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Article:

Ebrahim, MS and Sheikh, M (2016) Debt Instruments in Islamic Finance: A Critique. *Arab Law Quarterly*, 30 (2). pp. 185-198. ISSN 0268-0556

<https://doi.org/10.1163/15730255-12341317>

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Debt Instruments in Islamic Finance: A Critique

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Date of This Draft: May 5, 2015.

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Debt Instruments in Islamic Finance: A Critique

Abstract

This paper assesses the employment of the traditional Islamic debt instrument, by contemporary Islamic banks, from an economic efficiency perspective. We highlight the fact that the performance of the bulk of the instruments pales in front of the modern facility of Participating Preferred *Ijāra*. Thus, the shortcomings of the traditional instruments illustrate that the future does not augur well for neither the ‘Islamic’ banking industry nor the emerging Muslim economies. For the Muslim world to move forward, it is imperative to scientifically restructure its financial intermediation system consistent with the *Sharīʿa*.

Keywords

Ijāra - *Murābaḥa* - *Qard Ḥasan* - *Ribā* - *Sharīʿa* - *Tawarruq*

1 Introduction

It is undoubtedly clear that the foundation of the Islamic finance industry...is still weak...¹

The efficiency of the financial intermediation system is of utmost importance. Blejer reinforces this when he says, “Countries with efficient financial systems are less prone to banking crisis [...] Countries with efficient financial systems suffer (much) less when a crisis does occur. And, overall, countries with efficient financial systems grow faster”.² Glaeser further supports this by arguing that financial intermediaries have the capacity to render the economy vulnerable to risk, as they connect asset prices with the macro economy.³

The purpose of this article is to critically examine a wide array of traditional Islamic debt instruments in the context of their economic efficiency and permissibility in Islam. This issue is of utmost importance, especially if we accept the view of Timur Kuran – that the

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- 1 Rafe Haneef, “*Is the ban on “organized tawarruq” the tip of the iceberg?*”, Research Paper (Kuala Lumpur, Malaysia: International Shari’ah Research Academy for Islamic Finance, 2009), 17.
 - 2 Mario I. Blejer, “Economic Growth and the Stability and Efficiency of the Financial Sector”, *Journal of Banking and Finance* 30 (2006): 3432.
 - 3 Edward L. Glaeser, “Comment and Discussion: Real Estate and the Macroeconomy”, *Brooking Papers on Economic Activity*, 2 (2000): 146-150.

Muslim world has experienced centuries of underdevelopment.⁴ Arguably the social impact of this issue is still being observed in the current tragedies of the migrants, who risk their very lives to reach the shores of the developed nations (of the West) to live in dignity.⁵

There is, therefore, an urgency to revitalise financial intermediation in Muslim economies by adopting efficient financial facilities acceptable in the spirit of the Sharīʿa, to stem centuries of economic decline.⁶ This necessitates a critical overview of the traditional financial instruments as described below. The employment of the traditional commercial debt instruments is generally justified by Sharīʿa-scholars based on the fact that they were utilised in the era of the Prophet and that of the first generation of Muslim, known in Islamic lore as the Pious Predecessors (*al-Salaf al-ṣāliḥ*). There is nothing sacrosanct about these instruments per se as they were a feature of the economic landscape of Arabia long before Islam. The Qurʾān and the Sunna (the normative practice of Prophet Muhammad) prohibit only those financial arrangements that are potentially inequitable and capable of creating dissonance in society – those which fall out with this category are permitted. In the modern era, it is imperative that we employ efficient non-usurious (*ghayr ribawī*) facilities to enhance the financial intermediation system and revive economic growth in the Muslim world.

2. Plain Vanilla Interest Bearing (*Ribawī*) Debt Securities

This vehicle is explicitly forbidden in Islam.⁷ Ebrahim, Jaafar, Molyneux and Salleh attribute its prohibition to its potential to:⁸

4 See Timur Kuran, “Islam and Underdevelopment: An Old Puzzle Revisited”, *Journal of Institutional and Theoretical Economics* 153 (1997): 41-71; “The Islamic Commercial Crisis: Institutional Roots of Economic Underdevelopment in the Middle East”, *Journal of Economic History* 63 (2003): 414-446; and “Why the Middle East Is Economically Underdeveloped: Historical Mechanisms of Institutional Stagnation”, *Journal of Economic Perspectives* 18 (2004): 71-90.

5 James Politi, “Europe urged to act as death toll from migrant boats mounts,” *Financial Times* (April 20, 2015), 6.

6 Throughout this paper the term Sharīʿa is used as a synonym for Islamic law, defined lucidly by one well-known Islamic jurist and scholar as, “Shorthand for an amorphous body of legal rulings, judgments, and opinions that have been collected over the course of many centuries [...] The Islamic legal tradition is expressed in works that deal with jurisprudential theory and legal maxims, legal opinions (*fatawa*), adjudications in actual cases, and encyclopaedic volumes that note down the positive rulings of law (*ahkam*). Islamic law covers a broad array of topics, ranging from ritual practice to criminal law, personal status and family law, commercial and transactional law, international law and constitutional law”. Khaled Abou El Fadl, *The Great Theft: Wrestling Islam from the Extremists* (New York: Harper, 2005): 149.

7 See Wahba Al-Zuhailī, “The juridical meaning of *riba*”, in Abdulkader Thomas (Ed.), *Interest in Islamic economics: Understanding *riba** (New York: Routledge, 2006: 26-54). Muhammad Mazhar Iqbal, “Prohibition of Interest and Economic Rationality”, *Arab Law Quarterly* 24 (2010): 293-308. Hamid Harasani, “Analysing the Islamic Prohibition on *Ribā*: A Prohibition of Substance or Form? *Arab Law Quarterly* 27 (2013): 289-296.

- a. Expropriate the assets of the borrower or the lender;⁹
- b. Convey fragility to the underlying macro economy;¹⁰ and
- c. Lead to the financial exclusion of the poor.¹¹

In the contemporary stage of financial development, the first issue, i.e. expropriation, may not be of concern to credit-worthy customers. However, it is of concern to less credit-worthy ones, imposing an extraordinary amount of cost of financing, eventually leading to their financial exclusion. The second issue, i.e. fragility, is a serious concern for all economic agents, as observed in the recent financial crisis. It continues to be a problematic issue in all traditional Islamic financial instruments and is resolved only in contemporary hybrid ones.¹²

In this regard, Ebrahim and Hussain contrast plain vanilla debt with a family of synthetic (structured) debt (termed as Participating Mortgages – PMs), both collateralized by real assets.¹³ They demonstrate that *ribawī* debt is at the lowest rung of economic efficiency – that is, the most inefficient vehicle. This resonates with the view of Gerschenkron that, the prominence of banks in economic development stems from economic backwardness.¹⁴ The rationale behind the inefficiency of *ribawī* debt stems from its inability to address the above three issues, along with three more issues described below.

- d. Adverse Selection: This refers to the situation where a party (borrower or lender) to a financial contract has privileged access to ex-ante information. This informational advantage creates inefficiencies, and necessitates control mechanisms to overcome it.¹⁵
- e. Moral Hazard: This arises when economic agents maximise their own welfare to the detriment of others, especially in situations where they do not bear the full

8 Muhammed Shahid Ebrahim, Aziz Jaafar, Philip Molyneux, and Murizah Osman Salleh, “Agency Costs, Financial Contracting and the Muslim World,” Working Paper, Durham University Business School, Durham University, England, UK, 2015.

9 See Q4:161 and 30:39

10 See Q2:280.

11 See Q2:276-277 and 30:39

12 See Muhammed Shahid Ebrahim, Murizah O. Salleh and Mustapha Sheikh, “Rationalising Hybrid Financial Instruments from an *Uṣūlī* Perspective”, *Arab Law Quarterly* 28 (2014): 295-306.

13 Muhammed Shahid Ebrahim, and Sikandar Hussain, “Financial development and asset valuation: the special case of real estate”, *Journal of Banking and Finance* 34 (2010): 150–162.

14 Alexander Gerschenkron, *Economic Backwardness in Historical Perspective*, Cambridge (MA: Harvard University Press, 1962).

15 See Charles Wilson, “Adverse Selection”. In Steven N. Durlauf, and Lawrence E. Blume (Eds.), *The New Palgrave Dictionary of Economics Online* (Palgrave Macmillan, 2008).

consequences of their actions. Therefore they have a tendency to act less carefully than they otherwise would, leaving another party to bear some responsibility for the consequences of those actions.¹⁶ Moral hazard is generally considered in the literature as ensuing from ex-post information asymmetry. This too can be mitigated by underwriting iron-clad covenants in the financial contract.¹⁷

- f. Agency Cost of Debt: This refers to distortions in managerial decision making that are caused by conflicts of interest between stockholders and bondholders. This issue can be sub-divided into two separate problems described as follows: First, when firms are debt financed, manager-entrepreneurs have an incentive to transfer downside risk (of project) to the financiers while benefiting from the upside potential. This is a well-known problem of risk-shifting or asset substitution. A number of studies such as Smith and Warner and Barclay and Smith have illustrated that risk management through the use of secured debt alleviates this issue.¹⁸ The second is associated with debt financing, referred to as the under-investment problem.¹⁹ Here entrepreneurs are motivated to reject profitable (i.e., positive Net Present Value) investment proposals if the wealth enhancement associated with the project accrues mostly to financiers. Bodie and Taggart, Schnabel and others have argued that innovative instruments such as participating/convertible debt can be employed to mitigate this issue.²⁰

3. The Classic *Murābaḥa* and its Derivatives

The classic or the historic *murābaḥa* involves a simple sales transaction based on credit, whereby the seller declares his cost and profit. *Murābaḥa* sales are described in the well-known book of Prophetic traditions (*ḥadith*), the *Muwatta* of Mālik ibn Anas (d. 795 CE). The jurists (*fuqahā*) generally permit the credit sale of goods, which are classified as

16 Yehuda Kotowitz, "Moral hazard". In Steven N. Durlauf, and Lawrence E. Blume (Eds.), *The New Palgrave Dictionary of Economics* online, Palgrave Macmillan.

17 Clifford W. Smith, and Jerold B. Warner, "On financial contracting: An analysis of bond covenants", *Journal of Financial Economics* 7 (1979): 117-161.

18 Michael J. Barclay, and Clifford W. Smith, "The Priority Structure of Corporate Liabilities", *Journal of Finance* 50 (1995): 899-917.

19 See Stewart C. Myers, "Determinants of Corporate Borrowing", *Journal of Financial Economics* 5 (1977): 147-175.

20 See Zvi Bodie and Robert A. Taggart, "Future Investment Opportunities and the Value of Call Provision on a Bond", *Journal of Finance* 33 (1978): 1187-1200. Jacques A. Schnabel. "An Agency-Theoretic Perspective on Participation Clauses in Loan Contracts," *Journal of Business Finance and Accounting* 20 (1993): 133-142.

ghayr-ribawī (i.e., non-usurious). They rationalise this using the Qur’ānic verse: “God has permitted trade (implying credit sales) and forbidden *ribā* (implying usury)”.^{21, 22} Financial economists, however, rationalise the permissibility of credit sales (in the Qur’ān and Sunna) to the absence of financial markets in the era of the Prophet (PBUH) and the Pious Predecessors. This is due to the fact that “when financial markets are imperfect, a seller can find it optimal to offer a menu of deferred payment plans”.²³

The banking *murābaḥa*, in contrast to the classic one, is used as a financing tool instead of extending credit by a merchant to enhance the demand for his goods. This facility along with its derivative (called *tawarruq*, structured using a banking *murābaḥa* in conjunction with a simultaneous sale of the real asset purchased through it) can be critiqued as stratagems to bypass the injunction of *ribā*.²⁴ This is because they are employed purely in the financial sector of the economy.

The classic *murābaḥa* is priced employing the price elasticity of demand of the good being sold in conjunction with the expected rate of return of the merchant.²⁵ In contrast, the banking *murābaḥa* along with *tawarruq* are priced primarily using a *ribawī* index due to the global integration of capital markets. This implies that, in the contemporary era, the banking *murābaḥa* and *tawarruq* are not free from the “vapours of *ribā*.”

Comparing the attributes of *ribawī* debt to that of *murābaḥa*, we realize the following:
First, *murābaḥa* reduces adverse selection, as the “seller” of goods is aware of exactly where his resources are expended.²⁶

Second, *murābaḥa* reduces the agency cost of debt as it is collateralized.²⁷

Third, *tawarruq* is akin to a non-collateralized *ribawī* loan. It therefore suffers from adverse selection as well as high agency cost of debt. This results in a high cost of funding, and therefore yields low debt capacity. It is construed as a stratagem to thwart the spirit of

21 See Q2: 275.

22 See Al-Zuhailī Supra note 7.

23 Arijit Sen, “Seller Financing of Consumer Durables”, *Journal of Economics and Management Strategy* 7 (1998): 435–460.

24 Mahmoud A. El-Gamal, *Islamic finance: Law, economics, and practice* (Cambridge: Cambridge University Press, 2006).

25 Muhammad Rashid, and Devashis Mitra, “Price Elasticity of Demand and an Optimal Cash Discount Rate in Credit Policy”, *Financial Review* 34 (1999): 113-125.

26 Rajesh K. Aggarwal, and Tarik Yousef, “Islamic Banks and Investment Financing”, *Journal of Money, Credit and Banking*, 32 (2000): 93-120.

27 Supra notes 17 and 18.

the Sharīʿa and is being subject to censure from some scholars. Ibn Qayyim Al-Jawziyya, a prominent Jurist, expresses the opinion of his mentor (Ibn Taymiyyah,) on this issue as follows: “Our teacher (God bless his soul) forbade tawarruq. He was challenged on that opinion repeatedly in my presence, but never licensed it (even under special circumstance). He said: “*The precise economic substance for which ribā was forbidden is present in this contract, and transaction costs are increased through purchase and sale at a loss of some commodity. Sharīʿa would not forbid a smaller harm and permit a greater one!*”²⁸

Fourth, for credit worthy customers, both classic as well as banking murābaḥa will not be onerous. That is, in general, it will not extricate wealth of either party to the contract. However, it will be onerous to the less credit worthy customers, eventually leading to their financial exclusion.

Fifth, a banking murābaḥa will be more expensive than a ribawī debt contract due to reduced economies of scale and the incremental expenses of documenting the subterfuge, i.e., paying Sharīʿa scholars for their approval, etc. Currently, penalties are also imposed on late payments to alleviate moral hazard in violation of the Qurʾānic verse, which asks lenders to give respite to borrowers.²⁹ This leads one to question the efficiency of these vehicles.

Sixth, both murābaḥa facilities (along with tawarruq) are fragile ones even though the Sunna (in case of the two murabaha facilities) allows the “seller” of goods (i.e., lender) to retrieve his goods (i.e., the underlying collateral) upon the bankruptcy of the “buyer” of goods (i.e., borrower).

Seventh, murābaḥa facilities (along with tawarruq) are at the lowest rung of pareto-efficiency in accordance with the criteria of Ebrahim and Hussain.³⁰ This leads one to question the efforts of the late Sami Hassan Hamoud and the contemporary Ulema consenting to the employment of the inefficient banking murābaḥa and tawarruq contracts imitating ribawī contracts. This is also ostensibly in violation of the Prophetic injunction, “He who introduces some evil practice in Islam which is subsequently followed (by others) would be

28 Muhammad Ibn Qayyim al-Jawziyyah, *A'lam al-muwaqqi'in 'ala rabb al-'alamin*, (Beirut: Dar Al-Jeel, 1973), Vol 3, 170. See also Haneef, Supra note 1. Habib Ahmed and Nourah Mohammad Aleshaikh, “Debate on Tawarruq: Historical Discourse and Current Rulings”, Arab Law Quarterly 28 (2014): 278-294.

29 Q(2: 280).

30 Supra note 13.

required to bear the burden of those who followed this (evil practice), without theirs being diminished in any respect”.³¹

Nonetheless, the classic *murābaḥa* still serves an economic purpose. That is, it expands the demand for goods in the real sector of the economy for credit worthy clients. For the less credit worthy ones, efforts must be made to incorporate charitable funds (in the Islamic financial intermediation system) to alleviate their burden. This is illustrated in our discussion of *Qard Ḥasan* (Gratuitous Loan) in Section 5 given below.

4. *Ijāra* (Leasing)

Leasing or renting an asset is a useful tool for people or businesses who do not wish to expend cash at the onset of a project, or acquisition, and which is preferable to *ribā* based financing.³² It is applied to computers, telecommunications equipment, office equipment, rail cars, trucks and aviation, and even for home acquisition in the ‘lease to own’ contract. It generally makes economic sense to lease depreciating assets and own appreciating assets.

The ideal Islamic lease is similar to a closed end or operating lease in the US, in which the lessor owns title to the asset and the lessee has the right to use the asset for a specific period. The lease payments depend upon the type of asset, the lease period, the residual value of the asset, the tax regime, the expected rate of return, and the incorporation of various real options in the indenture of the contract.³³

The main difference between an Islamic lease and a *ribawī* lease is that the lease payments are evaluated using an expected rate of return. The realized returns could be different depending upon the use or abuse of the asset by the lessee, and the market conditions for the disposal of the asset at the end of the lease term. These risks are borne by the lessor.

Leasing is a highly competitive business. Islamic banks not only must compete with mainstream (i.e., *ribawī*) banks, but also with manufacturers who entice buyers with low lease payments in order to increase sales during recessions. With most mainstream

31 See Abdul Hamid Siddiqi, *Sahih Muslim-Translation* (New Delhi, India: Kitab Bhavan, 1986), IV: 1405-6 (Chapter 1115, Hadith Number 6466).

32 Andrea L. Eisfeld, and Adriano A. Rampini, “Leasing, Ability to Repossess, and Debt Capacity”, *Review of Financial Studies* 22 (2009): 1621-1657.

33 Stewart C. Myers, David A. Dill and Alberto J. Bautista, “Valuation of Financial Lease Contracts”, *Journal of Finance* 31 (1976): 799-819. John J. McConnell, and James S. Schalleim, “Valuation of Asset Leasing Contracts”, *Journal of Financial Economics* 12 (1983): 237-261. Steven R. Grenadier, “Leasing and Credit Risk”, *Journal of Financial Economics* 42 (1996): 333-364.

institutions, the true costs of leasing are often higher than the payments, as the lessee may be required to assume 100% of the residual market risks, and the lessor's acquisition costs at the term of the lease. These risks transfers in the west are not always well defined in lease contracts, and ensure high returns on the capital of leasing companies.

Contrasting the attributes of ribāwi debt with that of ijāra, we realize the following: First, for credit worthy customers, the ijāra payments will not be onerous. That is, in general, it will not extricate wealth of either party to the leasing contract. However, it will be onerous to the less credit worthy customers leading to their financial exclusion.

Second, ijāra facilities are fragile even though the Sunna allows the lessor to repossess the leased asset on default of the contract.

Third, leasing can be onerous to the less credit worthy customers eventually leading to their financial exclusion.

Comparing ijāra with secured “Islamic” debt (such as banking murābaḥa) we realize the following: One, ijāra is a substitute for debt financing.³⁴

Two, it involves stronger claims than secured lending.³⁵ This is attributed to the alleviation of asymmetric information and the ease of repossession of leased asset on default. This results in lower cost of funding and thus more debt capacity.

Three, ijāra is subject to monitoring costs, which in the case of some durable goods (such as automobiles) can be trivial³⁶ and can be more expensive in others.³⁷

In conclusion, we rank the traditional commercial “Islamic” debt instruments of murābaḥa, tawarruq and ijāra as follows. Ijāra is slightly more efficient than murābaḥa, followed by tawarruq. Nonetheless, in the nomenclature of Ebrahim and Hussain, these vehicles would still be classified at the lowest rung of economic efficiency.³⁸ From the perspective of the Sharīʿa, they still do not give respite to the users of funds and thus convey fragility to the economic system.³⁹ The only way to reduce (but not completely eliminate)

34 An Yan, “Leasing and Debt Financing: Substitutes or Complements?” *Journal of Financial and Quantitative Analysis* 41 (2006): 709-731.

35 *Supra* note 32.

36 See Justin P. Johnson and Michael Waldman, “Leasing, Lemons, and Moral Hazard”, *Journal of Law and Economics* 53 (2010): 307-328.

37 *Supra* note 32.

38 *Supra* note 13.

39 This is in contrast to the Qurʾānic verse (2: 280).

this fragility is to price the facilities meticulously with an optimal loan to value and tenure, so that the Put option to default is never in the money. This is illustrated in Ebrahim.⁴⁰

5. Qard *Hasan* (Gratuitous Loan):

The intuition behind the employment of this stems from the Qur'ān, which exhorts Muslims to lend without interest, classifying it as a loan to God Himself.⁴¹ This is reinforced in the *hadīth* of the Prophet Muhammad, which ranks interest free loans higher than voluntary charity (*sadaqa*).⁴² The shaykh al-Islām Ibn Taymiyya emphasised the contrast made in the Qur'ānic verse between charity and *ribā*.⁴³ The inference drawn from the verse is as follows: *ribā* alienates the segments (or classes) of society (due to its potential to expropriate assets as stated earlier), while charity unifies them.

Islamic charitable endowments or trusts (termed as *waqf*; plural: *awqāf*) have a vital role to play in uplifting the economic status of the underprivileged masses, by providing them access to gratuitous loans. This blends features of philanthropy with social service and is reinforced by prominent economists such as Green, Kirkpatrick and Murinde, as cited below:⁴⁴

The profound argument made by Stiglitz (1994) is that market failure is a fundamental cause of poverty and financial market failures, which mainly arise from market imperfections, asymmetric information and the high fixed costs of small-scale lending, limit the access of the poor to formal finance, thus pushing the poor to the informal financial sector or to the extreme case of financial exclusion. In addition, it is argued that improving the access of the poor to financial services enables these agents to build up productive assets and enhance their productivity and potential for sustainable livelihoods (World Bank 2001). Hence the bottom line argument is that improving the supply of financial services to the poor can directly contribute to poverty reduction (Jalilian and Kirkpatrick, 2002).⁴⁵

40 Muhammed Shahid Ebrahim, "Can an Islamic Model of Housing Finance Cooperative Elevate the Economic Status of the Underprivileged?" *Journal of Economic Behavior and Organization* 72 (2009): 864-883.

41 See Q2:245, 5:13, 57:11, 57:18, 64:17 and 73:20.

42 See Sunan Ibn Mājah, Book of *Aḥkām*, Chapter on Loans.

43 See Q2: 276-77 and 30:39.

44 Christopher J. Green, Colin H. Kirkpatrick and Victor Murinde, "How does finance contribute to the development process and poverty reduction?" in Christopher J. Green, Colin H. Kirkpatrick and Victor Murinde (Eds.), *Finance and Development: Survey of Theory, Evidence and Policy* (Northampton: Edward Elgar, 2005): 19.

45 Joseph Stiglitz, "The role of the state in financial markets" in *Proceeding of the World Bank Conference on Development Economics* (Washington, D.C., World Bank, 1994): 41-46. World Bank, *World Bank Development Report 2000/2001: Attacking Poverty* (New York: Oxford University Press, 2001). Hossein

Thus, our proposal of blending philanthropy with social service is classified as a rebirth of the waqf model from the perspective of Bremer, who elaborates it as follows:

Charities have played many critical functions in Islamic societies and have contributed to making these societies more just and fair through a number of mechanisms, in addition to the obvious one of providing service to the poor. Over and above their role in delivering services, Islamic charities served as a mechanism for narrowing social distances and reducing inequalities. Charities have particularly, served as a bridge between the haves and have-nots. They have provided a means by which the wealthier elements of society interact with poor individuals, come to know them as individuals, and recognize their obligations to assist them in combating poverty, its causes and effects. This linkage helps to keep low-income groups from becoming isolated from the social mainstream, strengthening the overall social order.

Charities, particularly awqaf, provided a source of support for institutions and interest groups independent of, and sometimes in opposition, to the state.

Islamic charities historically have played an additional role in society, that of promoter of decentralized economic development. Whether the charity is a waqf in the medieval Levant establishing commercial centers or building a khana for travelling business people, or an Indonesian zakat-funded charity teaching *business management skills in today's Indonesia*, Islamic charities have been actively engaged in economic development for centuries. In this respect, they reflect the blending of the religious and the secular, the social and the economic, that is the key characteristic of the Islamic idea.⁴⁶

She explicates the last sentence further in a footnote as follows:

This combination can be found present in the West in urban development-oriented civil society, as well, such as pro-poor non-profits that address inner-city economic development and civic business associations that promote the development of their respective cities. Generally, however, the mix of economic development and social service with charity is much more developed in the *tradition of Islamic charities than in the more "purely" charitable tradition of Western society.*⁴⁷

Jalilian, and Colin Kirkpatrick, "Financial development and poverty reduction in developing countries", *International Journal of Finance and Economics* 7 (2002): 97-108.

46 Bremer, J., "Islamic philanthropy: Reviving traditional forms for building social justice". Paper presented at the CSID fifth annual conference on "Defining and Establishing Justice in Muslim Societies" in Washington, District of Columbia (2004): p. 5-7.

47 Ibid, Footnote 4, p. 7.

The above illustrates the importance of integrating charitable funds in the Islamic financial architecture. However, it is not an easy task, as there are very few studies illustrating: (i) the structure of institutions (such as a finance cooperative) and the pricing of the underlying *qard ḥasan* facilities;⁴⁸ and (ii) open market operation by the Malaysian Government using this interest free facility in conjunction with paying an extraneous amount out of one's free will (e.g. as gifts - *hiba*) allowed in the Sunna.⁴⁹

The difficulty behind the integration of charitable funds in the Islamic financial intermediation stems from the following.

- a. Adverse Selection: How will the funds disbursed through this facility be expended? This is a crucial issue, as ex-ante controls are needed to ensure that funds are expended for the purpose requested. In Ebrahim, a *qard ḥasan* mortgage is issued only at the time of escrow when the title of the specific property is exchanged for cash.⁵⁰
- b. Moral Hazard: What control mechanisms are needed to ensure that the underprivileged borrower does not change his/ her behaviour after receiving the facility? This is another important issue for ex-post monitoring of borrower. In Ebrahim, this was accomplished via a financial cooperative, where peer pressure on borrower along with a lien on a home ensures payment on the mortgage on time.⁵¹ Furthermore, the following are also mandated in the mortgage covenant – (i) minimum maintenance on the home purchased; (ii) payment of taxes; and (iii) adequate liability insurance coverage.
- c. Financial Fragility: How do we avoid default in this facility? This is one more issue which needs to be addressed. It should be noted that in a *qard ḥasan* facility, the underinvestment issue discussed in Myers is not a problem.⁵² However, the risk or

48 See Ebrahim, Supra note 40. See also Murizah O. Salleh, Aziz Jaafar, and Muhammed Shahid Ebrahim, "Can an interest-free facility be more efficient than a usurious payday loan?" *Journal of Economic Behavior and Organization* 103 (2014): 74-92.

49 See Ali F. Darrat, A.F., and Muhammed Shahid Ebrahim, "On the Design of Interest-Free Instruments", *Journal of King Abdul Aziz University: Islamic Economics* 8 (1999): 51-60.

50 Supra note 40.

51 Ibid.

52 Supra note 19.

asset substitution issue of agency cost of debt is of concern. This requires meticulous pricing to ensure that the Put option to default does not go in the money.⁵³

- d. Economic Efficiency: How do we structure this facility to be economically efficient or even neutral (but not inferior) over *ribawī* as well as other “Islamic” debt facilities? This is a key issue of concern. Nonetheless, if *qarḍ ḥasan* is structured in an economically inefficient way, we can never incorporate it in the Islamic financial architecture. In Ebrahim, a *qarḍ ḥasan* mortgage, issued through a financial cooperative, is illustrated as efficient over a *ribāwī* mortgage (and therefore over a banking *murābaḥa* or a *tawarruq* too).⁵⁴ Our results are in harmony with Haneef, who states that “*tawarruq* is a highly profitable business for the Islamic finance industry...Naturally, the industry players are all keen to promote this form of financing to reap the huge margins.”⁵⁵ Prior to the development of financial cooperatives employing the ROSCA (Rotating Savings and Credit Associations)/ASCRA (Accumulating Saving and Credit Association) technology, it was difficult to offer a *qarḍ ḥasan* facility. *Tawarruq* was thus legitimized “based on social utility (*maṣlaḥah*)”.⁵⁶ With the current advancement of financial technology, there is no excuse for the Muslim world to resort to the inefficient *tawarruq* facility.

Thus, the dire economic state of the Muslim world necessitates the precise structure of financial cooperatives employing *qarḍ ḥasan* to allay poverty.

6. Conclusions:

There is nothing sacrosanct about the traditional Islamic debt facilities of *murābaḥa* and *ijāra* per se except that they were employed in the era of the Prophet and that of the Pious Predecessors.⁵⁷ The exception is that of *qarḍ ḥasan* which is recommended in the *Sharīʿa*. The first two facilities are still endowed with the potential to: (i) expropriate the assets of the counterparty to the contract; (ii) convey fragility to the financial system; and (iii) exclude the underprivileged from financial services. In contrast, the last facility also suffers

53 See Ebrahim, *Supra* note 40, for a description of a mathematical model (i.e., an algorithm) to reduce the risk of default.

54 *Ibid.*

55 *Supra* note 1, 24.

56 *Supra* note 1, 21.

57 See Monzer Kahf, and Tariqullah Khan, “Principles of Islamic Financing: A Survey”, Research Paper No. 16, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, Saudi Arabia (1992).

from the above issues (i) and (ii). The banking *murābaḥa* and its adaption in the form of *tawarruq* are mainly a *Sharīʿa* arbitrage.⁵⁸

The classic *murābaḥa*, banking *murābaḥa* and *ijāra* reduce adverse selection and need monitoring mechanisms to be set in place to reduce moral hazard. In contrast, *tawarruq* needs mechanisms to control for both adverse selection and moral hazard.

In terms of economic efficiency, we would rank *ijāra* over both forms of *murābaḥa* and *tawarruq*. *Qarḍ ḥasan* needs to be incorporated in the Islamic financial intermediation system to alleviate financial exclusion. It should be preferred over the controversial *tawarruq* facility. However, it should be structured meticulously via financial cooperatives to mitigate adverse selection, moral hazard and risk shifting. The efficiency of the traditional debt facilities of *murābaḥa* and *ijāra*, however, pales over that of the modern hybrid facilities discussed in Ebrahim, Salleh and Sheikh.⁵⁹ This is because hybrid facilities are in the rung above the traditional Islamic debt facilities from the perspective of Ebrahim and Hussain as they resolve the agency cost of debt better than the traditional commercial facilities.⁶⁰ They also alleviate the issue of fragility, as they are capable of bestowing respite to borrowers in poor states of economy in accordance with the Qurʾānic guidance.⁶¹

To conclude, the infatuation with the medieval Islamic instruments does not bode well for the Muslim world as the inefficiencies in intermediation will not extricate the same from its current morass. Drastic steps are needed to understand the magnanimity of the economic problems and to ‘fix’ them scientifically by employing the latest financial technology consistent with the *Sharīʿa*.

58 Supra note 24.

59 Supra note 12.

60 Supra note 13.

61 Q2: 280.