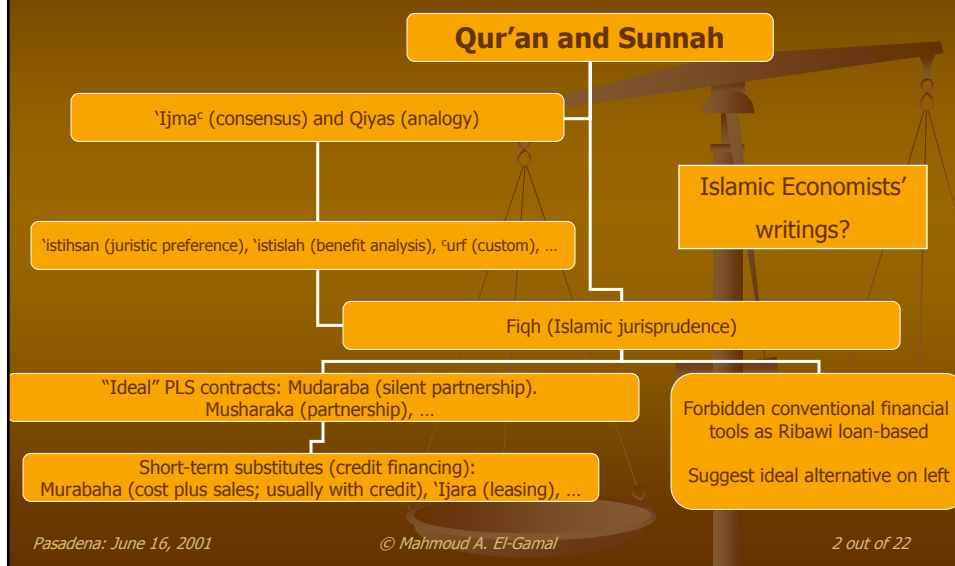


Reviving the roots of Islamic economics & finance

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Muslims' mental image of Islamic finance



The role of Islamic economists

- Influenced jurist perceptions of the ④✘ (instigating factor) and ④●Ⓜ (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 ④✘, ④●Ⓜ, ④✘, ④●Ⓜ, 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 6/11/62

- 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)

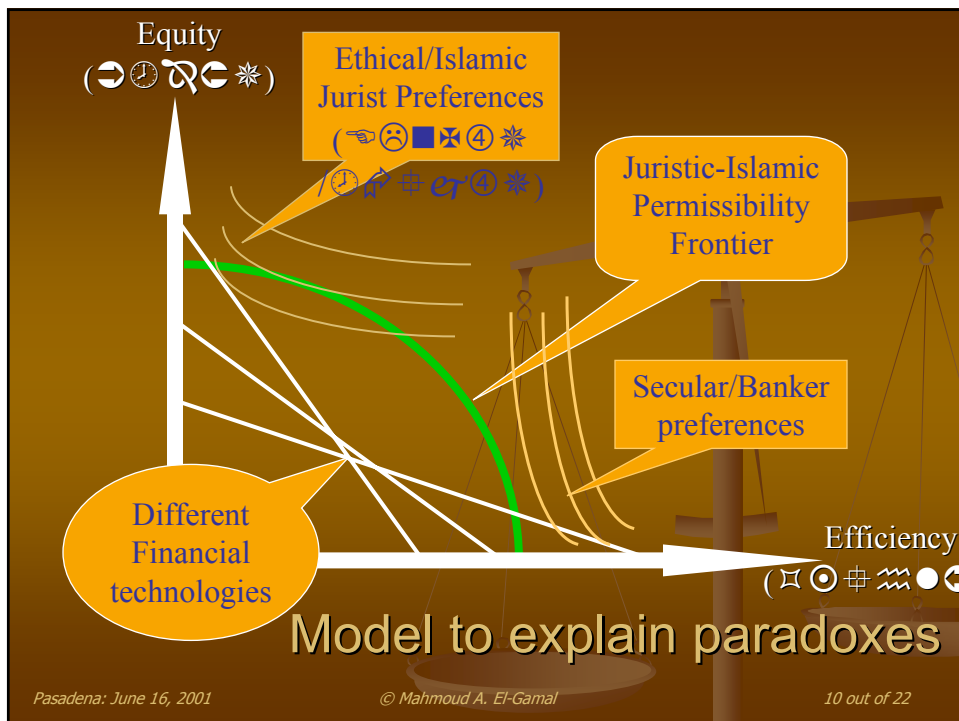
- A treasury-bill "cannot be classified" except as an interest bearing loan to the government, regardless of labels
- All other bonds have the same loan status
- Major contemporary jurists are in consensus that interest = *riba* + reference to Dr. Chapra's book on a "Just Monetary System"
- Scathing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

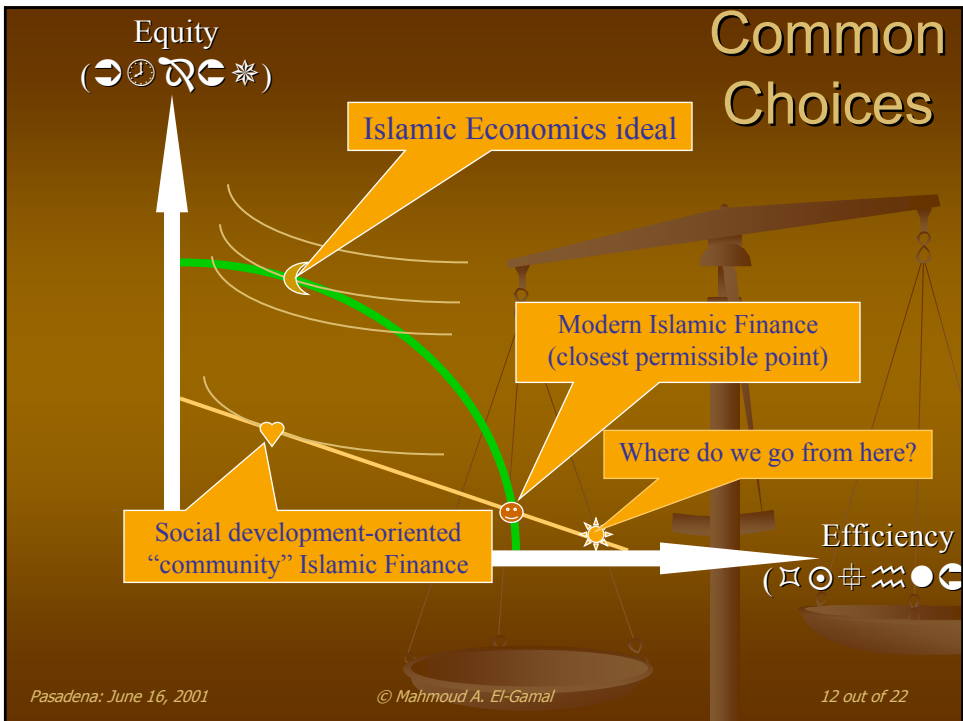
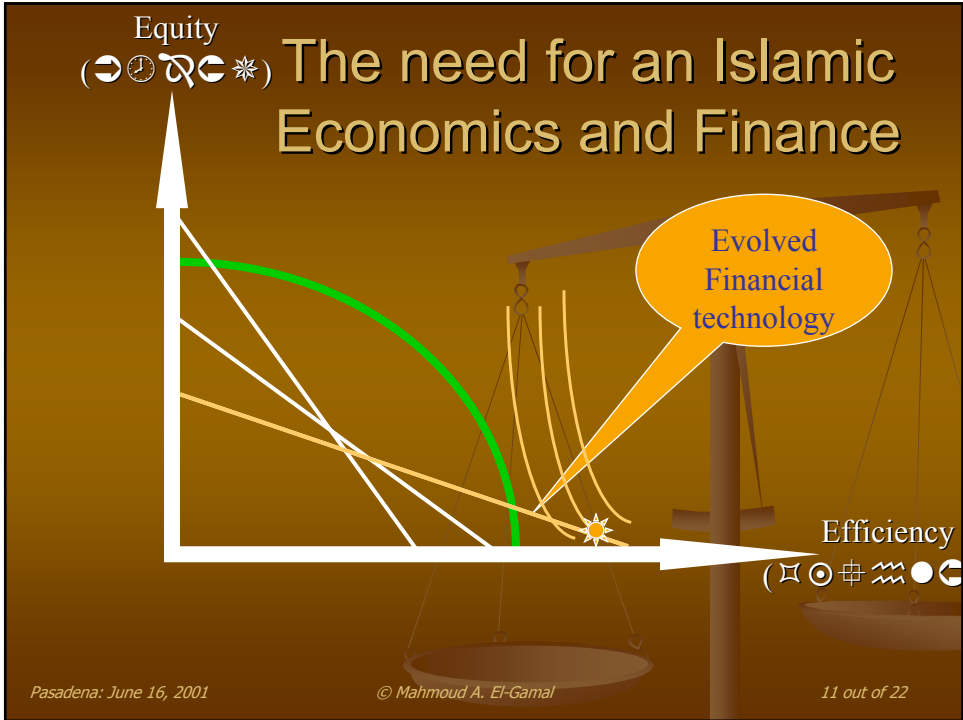
Economists & jurists I

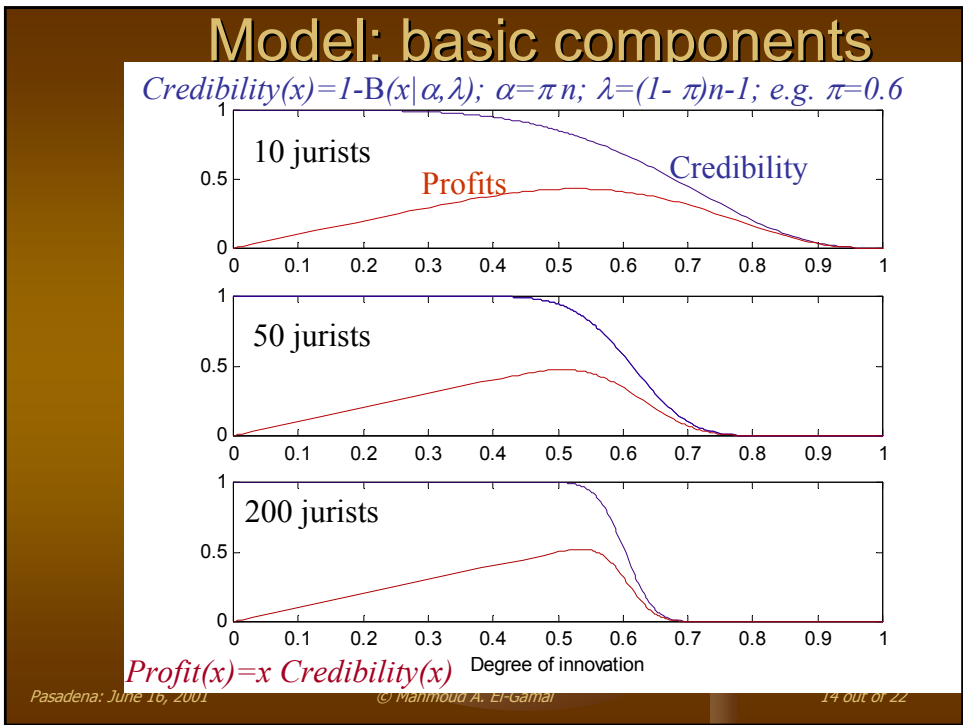
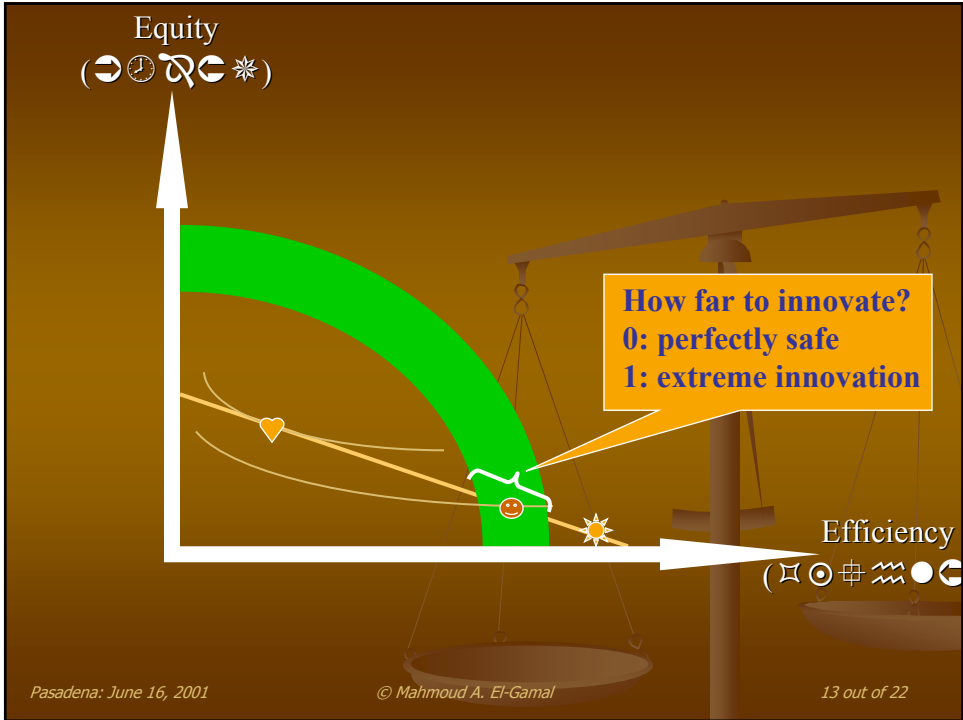
- Jurists have adopted the worst traits of Economists:
 - Treating new inventions (e.g. money, c.f. Goethe's Faust) like known historical entities
 - Seeking temporary solutions to permanent problems, then defending them stubbornly
- Economists have adopted the worst traits of jurists:
 - Legalistic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







Competition

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

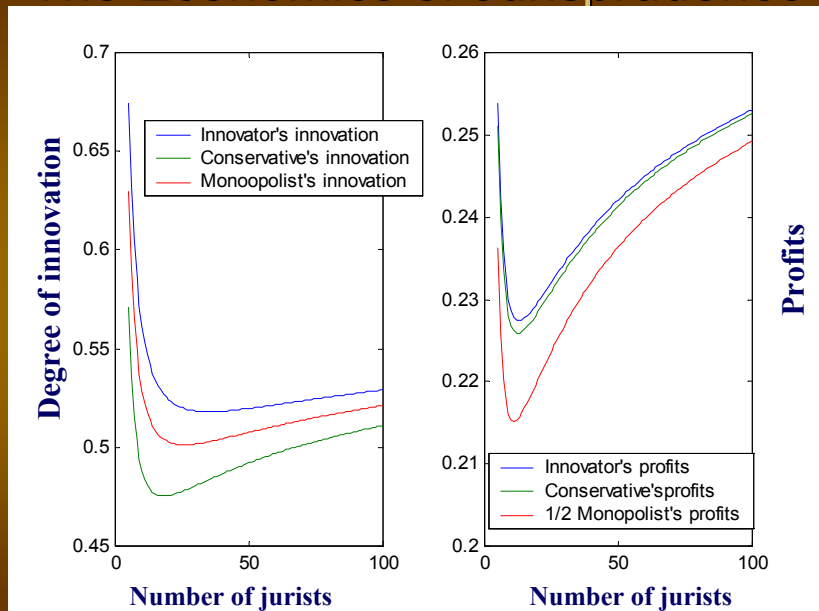
1. **Share** monopoly profits,
2. **Innovate** further, or
3. **Challenge**: discredit first bank to take his business

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



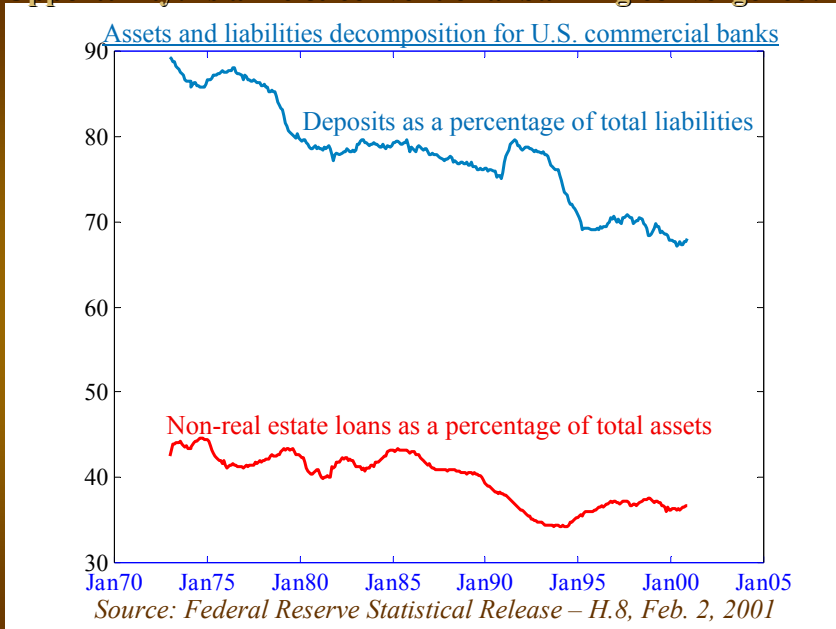
Explaining the paradoxes

- 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?

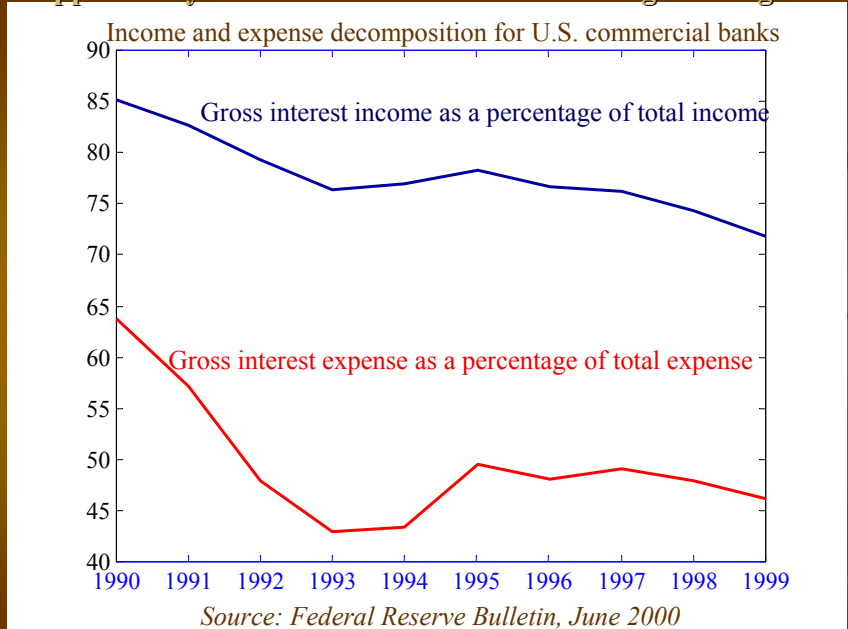


Pasadena: June 16, 2001

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19 out of 22

Opportunity: Islamic & conventional banking convergence?

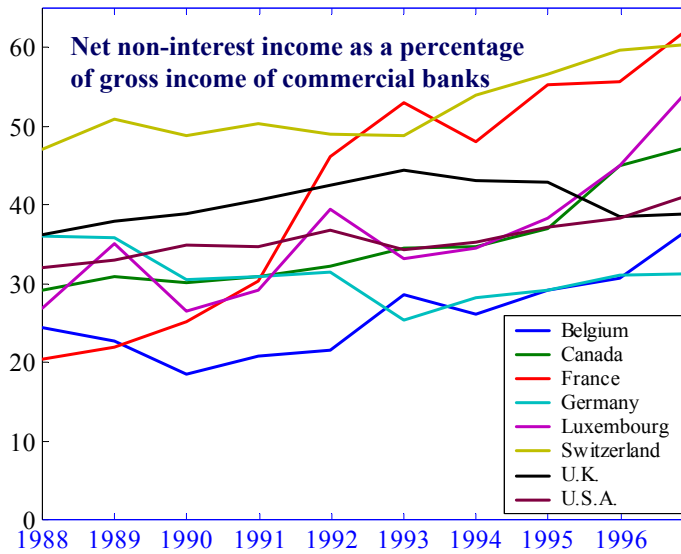


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Opportunity: Islamic & conventional banking convergence?



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

