feb. 2, 2001

# Opportunity: Islamic & conventional banking convergence?



Source: *Federal Reserve Bulletin, June 2000*

# Opportunity: Islamic & conventional banking convergence?



Source: *Bank Profitability: Financial Statements of Banks, OECD, 1999.*

# Economists & Jurists II

- Can jurists adopt the best traits of economists
  - Be skeptical about their “models”; recall that all human-judgment-based “knowledge” is wrong
  - Consult with “the best in the business”, rather than the “closest in ideology/rhetoric”
- Can economists adopt the best traits of jurists
  - Think about function rather than form & label
  - Consider overall social costs and benefits, rather than champion political/ideological causes