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In The Name of Allah,
The most Beneficent, The most Merciful

"O Believers: devour not Riba, doubled and redoubled;

and fear Allah, in the hope that you may get prosperity."

Sura Ale-Imran (verse No. 130)

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C O N T E N T S


روح افزا
PAKISTAN
SHARBAT
ROOH AFZA
اور کیا چاہیئے!

Editor's Note

Islamic banking has established its identity in the challenging times. It is however essential to develop a comprehensive and well established Islamic financial system consisting of a wide range of products and services, a good legal system, adequate financial infrastructure with competitive tax structure, low cost of doing business and high standard of business ethics. This would however requires commitment from policy makers as well as Bank's Management and significant investment in human resources, innovation remains imperative for growth of the industry that requires qualified and trained HR to man this growth, in this respect programs like this are step in the right direction but will have to be significantly intensified.

The proper implementation of Shariah and Islamic Economic System is the responsibility of every Muslim, when we try to become true Muslim and understand the soul and message of Islam, we would not face difficulties in the way of implementation of Islamic economic system in the period of globalization.

Islamic banking is no longer a niche market but an integral component of Global Financial System. The Global Islamic Finance has witnessed significant progress attracting both Muslim and non-Muslim clients with Middle East & Asia being the largest Islamic Financial Markets, many developed non-Muslim countries including USA, UK, Korea, Luxembourg, Singapore and China are gradually recognizing Islamic finance as an alternative and viable financial system. It is reported that approximately U$ 2 trillion industry present in over 75 countries, includes Australia, France, UK, Hong Kong, Singapore, Luxemburg, South Africa, Sri Lanka and Malaysia. The significant growth of Islamic finance is reflective of increasing acceptability of its merits, the globalization of Islamic finance will further increase in coming years as it has the capacity to fill in the gaps where the conventional finance has fallen short off. The past global financial crisis has exposed the fundamental deficiencies of the conventional banking system. It has offered an opportunity to the Islamic financial industry to reflect on its practices during the global financial crises, the Islamic financial sector less affected than conventional banking system. Islamic Banking in Pakistan has witnessed significant growth during the last decade and now constitute over 10 percent of the country's banking system reported with an assets based over Rs. 900 billion a network of more than 1100 branches. This expansionary trend is likely to continue and the industry is expected well set to double in market share by 2020.

Islamic Banking industry has always strived to appropriate solution to every business not only in accordance to their financial needs but also to organize their business practices aligned to Shariah guidelines.

This issue of Journal of Islamic Banking & Finance documents scholarly contributions from authors around the globe. Scholarly contributions in this current issue discuss the theoretical underpinnings of an Islamic economy, contemporary issues in Islamic finance and performance based empirical studies on Islamic banking and finance. Below, we introduce the research contributions with their key findings that are selected for inclusion in this issue.

The first paper is on "Cotton Industry of Pakistan – How to execute a Murabaha Transaction with an Islamic Bank?". The article by Usama bin Tariq explains the practical steps that are followed to execute Murabaha transaction in Cotton Industry of Pakistan. The paper focuses on the business practices of the cotton industry and the anomalies (as per Shariah) present in the system and the role of Islamic Banks to revolutionize the methodology. The paper is useful attempt to inform about how Islamic contracts are executed in practice and what challenges and obstacles may have to be faced in practical applications of Islamic contracts.

This second article is on "Muslim's Awareness and Willingness to Patronize Islamic Banking in Kazakhstan". The primary data based research survey conducted by Muhamad Abduh and Daniyar Omarov sought to know the awareness and willingness of Muslims in Kazakhstan for using Islamic banking. A total number of 300 respondents from different cities of Kazakhstan were selected for responses to a set of questions were asked in structured questionnaire. Descriptive analysis methods were adopted to analyze the results. The results show that more than half of the respondents are aware of Islamic banking in Kazakhstan, but they are not aware of most of the products and services offered by Islamic banks. Interestingly, despite the moderate level of Muslim Kazakhs understanding towards Islamic banking concepts, the willingness level of using Islamic banking products and services is high.

The third article is on "The Dynamics of Macroeconomics variables and the Volatility of Indonesia Stock Markets: Evidence from Islamic and Conventional Stock Markets". The empirical study by Muhamad Abduh and Miftakhus Surur aimed to investigate the impact of the movement of macroeconomic variables upon the Indonesia stock markets. They used the vector error correction model to investigate the research question. The macroeconomic variables employed in the study were exchange rate, economic growth, and inflation for the period of January 2003 to December 2010. The result showed that in the long run, the performance of the stock markets is negatively influenced by exchange rate and positively influenced by industrial production index. Interestingly, inflation is found to be significant only for conventional stock markets with negative relationship.

The next article is on "Measurement of Efficiency and Soundness of Islamic Bank Using Two-Stage Data Envelopment Analysis and Modified Camels". The empirical research by Muhammad Faza Firdaus and Muhamad Nadratuzzaman Hosen measures the efficiency of Islamic Bank in Indonesia and to analyze the factors that affect the level of efficiency. The noted scholars use Two-Stage Data Envelopment Analysis method. The empirical results of the study show that the efficiency levels of Islamic banks in Indonesia during the time period in this study have not yet reached the optimum level of efficiency.

Following fourth article, the next article is “Adoption of AAOIFI Shariah Standards: Case of Pakistan”. AAOIFI is one of globally recognized international bodies that prepare Shariah based accounting, auditing, governance, ethics and Shariah Standards for the Islamic financial industry. AAOIFI based standards are generally considered to be globally acceptance and are adopted in various jurisdictions of the world.

The sixth article is on “Investment of Zakat Fund: Modern Juristic Debate and Modes of Financing”. The theoretical study by Dr. Sayed Sikandar Shah discusses the possibility of investing Zakat funds from legal, economic and fiqhi point of view. The author provides an extensive literature review. The author highlights the importance of reviving socio-economic role of Zakat funds via its productive use for the benefit of its designated recipients. The author discusses two sides of the debate. One pertains to its legislative validity in the frame of Islam and the other is about the viable operational framework towards such end where neither the immediate needs of the poor and needy are neglected nor the original funds are lost. Through citing various fiqhi principles, Ahadith and opinion of jurists, the author recommends that investment of Zakat funds is possible and it will make the use of Zakat and effects more productive than the case now.

Moving ahead, the next article is on “Consumer Behavior & Marketing: Islamic Perspective”. Describing the micro economic theory of Consumer Behavior, Salman Ahmed Shaikh explains the normative basis of Islamic economics in general and elucidates consumer theory from Islamic perspective in particular. He notes that on the demand side, Islamic worldview based on oneness of God and afterlife accountability greatly influences the decisions, actions and choices of the consumer. He discusses how Islam places certain balancing limits on consumer choice set and budget constraints for greater welfare of the consumer himself and society in general. The author explains that on the supply side, what are the guiding principles and norms marketers must follow in product design, advertising and promoting their products. The author critically discusses the consumerism culture, its relation with credit based monetary system and its contemporaneous and intertemporal effects on environment and distribution of resources.

The eighth article is on “Re-Takaful and Its Corporate Governance”. The article by Prof. Dr. Mohd. Ma’sum Billah on Re-Takaful notes the challenges that Muslim populace face to keep itself away from interest based financial system that prevails in the world. The author highlights the importance of finding Islamic alternatives to manage various risks in contemporary challenging economic and financial landscape. The author notes that one of such key areas of modern financing where the Muslim world need a kind of economic co-operation in order to confront the challenges posed by western interest based financial system is Re-takaful Business. The author opines that modern day risk management needs are different from yester years and there is need to find Islamic solutions to contemporary financial and economic needs for growth.

The last article is on “Islamic Microfinance – Why is it Worth Considering?”. The article by Professor Badr El Din A. Ibrahim on Islamic Microfinance raises some vital questions regarding the reasons for the meager coverage of Islamic microfinance in Islamic countries despite the fact that conventional microfinance does not meet the requirements of these countries’ microfinance clients. The noted scholar shows that Islamic microfinance model is a superior one capable of solving many microfinance challenges. But, the author also cautions that Islamic microfinance (despite its merits) has a very weak spread and not-market-oriented in most cases. The author suggests workable Islamic microfinance model, on the basis of the successes that governed some sustainable institutional Islamic microfinance experiences.

Disclaimer

The authors themselves are responsible for the views and opinions expressed by them in their articles published in this Journal.

Cotton Industry of Pakistan – How to execute a Murabaha Transaction with an Islamic Bank?

By
Usama Bin Tariq[*]

Abstract:

Islamic Banking Industry has always strived to provide appropriate solutions to every business sector of Pakistan not only in accordance to their financial needs but also to organize their business practices aligned to Shariah guidelines. Similarly, Islamic Banking has also played its role in the Cotton Sector of Pakistan to regularize the business practices in conformity to the rulings of Islamic trade. This paper shall focus on the business practices of the cotton industry and the anomalies (as per Shariah) present in the system and the role of Islamic Banks to revolutionize the methodology.

Key Word: Business practices of the cotton industry and the anomalies (as per shariah) in the system, Role of Islamic Banks to revolutionize the methodology

Cotton Overview[1]:

Cotton is Pakistan's main industrial crop grown on 15 percent of the country's arable land. Production is concentrated mainly in two provinces, Punjab and Sindh, and cultivated by 1.6 million farmers mostly with small holdings of less than five hectares of land.

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* Author: Usama Bin Tariq is a senior member of the Product Structuring and Research Unit of the Product Development and Shariah Compliance Department at Meezan Bank Limited. He holds a Masters degree in Business Administration and also is a Certified Islamic Banking Professional from PAF-KIET. His area of research includes process cycles of different industries / commodities, manages the internal knowledge portal of the bank.

1 http://gain.fas.usda.gov/Recent%20GAIN%20Publications/Cotton%20and%20Products%20Annual_Islamabad_Pakistan_4-2-2013.pdf

Pakistan is the fourth largest producer and third largest consumer of cotton, in addition to being the largest exporter of cotton yarn in the world. Cotton is the country's foremost non-food cash crop and is considered the backbone of the national economy. The cotton sector, along with the textile and apparel industry, accounts for 11 percent of GDP, and 60 percent of the country's export value, while employing 35 percent of the industrial labor force. Consequently, cotton production supports Pakistan's largest industrial sector comprised of over 400 textile mills, 1,000 ginneries, and 300 cotton seed oil crushers and refiners.

Industry Practice:

Cotton is produced in bulk in two regions of the country and goes through different cycles to ultimately turn up in the shape of Cotton Bales. Raw cotton which is unanimously known as **"Phutti"** in the local market is procured through Farmers, Growers and Landlords and also through Commission Agents itinerant in the market by the Cotton ginners which are the core buyers for this particular commodity. Following are some important areas of notice:

- ✓ **Order Mechanism**: Ginners have buying relationships with Farmers, Growers, Landlords who delivers the commodity at the doorsteps of their customers, however commission agents wander different commodity markets to help them to purchase the commodity.
- ✓ **Payment Mechanism**: Payments are usually done in advance to the suppliers or either on Spot (at the time of delivery) or on credit basis as well.
- ✓ **Delivery Methods**: As mentioned above delivery of goods is the responsibility of the supplier and they deliver the goods at the doorsteps of the buyers in their risk.
- ✓ **Measuring Units:** Commodity is available in the base unit of Mounds/Kgs and is always weighed again at the time of receipt of goods at the Ginning Units at their own weighbridge or at nearby rented weighbridge.
- ✓ **Storage Technique:** Goods are received in unwrap Form and are dumped all over the place of the warehouse in the shape of heaps depending on the quality of the commodity. Heaps are made to dry out the moisture present in the commodity, once the goods are completely dried and are ready to be used for further processing (Ginning) they mix the goods in other heaps which are much bigger in size but again after sensing the quality of the goods.
- ✓ **Ginning Process:** Immediately after the parching process goods are transferred to the ginning units to extract the cotton staple and other byproducts from the raw product.

- ✓ **Bales Production**: End product which is Cotton Bales for the ginners are produced after the completion of ginning process and stacks of different weights and quality are produced for sale in the market.

Industry's Need of Financial Assistance:

Ginners face shortage of liquidity during their peak season where extensive purchases are done and bulk processing is in process. In the absence of Islamic financial solutions they had their financial lines developed with numerous interest-based institutions or local lenders. They borrowed the funds to utilize them to facilitate their bulk purchasing or to accomplish processing cycles.

Soon after the addition of Islamic Banks in the market, the lending practices and other Non-Shariah Compliant practices had to be stopped by the ginners. Islamic financial institutions comprehended their needs and proposed alternate solutions to the market players fulfilling the requirements of Shariah.

To facilitate the need of purchasing of raw material, Murabaha[2] was proposed by the Islamic Banks to the ginners. But to execute the Murabaha transactions with their complete essence certain rules of sales were necessarily to be followed. For e.g. Existence of goods, Fixation of Price, Identification of goods, Separation of goods etc. but unfortunately the industry was practicing their business in accordance to their self defined methods which were not in accordance to the rules of trading devised by Shariah. Therefore, a Shariah Compliant transaction of Murabaha was not feasible with the presence of all those non-Shariah compliant aspects.

Anomalies in the industry norms and impediments found for Murabaha transactions as per the Shariah Guidelines of Trading:

Pakistani traders have numerous market norms which have been defined ages ago by the market players observing their own benefits and profits. These practices differ from industry to industry irrespective of their repercussions and consequences of the transactions. Similar scenarios have been seen in the Cotton Industry where the players have defined their own rules and regulations for the trade of the commodity. Some important areas which were highly acceptable to the stakeholders but are not in conformity to Shariah rulings of trade are highlighted hereunder:

1. **Payment Norm:** Payment mechanism prevalent in the market is somewhat different in comparison to the routine payment mechanisms. A market practice referred to as Mudda'a is prevalent in the industry in which the price of the commodity is not fixed/defined at the time of delivery or before delivery of goods. But in fact a rate is quoted for each day in the market of Phutti and the sellers are notified at the time of delivery of goods that price of the delivered goods shall be paid in equivalence to the rate of approaching days. For e.g. If goods are delivered

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2 Murabaha is a particular kind of sale where the seller expressly mentions the cost of the sold commodity he has incurred, and sells it to another person by adding some profit thereon. Thus, Murabaha is not a loan given on interest; it is a sale of a commodity for cash/deferred price.
(Meezan Banks Guide to Islamic Banking by Dr. Imran Ashraf Usmani)

on 6th August 2013 accordingly the price of the goods may be paid at the rate of 8th August 2013 on a credit of 2 Days.

Shariah guidelines do not allow such kind of practice for a Sale transaction. Indeed it creates a flaw in the Sale transaction and the transaction cannot be rendered as a valid transaction (Bai' Sahih)[1]. Fixation of price is a must for any sale transaction and transaction stands inapt till all the rules and conditions of sale are fulfilled. Therefore, all the transactions executed with such practice are considered as erroneous and profit rendered through these types of transactions is unacceptable as per Shariah.

2. **Mixing of goods:** Whenever Phutti is purchased it's received in Unwrap or Open form and the goods are dumped in the open air areas of the ginning units in the shape of heaps. Immediately after the completion of drying process goods are dumped into bigger heaps of similar quantity. Shariah allows that if the goods are owned exclusively by an individual or a company then the mixing of goods does not create any imperfection in the transaction, however it is necessary to define the ownership ratios of the goods if the goods are not owned in exclusivity but in joint ownership by two or more partners.

3. **Immediate consumption of Goods:** Once the moisture of the goods is dried out and the goods are present in the bigger heaps, they are considered to be as a ready product for production process. Immediately the goods are transferred to Ginning units for mechanized processes. As soon as the goods are shifted in the machines they immediately change their shape and value. This transformation of goods is considered as Consumption by Shariah and Sale is not allowed for the consumed commodity. As the subject matter for the sale was defined was Phutti but the item to be sold after consumption was not Phutti by any means. Therefore, if the transaction occurs after the start of consumption process this would not be considered as a valid transaction as per Shariah, since the goods have not been existed at the time of Sale.

Solutions offered and Implemented by Islamic Banks – A revolution for the industry:

Islamic Banks have played their role amicably to change the off-putting norms prevalent in the industry. They engaged themselves to understand the business nature and business cycles to offer them a usable structure while remaining in the sphere of Shariah and which have equally produced better results for the industry not even in economic terms but also in social terms. Some significant advancement areas were noticed which are as follows:

1. **Payment Flaws Rectifications:** Industry offers an option of Daily quote of rate by the market players. Islamic bank eyed the same and ask the buyers to consider the spot rate of the day for all the transactions either they are based on credit payment or on spot payment basis. Hence any transaction which

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[1] Meezan Banks Guide to Islamic Banking by Dr. Imran Ashraf Usmani

shall be executed it will fulfill the basic ruling of Shariah to fix the price of the commodity at the time of Sale.

2. **Identification of goods:** Whenever the goods are placed in heaps its mandatory for the buyer to place the goods in accordance to their purchase due to quality issues. Islamic Banks advised them to not to mix the goods with other goods till the execution of Sale contract between bank and the customer. Since the goods are not mixed with other goods and are present in separated form and identical in nature therefore, the flaw for the mixing of goods was also detached from the transaction.

3. **Immediate consumption of goods:** Usually goods are not being sent for ginning process if the required quantity for the production is not completed and it's very difficult to arrange the complete quantity of goods before the mixing of goods from different purchases. Since the goods are sold to the buyer by the bank before the mixing in the customer owned goods therefore the doubt of consumption was abandoned. However, if the goods are received in ample quantity which is enough for the start of production in such case Islamic Banks and customer have to execute the transaction before the start of consumption process. Customers had been advised to immediately inform the banks and complete the transaction where the banks shall sell the goods to customers and transfers the risk of the goods to customers therefore they can consume the goods as per their needs.

Conclusion:

The world considers Islamic Banking as a Banking of ethics and good morals. Islamic Banks have always helped the humanity to better their social and financial practices. A huge number of Pakistani businesses are not following the ethical practices for their businesses. Soon after the addition of Islamic Banks in the market ethics have been formally introduced to each industry which is associated with Islamic Banks. We can see this transformation towards a better society with improved ethical behaviors and superior business market with justified business methods.

Muslim's Awareness and Willingness to Patronize Islamic Banking in Kazakhstan

By

Muhamad Abduh & Daniyar Omarov[*]

ABSTRACT

Islamic banking was an abstract concept until the first half of the twentieth century. In Kazakhstan, it has been only three years since the first Islamic bank made its debut. Islamic banks have to compete with their rival, conventional banks, which have far longer history than Islamic banks. This competition urges Islamic banks to know the awareness and willingness of Muslim in Kazakhstan upon them. The purpose of this research is to examine the level of awareness and willingness of Muslims to patronize Islamic banking in Kazakhstan. Thus, a total number of 300 respondents from different cities of Kazakhstan were collected and descriptive analysis methods were adopted. The results show that more than half of the respondents are aware of Islamic banking in Kazakhstan, but they are not aware of most of the products and services offered by Islamic banks. Interestingly, despite the moderate level of Muslim Kazakhs understanding towards Islamic banking concepts, the willingness level of using Islamic banking products and services is high.

Keywords: Islamic banking, awareness, willingness, Kazakhstan

Introduction:

Kazakhstan, officially known as the Republic of Kazakhstan is a country in Central Asia. The ninth largest country in the world by land area which consisting of 2,727,300 square kilometers. It is larger than Western Europe and it shares boundaries with Russia, China, Kyrgyzstan, Uzbekistan, Turkmenistan and significant part of the Caspian Sea. With 16.6 million people in 2012[2] Kazakhstan has the 62nd largest population in the world. Since the 8th century, Islam has been the religion of the Kazakh people.[3]

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* Author: Muhamad Abduh, Head of Research/Assistant Professor at IIUM, Institute of Islamic Banking and Finance, Malaysia

Daniyar Omarov: PhD Student, IIUM, Institute of Islamic Banking and Finance International Islamic University Malaysia

2 Statistical Agency of Kazakhstan, retrieved 26 march, 2012

3 Kazakhstan department of Religion Council's report, 2012

The financial system of the Kazakhstan is dominated by the banking sector, which consist of 26 locally owned commercial and 11[4] foreign owned commercial banks and one foreign owned Islamic bank.[5] Since 1993, the Kazakh banking system has been arranged into two tiers, the National Bank of Kazakhstan (NBK) comprising the first tier and all commercial banks comprising the second tier (National Bank of Kazakhstan, 2012). The NBK is an independent financial institution and its main objectives contain control and regulation of the banking sector, and maintenance of the national currency.

The move to establish Islamic banking in Kazakhstan began in January 2010 with signing of a Memorandum of Understanding between Government of United Arab Emirates and the Government of Kazakhstan. As a result, Al Hilal Islamic Bank was established and registered as a legal entity. According to Mr. Prasad Abraham, Chairman of the Al Hilal bank, sharing the Bank's plans, said: "Al Hilal Bank entered the Kazakhstan market with a plan to finance large public companies. Furthermore, by virtue of the high interest and patronage from consumers the Bank is planning to start funding of private companies and individuals in the future".[6]To create and implement the first Islamic bank there was a need to make changes and amendments to the Civil and Tax Code, as well as in the regulations that govern the scope of banking services in Kazakhstan.

However, the introduction of Islamic finance in Kazakhstan is not without a number of challenges. The first is its operation in a dual banking environment. As such, the nascent Islamic finance will have to compete with the already established conventional banks, using the same regulation. The second challenge is the paucity of well-trained Islamic finance experts. This is one of the challenges facing the Islamic finance throughout the world and Kazakhstan cannot be different. The third challenge is the lack of awareness of citizens about Islamic finance which results in its low adoption.

The third challenge is the most significant challenge faced by a country which newly introduces Islamic banking. Thus, this study is aimed at investigating the awareness and willingness of Muslim in Kazakhstan to deal with Islamic banking products and services and is expected to be able to provide recommendations for practitioners and policy makers on how to prepare a better marketing approach of Islamic banking products and services.

The structure of this paper is as following. Part one provides the introduction to explain the needs of doing this study and part two shows previous related studies. Part three will discuss the data and methodology and continued by finding and discussion in part four. Finally, the conclusion and suggestions are drawn in the last part of this paper.

Literature Review:

Lateh et al. (2009) examined the perception of the customers towards the objectives, characteristics and criteria of selecting an Islamic bank in Thailand. They found that most of the Thai customers were aware of the special characteristics of Islamic

4 National Bank of Kazakhstan, 2012

5 Kazakhstan financial authority, 2012

6 Interview with Prasad J. Abraham, Capital Business Newspaper, 2012

banking system and is different from the conventional banking system, like the forbidden of taking interest. However, the study concluded that Thai customers have little awareness about Islamic banking products and services.

Khattak and Rahman (2010) and Okumus (2005) found that the customer's awareness level towards Islamic banking products in Pakistan and Turkey is good in some of the general products like current accounts and time deposit account. However, for some of the Islamic banking products such as *Murabahah* and *Ijarah*, most of the customers are unaware of them. According to Thambiah et.al (2011), Islamic banking terms such as *Mudarabah, Bai Bithaman Ajil and Bai Al-inah* appeared to be less popular among the bank customers. The reason for low awareness and usage for individual borrowing products might be due to the fact that Islamic banking products are named in Arabic terms.

Khan et al. (2008) examined the awareness and usage of various Islamic banking products and services among Islamic bank customers in Bangladesh. The results have shown that there is a high level of customer awareness of some general products such as current account and saving account. On another occasion, Rammal and Zurbruegg (2006) studied the awareness of Australian Muslims on Islamic banking products, especially the demand for profit-and-loss sharing agreements. They found that in general there is a lack of awareness on the knowledge of the basic rules and principles of Islamic banking. Thambiah et al. (2011) analyzed the awareness of the urban and rural banking customers in Peninsular Malaysia on Islamic retail banking products and services and concluded that generally there is a different level of awareness on Islamic banking products and services between urban and rural banking customers.

With regard to religion, Haque et al. (2009) argued that perception about Islamic banking is also being influenced significantly by religious perspective. This means that religious factors do influence the awareness, understanding and perceptions of bank customers towards Islamic banking products and services. Bley and Kuehn (2004) conducted research in UAE and concluded that Muslim students are more interested and knowledgeable in Islamic banking as compared to non-Muslims. In the case of Malaysia, results from Ahmad and Haron (2002) and Loo (2010) had shown that the non-Muslims still do not understand the concept of Islamic banking even though there are a lot of advertising campaigns had been addressed to them. However, for Muslims, 100 percent of them agreed that they understand the concept of Islamic banking system.

In term of the age factor, Khattak and Rehman (2010) results had shown that the awareness of the Islamic banking products varied among different groups in Pakistan. Majority of the customers that are aware of Islamic banking ranged between the ages of 21 to 40 years. However, Amin (2007) concluded that Malaysian customers are homogenous in terms of their "awareness and usage" as corroborated by age. In the case of Bangladesh, Khan et al. (2008) found that the age of the majority of the customers patronizing Islamic banking ranged between 25 to 35 years old. The reason for high awareness in the "25 to 35 years" category, 58 percent, might be due to the relatively short history of Islamic banking in Bangladesh, which was started in 1983.

According to Khattak and Rehman (2010), occupation and reasons for dealing with Islamic banking has a significant relationship. In Bangladesh, most of the Islamic banks customers are executives and professionals both in the private and public sector (Khan et al., 2008). In Malaysia, a study by Haque et.al (2009) also revealed that there is significant relationship between occupation and perception towards Islamic bank. This shows that occupation has influence on the awareness and usage of Islamic banking products and services. It was also found that government employees have a significantly higher level of understanding about Islamic banking products and services. However, these results are in contrast with the study done by Amin (2007) in Eastern Malaysia, which shows that occupation has no significant relationship with awareness and usage of Islamic banking products and services.

Data and Methods of Analysis:

The targeted population in this research is the Muslim Kazakhs in Kazakhstan. By 2010, there were around 65% of Muslims in Kazakhstan (Statistical Agency of Kazakhstan, 2011). The data collected using self-administered questionnaires and were distributed to the Muslims in Kazakhstan in five areas i.e. Astana, Almaty, Astana, Kyzylorda and Shymkent.

Sampling method used in this study is convenience sampling as part of non-probability sampling techniques. The following formula from Israel (1992) is used to determine the sample size:

$$n_0 = \frac{z^2 pq}{e^2}$$

where:

n_0 = sample size

z = Z-value of α (α is 5%)

p = variability (0.5)

q = 1-p

e = sampling error (5%)

and thus, the sample size required is equal to

$$n_0 = \frac{z^2 pq}{e^2} = \frac{(1.96)^2 (0.5)(0.5)}{0.05^2} = 385 \; samples$$

Hence, as many as 400 questionnaires distributed with the target of getting 385 respondents completely answering the questionnaires. However, there were only 300 questionnaires available for the analysis. This is due to some respondents did not respond some items in the questionnaire and made it incomplete questionnaire and thus cannot be included in the analysis. Descriptive analysis is used to extract the information gathered from the respondents.

Table 1. Respondents Demographic Profile

		Frequency	Percent
Age	20-29 years	84	28.0
	30-39 years	72	24.0
	40-49 years	91	30.3
	50-59 years	36	12.0
	60 and above	17	5.7
Occupation	Government sector employee	172	57.3
	Private sector employee	88	29.3
	Self employed	21	7.0
	Student	6	2.0
	Retired	13	4.3
Monthly Income level	Less than 40,000kzt	40	13.3
	40,000-100,000kzt	173	57.7
	100,000-200,000kzt	61	20.3
	200,000kzt and above	26	8.7

Findings and Discussion:

In this study, there are 300 respondents. Among these 300 respondents, 91 of them are between 40-49 years old. In other words one third of the respondents are above 40 years, 84 respondents aged between 20-29 years followed by 72 respondents whose ages between 30-39 years old. Above 60 years old is nearly 6 percent (17 respondents). As for occupation, 172 (57.3%) respondents are government sector employees and 88 (23.9%) of respondents work in the non-government sector. The respondents who work as a self-employed are 21 (7%), 13 (4.3%) of them are retired and 6 (2.0%) of the respondents are students. With regard to the income level, as many as 173 (57.7%) respondents earn monthly income level between KZT40,000 – KZT100,000, 61 (20.3%) respondents receive KZT100,000 - KZT200,000 monthly, 40 (13.3%) respondents with monthly income less than KZT40,000 and 26 (8.7%) respondents monthly income level higher than KZT200,000 (see Table 1).

Table 2. Respondents' awareness towards Islamic banking in Kazakhstan

	Yes		No	
	Freq.	%	Freq.	%
Do you know the existence of Islamic banking in Kazakhstan	249	83	51	17

With regard to respondents' awareness towards Islamic banking in Kazakhstan, Table 2 shows that 249 (83%) of respondents are aware of the existence of Islamic banking in Kazakhstan and 51 (17%) respondents are not aware of the existence of the Islamic banking in Kazakhstan. The unawareness can be due to recent introduction of Islamic banking in the country.

Table 3. Respondent's Awareness upon Islamic Banking Products and Services

	Yes		No	
	Freq.	%	Freq.	%
Do you know the principles of the Islamic banking system	41	13.7	259	86.3
Do you know the differences between IBF and conventional banking	48	16.0	252	84.0
Do you know that all kind of interest *(riba)* is prohibited in Quran	250	83.3	50	16.7
Do you know the debt based financing products in Islamic banking (e.g. *BBA, Murabaha*)	42	14.0	258	86.0
Do you know the partnership based contracts in Islamic banking (e.g. *musharaka, mudaraba*)	42	14.0	258	86.0

As shown in Table 3, the awareness of the respondents upon Islamic banking principles is 13.7% which represents 41 respondents, 259 (86.3%) respondents out of 300 are not aware on the Islamic banking principles. Only 48 (16.0%) respondents know the difference between Islamic banking system and conventional banking while remaining 252 (84%) respondents do not know the difference between the two banking systems. On the question "Do you know that all kind of interest *(riba)* is prohibited in Quran?" 250 (83.3%) respondents were aware of it. 42 respondents are aware of the debt based financing products, and the same number of the respondents are aware of the partnership contract.

Table 4. Respondents' Perception upon Islamic Banking

	SA	A	N	DA	SDA
There is a very high potential of Islamic banking in Kazakhstan	92	126	64	17	1
Islamic banks are able to compete with conventional banks	94	117	71	18	0.0
Islamic banking products are not similar to the products of conventional banking	109	121	56	14	0.0
Islamic banks have not done enough marketing activities to the public	123	108	55	13	1
Islamic banks provide lower cost products and services compared to conventional banking	110	88	86	13	3

Note: SA = Strongly Agree; A = Agree; N = Not sure; DA = Disagree; SDA = Strongly Disagree

From Table 4, it shows that 218 (72.7%) of the respondents perceived that there is a very high potential of Islamic banking in Kazakhstan. Furthermore, as many as 211 (70.3%) respondents agreed and confident that those Islamic banks are able to compete with conventional banks. With regard to its concept and principles, 230 (76.7%) respondents agreed that Islamic banking products are not similar to the products of the conventional banking and 198 (66%) respondents agreed that Islamic banks provide lower cost products and services compared to the conventional banking. However, as a critique for Islamic banking in Kazakhstan, as many 231 (77%) respondents said that Islamic banking has not done enough marketing activities to inform and educate the public.

Table 5. Respondents' Willingness to Patronize Islamic Banking in Kazakhstan

	SA	A	N	DA	SDA
I am willing to open an account if an Islamic bank is established in my area	116	99	61	21	3
I will choose an Islamic banks, because they follow strict *Shariah* requirements	113	101	58	25	3
In future I will choose Islamic banks because I believe they will provide better services to the customers	115	82	74	26	3
For Kazakhstan to have Islamic bank for retail customers is very important to me	99	118	66	11	6

Note: SA = Strongly Agree; A = Agree; N = Not sure; DA = Disagree; SDA = Strongly Disagree

Table 5 shows that 215 (71.7%) respondents are willing to open a bank account if an Islamic bank is established in their area and 214 (70.4%) respondents are willing to choose an Islamic bank because Islamic bank follows *Shariah* principles which in line with their faith. Interestingly, 217 (72.3%) respondents are willing to choose an Islamic bank because in the future because they believe that Islamic banks will provide better services to their customers. Lastly, as many as 201 (67%) respondents are agreed that for Kazakhstan to establish an Islamic bank for retail customers is important to them.

With reference to previous tables, this study shows that 83 percent of the respondents are aware of the existence of Islamic banking in Kazakhstan. However, even though more than half of the respondents are aware of the existence of Islamic banking, it is still not sufficient for Kazakhstan government to open Islamic banks which serve individual customers' needs. Perhaps the reason is because even though Muslims are aware of Islamic banking in Kazakhstan, this will not guarantee they will use Islamic banking products and services. In the study conducted by Khattak and Rahman (2010), the percentage of respondents who are aware of Islamic banking but do not patronize it was quite high in percentage, it was 20 percent. As an impact, practitioners must give more efforts in promoting Islamic banking to lift up the customers' awareness and to educate the Muslims to understand, accept and willing to support Islamic banking by patronizing them. It is unfortunate to realize that there are no enough advertising activities taking place in the country.

In addition, this study examines the level of understanding of Muslims towards the basic concepts of Islamic banking and found that more than half of the respondents have enough knowledge on the basic concepts of Islamic banking operations. This is interesting since Islamic banking has not yet operated for individual customers. One of the reasons is because respondents have the access to internet and able to gather the information about Islamic banking from there. Thus, as time pass by, it is believed that the customers' level of understanding upon Islamic banking will improve which will boost up the usage of Islamic banking products and services in Kazakhstan in the future.

This study also aimed at examining the willingness of Muslims in Kazakhstan to patronize Islamic banking. This study shows that 71.4 percent of the respondents are willing to patronize Islamic bank, because of the Shariah compliance issues. They feel more comfortable to deal with Islamic banks for their banking activities rather than with conventional banks. On the other hand, 65.6 percent of the respondents are willing to patronize Islamic bank, because they believe that Islamic banks should provide better service to the customers. This reflects that Islamic banking in Kazakhstan has a high potential growth in the future.

Conclusion:

Since Islamic banking industry in Kazakhstan just started less than four years ago, study on customers' awareness upon Islamic banking and willingness to patronize it is very important. The significance of this study is to help regulators and practitioners in recognizing the attitude and behavior of their targeted customers so they can develop the best marketing strategy for Islamic banking.

The purpose of this study is to examine the level of awareness and willingness of Muslims in Kazakhstan to patronize Islamic banking. As many as 300 respondents from different cities of Kazakhstan were collected and the analysis method used is descriptive analysis. The results show that more than half of the respondents are aware of Islamic banking in Kazakhstan, but they are not aware of most of the products and services offered by Islamic banks. Furthermore, despite the moderate level of Muslim Kazakhs understanding towards Islamic banking concepts, the willingness level of using Islamic banking products and services is high.

Limitations and Suggestions:

This study is believed not without limitations. Among its limitations are: (i) due to missing answers in many questionnaires, sample used is only 300 and thus considered mediocre level for sample size with unknown population number; and (ii) the method used in this study is only descriptive analysis.

Therefore, in order for future studies in the same field and country to have more robust results, it is suggested for them to increase the sample size and use inferential statistics methods, both parametric and non-parametric.

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The Dynamics of Macroeconomics Variables and The Volatility of Indonesia Stock Markets: Evidence from Islamic and Conventional Stock Markets

By

Muhamad Abduh[*]

Miftakhus Surur

Abstract

This study aims to investigate the impact of the movement of macroeconomic variables upon the Indonesia stock markets, both Islamic and conventional stock markets, by using vector error correction model. The macroeconomic variables employed in the study are exchange rate, economic growth, and inflation within the period of January 2003 to December 2010. The result shows that in the long run, the performance of the stock markets is negatively influenced by exchange rate and positively influenced by industrial production index. Interestingly, inflation is found to be significant only for conventional stock markets with negative relationship.

Keywords: Islamic finance, stock markets, growth, inflation, Indonesia.

1. Introduction:

In the current system of the global economy, capital markets have a very important role to drive the economic growth of the country. It is set to be a vehicle to bring together two different interests which are the surplus and deficit units. At the same time, it also provides the possibility and opportunity to earn rewards for the surplus units as the owner of the funds. In Indonesia, the existence of capital market is to encourage not only government as the responsible party but also private communities as voluntary parties to participate in the economic development.

[*] Author: Muhamad Abduh, working as Assistant Professor at IIUM Institute of Islamic Banking and Finance, Malaysia.
Miftakhus Surur, MS (Finance) Teaching at Tazkia University College of Islamic Economics, Indonesia.

The capital markets in Indonesia have started since the Dutch colonial era, which is on December 14, 1912 along with the establishment of VereningingVoor de Effectenhandel. Securities that are traded at that time were stocks and bonds of Dutch plantation companies operating in Indonesia, bonds issued by the Dutch government, shares of American companies and other Netherlands's securities with 13 members of brokers (Ahmad, 2004).

Today, the Indonesia capital market is named Bursa Efek Indonesia (BEI). In year 1925, exchanges market of Surabaya and Semarang were opened. At the time of World War II took place in 1939, the Surabaya and Semarang Stock Exchange were closed followed by the Jakarta Stock Exchange. It began to flare up again in 1950 with the issuance of bonds by the Indonesian government. On November 1, 1951, the Jakarta Stock Exchange reopened after a halt for approximately 12 years. Reopening of the Jakarta Stock

Exchange is a breath of fresh air for the development of capital market activities in Indonesia (Ahmad, 2004).

In addition to the conventional capital markets, Indonesia also has the capital markets using the Shariah rules. The existence of Islamic capital market in Indonesia was actually started in 1997, by the issuance of Islamic mutual funds instrument by PT Danareksa Investment Management on July 3, 1997. However, the Capital Market Supervisory Agency (Bapepam) recently launched its Islamic capital market officially on March 14, 2003.

Capital market has become a key factor to raise large monies from worldwide investors in the primary market. The government can use these monies to develop their economy and provide a lot of jobs for societies through investment mechanism for funding expansion and to set up new ventures. From investors' side, the existing of capital market is more interesting because they have an exit mechanism. When they need their monies back for urgent purposes as well as changing business decisions from their portfolio investment, there is an available market to sell their investment which is secondary market.

According to Kormendi and Lipe (1987), if there are changes in such economic variable as real output, money supply, exchange rate and others will have a significant impact on firm's cash flow and discount factor, furthermore it will affect stock price. On the other hand, changes in stock price may also influence economic activities and act as a channel of monetary transitions mechanism. Thus, this study is aimed at understanding the dynamic interactions among macroeconomic variables and stock prices movements, particularly in Indonesia.

II. Literature review:

There are a number of existing studies that attempt to analyze the interaction between the movement of macroeconomics variables and the volatility of stock markets. Zafar et.al. (2008) studied the effect of interest rates (T-Bill rate) on the profits and stock movements in Karachi Stock Exchange for the period of January 2002 to June 2006. There are two models of GARCH (1,1) used in these study. The first model did not include the interest rate and the second included the interest rate. They found that interest rates had a significant negative impact on profits of stocks. Aydemir and Demirhan (2009) conducted the research in Turkey on the influence of exchange rate on stock prices using VAR methods using data from February 2001 to January 2008. The study had shown that the exchange rate has a negative impact on the stock prices in that particular country.

Ibrahim and Yusoff (2001) analyzed the dynamic interactions between macroeconomic variables i.e. real output, price and money supply, exchange rate and equity prices in Malaysia. Using variance decomposition and impulse response functions to know the strength of the interaction between the macroeconomic variables and stock price, they found that Malaysian stock price seemed to be driven more by changes in domestic factors, particularly money supply. The result had shown positive effects of the money supply towards the stock price in the short-run but negatively associated in the long-run.

Morales (2007) examined the dynamic relationship between exchange rates and stock prices in the four Easter European markets during a 7 year periods from 1999 to 2006 by using the Johansen Cointegration technique, vector error correction modeling, and the standard Granger causality. The study had found that there is no evidence of stock prices and exchanges rate moving together in the short-run as well as in the long-run in selected countries. However, long run Cointegration between exchanges rate and stock prices was found in Slovakia. In terms of analysis of causality relationship using Granger-causality technique, Morales (2007) found a unidirectional causality from the exchange rate to the stock prices in the case of Hungary, Poland and Czech Republic.

Oktavia (2007) conducted a study on the effect of exchange rate and the level of interest rates towards stock prices in the Jakarta Stock Exchange during the period of 2003 to 2005. By using multiple regression analysis, she found that the exchange rate and interest rate have a significant influence on the movement of the stock prices in Jakarta Stock Exchange. While exchange rate shown a positive influence on the stock price performance, the interest rate shown a negative effect. Mansur (2009) studied similar issue for the period of 2000 to 2002 and found that exchange rate and interest rate have a significant impact on the stock price movement. However, the result has shown that exchange rate has a significant negative influence on the index.

In the case of Islamic stock markets, Yusof and Majid (2007) in Malaysia conducted a study to examine the effect of monetary policy on stock market movements in the conventional and Islamic in the period of January 1992 to December 2000 using vector autoregression. The study found that the existing monetary policy variables had effect on the volatility of stock markets in both conventional and Islamic. Interestingly, the study has shown that the interest rate has no significant influence on the movement of Islamic stock market. This is consistent with the existing theory that the interest rates are not a significant variable in explaining the Shariah stock market movements.

In addition, Zubaidah (2004) examined the effect of inflation and the changes in exchange rate towards the Shariah beta stocks from the 30 companies listed in the Jakarta Islamic Index (JII) for the period of 2001 to 2003. By using multiple linear regression, she concluded that the exchange rate and inflation rate have no significant effect on the beta of Shariah stocks.

While studies exploring on relationship between macroeconomic variables and the volatility of conventional stock markets are flourishing, limited number of studies found which analyzed the relationship between macroeconomic variables and the volatility of Islamic stock markets. Therefore, this study tries to fill the gap by investigating the impact of the macroeconomic variables upon the conventional and Islamic stock markets' volatility.

III. DATA AND METHODS:

Data

The data utilized are monthly data taken from official sources covering the period of January 2003 to December 2010. The macroeconomic variables used are exchange rate, industrial production index, and consumer price index and the stock markets data are retrieved from Jakarta composite index as the representative of conventional stocks and Jakarta Islamic index that represents Islamic stocks.

Stationary Test:

A unit root is tested with Augmented Dickey-Fuller (ADF) and Phillip-Perron (PP) test. Do the variables observed have a tendency to return to the long-term trend following a shock or the variables follow a random walk? If the variables follow a random walk after a temporary or permanent shock, the regression between variables is spurious. Hence, the OLS will not produce consistent parameter estimates.

All series should be stationary at the same level. ADF test is can be determined as in Equation (1).

$$\Delta Y_t = \beta_1 + \beta_2 t + \delta Y_{t-1} + \alpha_i \sum_i^m \Delta Y_{t-1} + \varepsilon_t \tag{1}$$

The hypothesis tested:
H0: $\delta = 0$ (contains a unit root, the data are not stationary)
H1: $\delta < 0$ (does not contains a unit root, the data are stationary)

Meanwhile, PP test can be determined as in Equation (2).

$$\Delta Y_t = \eta_0 + \eta_1 t + \delta Y_{t-1} + v_t \tag{2}$$

The hypothesis tested:
H0: $\delta = 0$ (contains a unit root, the data are not stationary)
H1: $\delta < 0$ (does not contains a unit root, the data are stationary)

Cointegration Test:

Cointegration means that even though the variables are not stationary individually, the linear combination between two or more variables may be stationary. To test Cointegration, Johansen Cointegration test is used.

Components in vector Y_t is said to be cointegrated at d, b degree, presented by CI (d, b) if:

i. All components of Y_t is I(d)

ii. There is a non-zero vector $\beta = (\beta_1, \beta_2, \ldots, \beta_n)$ so that the linear combination of $\beta Y_t = \beta_1 Y_{1t} + \beta_2 Y_{2t} + \ldots + \beta_n Y_{nt}$ will be cointegrated at (d – b) degree where b>0. Vector β is the Cointegration vector. In the case of b=d=1, Y_t is I(1) and their linear combination is I(0).

Johansen (1991) and Johansen and Juselius (1990) produce the maximum likelihood approach using the vector autoregressive model to estimate the Cointegration relationship amongst components in vector k variable Yt. Consider vector autoregressive model for Y_t:

$$A(L)x_i = \varepsilon_t \qquad (3)$$

The parameter can be presented in the form of vector autoregressive error correction mechanism:

$$\Delta Y_t = \sum_{i=1}^{p-1} \Pi_i \Delta Y_{t-i} + \alpha\beta Y_{t-p} + \varepsilon_t \qquad (4)$$

Where vector $\beta = (-1, \beta_2, \ldots, \beta_n)$ that contain r Cointegration vectors, and speed of adjustment parameter is given as $\alpha = (\alpha_1, \alpha_2, \ldots, \alpha_n)$ when rank $\beta = r < k$, k is the number of endogenous variables. If the number of Cointegration relations is known, hypothesis testing on α and β can be performed. Lag length specification for the model can be determined by vector autoregressive equation using the Akaike Information Criteria and Schwartz criteria.

Hence, to assess the impact of the shock in macroeconomic variables upon the volatility of the stock markets for both Islamic and conventional. The models developed are following:

Model 1:

$$LnJCI = \alpha_0 + \alpha_1 LnIPI + \alpha_2 LnCPI + \alpha_3 LnER + \pi_t \qquad (5)$$

Model 2:

$$LnJII = \delta_0 + \delta_1 LnIPI + \delta_2 LnCPI + \delta_3 LnER + \tau_t \qquad (6)$$

IV. Results & discussions:

Preliminary Tests

The vector autoregressive method requires all variables in the system should be stationary in first difference. Augmented Dickey-Fuller (ADF) and Phillips-Perron (PP) stationarity tests are employed on Consumer Price Index (lnCPI), Exchange Rate (lnER), Industrial Production Index (lnIPI), Jakarta Composite Index (lnJCI), and Jakarta Islamic Index (lnJII). The results of unit root test for the level as well as for the first-difference of the variables are provided in the Table 1.

Table 1: Unit root test

Variables	ADF		PP	
	Level	**1st difference**	**Level**	**1st difference**
lnJCI	-1.603	-6.996***	-1.965	-6.950***
lnJII	-1.742	-6.856***	-2.096	-6.818***
lnCPI	-2.720	-9.407***	-2.720	-9.408***
lnER	-2.058	-7.821***	-2.176	-7.894***
lnIPI	-2.796	-3.617***	-4.036***	-14.508***

Note: ** and *** denote significance at 5 percent and 1 percent level respectively.

Based on the ADF and PP tests, the lnIPI is found to be stationary at level but the rest four variables i.e. lnJCI, lnJII, lnCPI, and lnER are found to be stationary at first difference in both ADF and PP tests. In the case of conflicting result like in the IPI variable, it motivates us to further assess its stochastic property by plotting its correlogram. Ibrahim (2006) suggests that if the correlogram is gradually declining, it indicates that the variable is non-stationary in level. We find that the correlogram of lnIPI is gradually declining, which suggests non-stationarity in level. Accordingly, like other variables, we also treat lnIPI as an I(1) process. Given results of the unit root tests, we proceed to Cointegration test. The lag length of the test is set to 3 in both Model 1 and Model 2, which we find sufficient to render the error terms serially uncorrelated.

Table 2. Johansen Juselius Cointegration Test

Equation	Hypothesized No of CE(s)	Trace Stat.	0.05 Critical Value	Adj.Trace Stat.
Model 1 (lnJCI)	r = 0	49.49925***	47.85613	42.56936
	r ≤ 1	27.47509	29.79707	23.62858
	r ≤ 2	14.38900	15.49471	12.37454
	r ≤ 3	5.498857***	3.841466	4.72877**
Model 2 (lnJII)	r = 0	47.59365	47.85613	40.93054
	r ≤ 1	27.05550	29.79707	23.26773
	r ≤ 2	14.41869	15.49471	12.40007
	r ≤ 3	5.684044***	3.841466	4.88828**

Note: **, *** denotes rejection of the null hypothesis at the 5 and 10 percent significance level respectively.

For a small sample analysis, Reinsel and Ahn (1992) suggested an adjustment to the estimated trace statistics. The degree-of-freedom correction suggested by Reinsel and Ahn (1992) is to multiply the computed trace statistic by (T-pk)/T, where T is the sample size, p is the number of variables, and k is the lag length of the estimated VAR system. Table 2 depicts the Cointegration results for Model 1 and Model 2 which suggest unique cointegrating vector that ties these variables together in the long run.

Equation (7) and (8) are the long run equations depicting the relationship between the macroeconomic variables' shock towards the volatility of the stock markets, conventional and Islamic stock markets respectively. In both model, economic growth is positively affecting the stock markets volatility and exchange rate is negatively affecting them in the long run. In other words, capital markets performance in Indonesia is determined by the performance of the economy and the exchange rate regime adopted. With regard to the exchange rate, the finding of negative relationship towards stock markets volatility is supporting Mansur (2009) but not in favor of Oktavia (2007). However, the finding is supporting Oktavia (2007) with regard to inflation which has shown no significant impact towards the volatility of Indonesia stock markets.

$$ect = \ln JCI(-1) - \underset{(-4.19415)}{9.14\ln IPI(-1)} + \underset{(2.40593)}{4.58\ln RER(-1)} - \underset{(-0.39507)}{0.20\ln CPI(-1)} - 4.29 \quad (7)$$

$$ect = \ln JII(-1) - \underset{(-3.06893)}{8.53\ln IPI(-1)} + \underset{(2.16096)}{5.22\ln RER(-1)} - \underset{(-0.81277)}{0.53\ln CPI(-1)} - 9.62 \quad (8)$$

In the short run, Table 3 provides the relationship resulted from the error correction model for Model 1 and Model 2. The variable of ect or the speed of adjustment in short run dynamic in Model 1 and Model 2 are negative and significant at alpha 10% and 5% respectively, which means good. Exchange rate seems to negatively and statistically significant in affecting the performance of both stock markets, Islamic and conventional. Since they are priced using local currency, therefore the fluctuation of US dollar as the benchmark currency will affect their performance directly. Negative relationship means that the higher the exchange rate to US dollar, the lower the stocks' performance and the lower the exchange rate to US dollar, the higher the performance of stocks in Indonesia.

Table 3. Error Correction Model for Model 1 and Model 2

Variable	Model 1 (lnJCI)		Model 2 (lnJII)	
	Coefficient	t-Stat.	Coefficient	t-Stat.
C	0.019***	3.029173	0.024***	3.408388
ECT(-1)	-0.01946*	-1.790685	-0.0245**	-2.049679
DJCI(-3)	0.207048	1.832875	-	-
DJII(-1)	-	-	0.052706	0.606322
DIPI	0.107666	0.819790	-	-
DIPI(-1)	-0.202935	0.1732	-0.3862**	-2.435689
DIPI(-2)	-0.189668	0.1401	-0.3155**	-2.188659
DCPI(-2)	-0.09082*	1.746451	0.080884	1.363015
DER	-1.681***	-9.069256	-1.678***	-7.496294
DER(-3)	0.46813*	1.885356	-	-

Note: *, **, *** denotes rejection of the null hypothesis at the 10, 5, and 1 percent significance level respectively.

For conventional stocks, the result shows that inflation has given an impact towards its performance but not for the production index. Interestingly, the result is in the opposite direction with regard to Islamic stock whereby production index has given an significant impact towards its performance but not for the inflation. These findings show that Islamic stock markets, as proposed in the theory, are not significantly tied to interest rate and inflation but more towards the real economic activity. The findings also recommend the Indonesian government to support the development of Islamic capital markets by providing the necessary infrastructures and regulations.

V. Conclusion:

The purpose of this study is to analyze the impact of changes in macroeconomic variables i.e. exchange rate, industrial production index, and consumer price index towards the volatility of Indonesia stock markets i.e. Jakarta Composite Index (JCI) and Jakarta Islamic Index (JII). Using error correction method, the results show that industrial production index and exchange rate are affecting the performance of both types of stock markets in the long run. The relationship between industrial production index and both stock markets is positive in the long run whereby for the exchange rate in negative relationship. In the short run, exchange rate still gives negative and significant impact to the both stock markets. However, inflation only significant towards the performance of conventional stock markets and the direction is negative relationship. On the other hand, industrial production index is positively and significantly affecting the performance of Islamic stock markets and not towards the conventional stock markets. As a recommendation, the Indonesian government need to support the development of Islamic stock markets since it is interest and inflation-free by providing the necessary infrastructures and regulations.

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Measurement of Efficiency and Soundness of Islamic Bank Using Two-Stage Data Envelopment Analysis and Modified Camels

By

Muhammad Faza Firdaus[*]

Muhamad Nadratuzzaman Hosen

Abstract

The aim of this study is to measure the efficiency of Islamic Bank in Indonesia, to analyze the factors that affect the level of efficiency which is known as Two-Stage Data Envelopment Analysis method and to propose measurement of Bank Soundness with modified CAMELS. The objects of this study are 10 (ten) Islamic Bank (BUS) in Indonesia which analyzes from the second Quarter of 2010 until the fourth Quarter of 2012. There are 2 (two) methods which are used in this study, namely non-parametric method of Data Envelopment Analysis (DEA) on the first stage and Tobit model on the second stage. In addition, this study will illustrate the formulation of the financial factors of CAELS instead of CAMEL by integrating the results of efficiency level measurement using DEA in CAELS formulation. Overall, the results, show that the efficiency level of Islamic banks in Indonesia during the time period in this study, have not yet reach the optimum level of efficiency. In addition, modification of CAELS for the bank performance level method by integrating the result of DEA shows that the modification of CAELS could be more accurate in describing the bank performance level, particularly for Islamic Bank in Indonesia.

Keyword: Efficiency, Data Envelopment Analysis (DEA), Tobit Model, CAELS + DEA

1. Introduction:

[*] Authors: Muhammad Faza Firdaus (m.faza_firdaus@yahoo.com) and Muhamad Nadratuzzaman (mnhosen@gmail.com) Faculty of Shariah and Law at State Islamic University, Jakarta, Indonesia.

1.1. Background:

The rapid development of the Islamic banking industry in Indonesia increasingly requires the measurement of the level of efficiency of Islamic banks. Through Table 1 and 2 can be seen that on several financial indicators of Islamic banks and financial ratios indicate a fairly rapid growth in the Islamic banking industry in Indonesia. During 2005 to 2010 there was increasing in the amount of Third Party Funds (DPK), Asset, and Financing extended by Islamic banks. In addition, the data in some financial ratios such as Non-Performing Financing (NPF) and Financing Deposit Ratio (FDR) also indicates an increase in performance that automatically also describes the development of the Islamic banking industry in Indonesia. With exposure to some of these data, the measurement of the efficiency level of bank is required. That is because by knowing the level of efficiency of an Islamic Bank, we can find out how much the Bank's ability to optimize all of its resources and provide greater benefit to the community as well as deposit customers and financing customers

Table 1. Growing of Asset, DPK and Financing in Islamic Banks in Indonesia, 2005-2011 (in billion Rupiah/IDR)

	2005	2006	2007	2008	2009	2010	2011
Asset	20,879	26,722	36,538	49,555	66,090	97,519	145,466
DPK	15,581	24,128	28,011	36,852	52,272	76,037	115,415
Pembiayaan	15,232	20,445	27,944	38,199	46,887	68,181	186,359

Source: Indonesian Banking Statistic, Central Bank of Indonesia, 2011

Table 2. Percentage of Non-Performing Financing and Financing Debt to Ratio in Indonesian Islamic Banks during 2005-2011

Dinyatakan Dalam Persen

	2005	2006	2007	2008	2009	2010	2011
NPF	2.82	4.75	4.05	3.95	4.01	3.02	2.52
FDR	97.75	98.90	99.76	103.65	89.69	89.66	88.94

Source: Indonesian Banking Statistic, Central Bank of Indonesia, 2011

Measuring the level of efficiency in the Islamic banking industry is something urgent to see intense competition in the Islamic banking industry, particularly during the years 2005 to 2011. This can occur due to the rapid growth in the number of Islamic banks were established during that time span. Table 3 can be seen that in the span of an increase quite rapidly about the growing number of Islamic banks in Indonesia, both in full-pledge Islamic Banks (BUS) and Unit of Islamic Banks (UUS). Therefore, by measuring the efficiency of the Islamic banking can be an important indicator in view of the ability of Islamic banks to survive and face intense competition in the Islamic banking industry as well as at the national competition in the banking industry in Indonesia.

Table 3. Numbers of Islamic Banks in Indonesia during 2005-2011

	2005	2006	2007	2008	2009	2010	2011
BUS	3	3	3	5	6	11	11
UUS	19	20	26	27	25	23	24

Source: Indonesian Banking Statistic, Central Bank of Indonesia, 2011

One method that is commonly used in analyzing the efficiency of the bank is using a non-parametric method called Data Envelopment Analysis (DEA). DEA is a mathematical programming optimization method that measures the efficiency of a technique Economic Activity Unit (UKE) and compare relative to other UKE. This method has an advantage over parametric methods. The advantage in using a non-parametric method is that we can identify the unit that is used as a reference.

After that, research on bank efficiency level or unit of economic activity (UKE) had been developed in various countries so popped a research procedure called Two-Stage Data Envelopment Analysis. This procedure will be done at two stages of the study (First Stage and Second Stage). In the First Stage, it will be measured on the level of efficiency using Data Envelopment Analysis (DEA). While at Second Stage, it will be analyzed to determine the factors that affect the level of efficiency of a bank using Tobit models. Endri (2008) opined that the overall result will be obtained the level of efficiency of a bank or Economic Activity Unit (UKE).

In addition, regardless of the research on the efficiency of a bank, before we had known method of measuring the soundness of banks called CAMELS. In this method there are six components of the source and form an integral calculation of value in describing the soundness of a bank. One of the components of the calculation method is the component in which is Earning ROA ratio. As we have seen, ROA ratio is used to measure the level of a bank's efficiency by comparing with the Operating Expenses to Operating Income (OE/OI). But by looking at the banking industry as an intermediary institutions that use a lot of input and output, then the measurement of the level of efficiency using ROA ratio is considered not describe the level of efficiency of a bank. This is because the measurement of the level of efficiency using a partial efficiency, namely ROA ratio. In addition, the portion of weight in the calculation of the level of efficiency of the CAMELS method is only 5% to a separate concern especially keeping in mind the urgency of the measurement of the level of efficiency in describing the soundness of a bank.

1.2 Research Problems:

1. How to measure the level of efficiency of Islamic Banks (BUS) in Indonesia during the second quarter of 2010-fourth quarter of 2012?
2. How to affect the efficiency of Islamic Banks (BUS) by several factors such as Assets, Total Branches of Bank, ROA, ROE, CAR, and the NPF during the Second Quarter of 2010-fourth quarter of 2012?
3. How to integrate the method of measuring the level of efficiency using Data Envelopment Analysis (DEA) with the method of measuring the soundness of banks by CAELS?

4. How Policy Implications can be given as an implementation of the results of measurements of the level of efficiency using Data Envelopment Analysis (DEA)?

1.3 Research Objectives:

1. To measure the efficiency of Islamic Banks (BUS) in Indonesia during the second quarter of 2010-Fourth Quarter of 2012

2. To analyze the influence of Assets, Total Branch Bank, ROA, ROE, CAR, and the NPF to the efficiency of Islamic Banks (BUS) in Indonesia during the Second Quarter of 2010-Fourth Quarter of 2012

3. To integrate the method of measuring the level of efficiency using Data Envelopment Analysis (DEA) with the method of measuring the soundness of banks by CAELS

4. formulate a Policy Implication that can be given as an implementation of the results of measurements of the level of efficiency using Data Envelopment Analysis (DEA

2. Research Method:

2.1 Data and Variables:

Ten Islamic Banks (BUS) in Indonesia are used in this study such as Bank Muamalat Indonesia (BMI), Bank Syariah Mandiri (BSM), Bank Syariah Mega Indonesia (BSMI), Bank Syariah Bukopin (BSB), Bank Rakyat Indonesia Syariah (BRIS), Bank Panin Syariah (BPS), Bank Jabar Banten Syariah (BJBS), Bank Victoria Syariah (BVS), Bank Negara Indonesia Syariah (BNIS) and Bank Central Asia Shariah (BCAS) for second Quarter of 2010 until the fourth quarter of 2012. This study used secondary data.

In this study, the selection of input and output variables to measure the level of efficiency using Data Envelopment Analysis (DEA) in the First Stage intermediation approach as used by Efendie (2009: 1-13) and Rahmat Hidayat (2011: 1-19). There are inputs and outputs that are used in this study.

a. Input Variable (I) : DPK (I1), Asset (I2), and Cost of Labor (I3)

b. Output Variable (O) : Financing (O1) and Operating Income (O2).

While the variables used in the Second Stage including the Dependent Variable (Y) and Independent Variables (X) are analyzed using a Tobit model to measure the factors which affect the level of efficiency of Islamic Banks (BUS) in Indonesia. Several variables used in the Second Stage

a. Dependent Variable (Y) : Score of DEA
b. Independent Variable (X): Asset (X1), number of Bank Branch (X2), ROA (X3), ROE (X4), CAR (X5), dan NPF (X6).

2.2 Data Envelopment Analysis (DEA):

In particular, DEA is a linear programming technique development in which there are objective functions and constraint functions. There is the general equation of the method DEA

$$h_s = \frac{\sum_{1=1}^{m} u_{is} y_{is}}{\sum_{1=1}^{n} v_{js} x_{js}}$$

where:
h_s = technical efficiency in bank s
u_{is} = weighted output i which is resulted in bank s
y_{is} = weighted input i which is produced by bank s
v_{js} = weighted input j which is used by bank s
x_{js} = Sum input j which is given by bank s

In this case, as well as finding values are for u and v, as measurements of hs maximum efficiency. With a view to the constraint that all efficiency measures must be less or equal to one, one of the problems with the formulation or the formulation of this ratio is that it has an infinite number of solutions (infinite). To avoid this, then we can specify constraints that will simplify the process of specifying and subsequently use the computational techniques that had been developed. The constraint functions are:

$$\frac{\sum_{1=1}^{m} u_{is} y_{is}}{\sum_{1=1}^{n} v_{js} x_{js}} \leq 1, \text{ r} = 1, 2, \text{N}$$

$$u_i \text{ and } v_j \geq 0$$

where N denotes the number of banks in the sample. The first inequality shows the efficiency ratio to other companies is not more than 1, the second inequality temporary shows positive weight. The ratio will vary between 0 and 1. Bank can be efficient if it has the ratio which is close to 1 or 100 percent, otherwise if close to 0 indicate low efficiency of the bank. At the DEA, each bank can determine weighted each and ensure that the selected weighting would yield the best measurement of performance.

Related to the input and output that are used in the measurement of efficiency, there are 3 (three) approaches which are used, namely the asset approach, the production approach, and the intermediation approach. This study used the intermediation approach because according to Hadad (2003: 3) explained the real activity of a banking institution with its function as an intermediary institution. Additionally intermediation approach has been widely used in research to measure the efficiency of banking which is done in many countries.

In addition, to determining the input and output of research and the measurement of the efficiency level, there are 2 models, namely The first model developed models assuming constant returns to scale (CRS) or so-called model of CCR (Charnes-Cooper-Rhodes) and this model is constant returns to scale for each UKE. UKE will be compared with all that is in the sample with the assumption that the internal and external conditions are the same UKE. This model can indicate overall technical efficiency or value of profit efficiency for each UKE.

CRS model is mathematical equation which has generally been described in the general equation above. The equation can explain that the value / technical efficiency score obtained by a comparison between the ratio of output to input ratio. Moreover, in the equation explained that the value of the measurement of the level of efficiency is limited in the range 0 to 1 and the weight must be a positive value. Through these equations, it can be concluded that the Bank said to be efficient if it has the ratio approaches 1 or 100 percent, otherwise if close to 0 indicate lower bank efficiency. This is the equation in the model CCR

$$\text{Maximize } h_s = \sum_{i=1}^{m} u_i y_{is}$$

$$\text{subject to} \sum_{j=1}^{m} u_i y_{ir} - \sum_{j=1}^{m} v_j x_{jr} \leq 0, r = 1, \ldots N$$

$$\sum_{j=1}^{m} v_j x_{js} = 1 \text{ and } u_{i,} \text{ and } v_j \geq 0$$

The equation explained that the objective function of the equation is to maximize the output constraint functions that input value is equal to one, so that the value of output less the value of the input value is less than or equal to 0. This means that all banks will be up or below the level of technical efficiency.

The second model developed in the measurement of the level of efficiency is the model assuming variable returns to scale (VRS) or commonly called BCC models (Bankers-Charnes-Cooper). In this model, it is assumed that all the conditions are not the same UKE or it can be said that not all UKE operate optimally. Imperfect competition and financial constraints may cause a company not operating at optimal scale. Mathematical models with VRS approach obtained through modification of the model with CRS approach and remain guided by the DEA as a general mathematical model equation in measuring the level of technical efficiency. By adding connectivity constraints (convexity constraint) into the equation so that a mathematical formula:

$$\text{Maximize } h_s = \sum_{i=1}^{m} u_i y_{is} + U_0$$

$$\text{subject to} \sum_{j=1}^{m} u_i y_{ir} - \sum_{j=1}^{m} v_j x_{jr} \leq 0, r = 1, \ldots N$$

$$\sum_{j=1}^{m} v_j x_{js} = 1 \text{ and } u_i \text{ , and } v_j \geq 0$$

Where U_0 is a cut that can be positive or negative.

This research will use models with the assumption of constant returns to scale (CRS) or called the CCR model (Charnes-Cooper-Rhodes). The model was chosen based on research conducted by Suseno (2008: 35-55) about the lack of a relationship between the level of efficiency Islamic Bank (Islamic Bank study in 10) with a production scale. Suseno (2008) opined that economies of scale in the banking industry are not going to scale because the company has integrated the functions of a bank with other banks. Thus, economies of scale have been shifted from the company to the functional scale of bank. In Indonesia, it can be observed from existing phenomenon with the use of public ATM machines, credit card services or joint marketing together, so that the level of efficiency will not be visible in the scale of the company but it is possible in a functional scale of national banking industry (not just Islamic banking industry). This research also uses efficiency with model CRS approach.

2.3. Tobit Model:

At this stage, there will be an analysis of the factors that affect the level of efficiency. By first getting the value of efficiency in the first stage (first stage) using DEA method, then the value will be analyzed by several environment variables to know the nature of the relationship and the relationship between these variables on the efficiency (second stage). So that the second stage in the investigations referred to as Two-Stage Data Envelopment Analysis. In analyzing the factors that affect the level of efficiency of use Tobit models.

Tobit method assumes that the independent variables are not limited to the value (non-censured); just that censured the dependent variable, and all variables (both free and not free) is measured correctly, there is no autocorrelation; no heteroeskedasticity and there is no perfect multicollinearity , and mathematical models used to be right. In the use of regression analysis method to research, Endri (2008) showed that the social and economic fields found many data structures where the variable response has a value of zero for most observations, whereas for most other observations have certain values that varied. Such data structure called censored data

2.4 Method of CAELS and Wilcoxon Signed Ranks Test:

This study described the level of efficiency of the BUS procedures through Two-Stage DEA, a comparison will be made between the results of the DEA method to measure the level of efficiency and to integrate methods CAELS for soundness of bank. The reasons for the use of the method does not use components CAELS with "M" known as CAMELS because the CAMELS method used in Indonesia there is a difference in treatment to assess the financial factors which are combined into CAELS and “M” (management factors). In addition, in order to integrate the results of the DEA method to use CAELS method (CAMELS without “M”), then the results of the DEA method is divided into 5 categories, namely:

- Category “1”: 100% (Fully Efficient)
- Category “2”: 80% s/d 99.99% (Very Efficient)
- Category “3”: 60% s/d 79.99% (Efficient)
- Category “4”: 40% s/d 59.99% (Less Efficient)
- Category “5”: 0% s/d 39.9% (Not Efficient)

While the method considers the comparison between the results of DEA and CAELS are used different test method of Wilcoxon signed rank test. Normally, the method is a nonparametric test hat can be used when the data distribution is not normal which is not being used to test whether there are differences between the two groups of paired samples. Furthermore, the results in the different test methods and CAELS + DEA will be analyzed and made some modifications illustration depicting CAELS + DEA method in the form of mapping.

3. Results and Discussions:

3.1 Results for First Stage:

Discussion will be displayed on the efficiency level of 10 (ten) Islamic Banks. Through the method of Data Envelopment Analysis (DEA) during the fourth quarter of 2010 until the fourth quarter of 2012 and an average efficiency levels achieved by each of the BUS during that period. The data on input and output variables in measuring the level of efficiency obtained through the publication of a report by Bank Indonesia Islamic Banks. As explained earlier, that the DEA method will be shown through the results of measuring the degree of efficiency with the efficiency score range 1-100. Score 100 describes the ability of a BUS to optimize all the resources that BUS owned. Whereas when further away from the efficiency scores indicate a BUS 100 can be said to be inefficient in optimizing its resources and has not been able to perform his role as intermediary optimally. In the measurement results using the method of DEA in this study will be presented in a graph that describes the achievement level of efficiency in their respective BUS quarter, achieving average efficiency level of each BUS, BUS and the achievement of the overall level of efficiency.

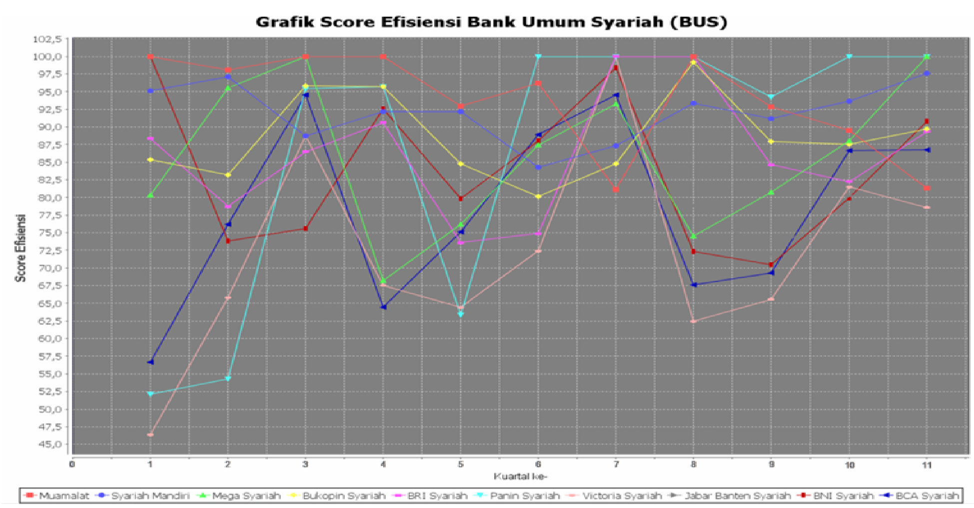

Figure 1. Efficiency Scores for 10 Islamic Banks

Results of measuring the level of efficiency of Islamic Banks in the second quarter of 2010 until the fourth quarter of 2012 showed a fluctuating trend, there is no Islamic Banks (BUS) which has a stable efficiency score of each measurement time. Moreover, based on the results of the efficiency measurements can be seen that there are some

Islamic Banks who got score 100, or can be interpreted that the bank has been able to optimize all of its resources efficiently. The bank is considered efficient in this study is Bank Muamalat Indonesia and Bank BNI Syariah in the first quarter (I), Bank Muamalat Indonesia and Bank Syariah Mega Indonesia in the third quarter (III), Bank Muamalat Indonesia and Bank Jabar Banten Shariah in the fourth quarter (IV), Bank Panin Syariah sixth quarter (VI) , Bank BRI Syariah, Bank Victoria Syariah and Bank Panin Syariah VII quarter, Bank Muamalat Indonesia, Bank Syariah BRI, and Bank Panin Syariah VIII quarter, Bank Panin Syariah X quarter, Bank Syariah Mega Indonesia and Bank Panin Syariah quarter XI. Islamic Banks while others are still considered inefficient, or cannot be interpreted to optimize all its resources.

After displaying graph of Islamic Banks efficiency levels during the second quarter of 2010 until the fourth quarter of 2012, it can be seen the achievement of the average level of efficiency in their respective Islamic Banks during the period of this study. Through Figure 2 can be seen that Islamic Banks (BUS) that previously stood as Bank Muamalat Indonesia and Bank Syariah Mandiri has average efficiency levels are very good when compared to other BUS can be said that the new stand as Victoria Bank, Bank BNI Syariah and Bank Syariah BCA. But it likely it can be said on the previous discussion that there is a new BUS stand namely, Bank Panin Syariah is reaching efficiency score at level of 100 for 5 times. However, there is no other Islamic Bank can reach level of 100 during the observation period. Likewise with the achievement of Bank BRI Syariah and Bank Syariah Bukopin who have a good level of efficiency although they got classify as a BUS which has recently been in the Islamic banking industry in Indonesia.

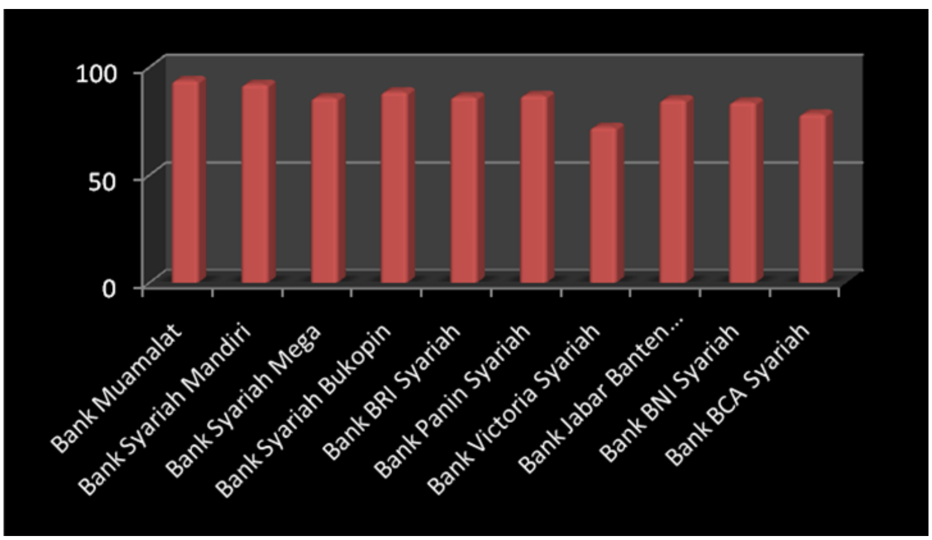

Figure 2. Average Efficiency for All Islamic Banks during Second Quarter of 2010 – Fourth Quarter of 2012

Based on the results above, the overall growth rate of the efficiency of Islamic Banks have a fluctuating trend due BUS individual efficiency levels also fluctuated as shown in Figure 1. During the study period the efficiency score Islamic Banks (BUS) achieved the highest in the fourth quarter of 2011 with a score of 91.89 and the lowest efficiency scores are in the second quarter of 2011 with a score of 78.46. With the results of these measurements it can be concluded that Islamic Banks in Indonesia is still considered inefficient or not optimal in managing its resources. This result is similar results accordance with research conducted by Endri (2008).

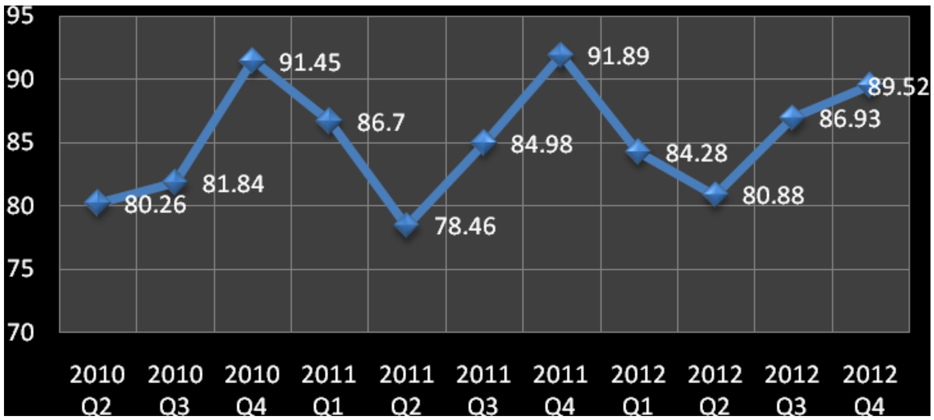

Figure 3. Average Efficiency for All Islamic Banks at Second Quarter of 2010 – Second Quarter of2012

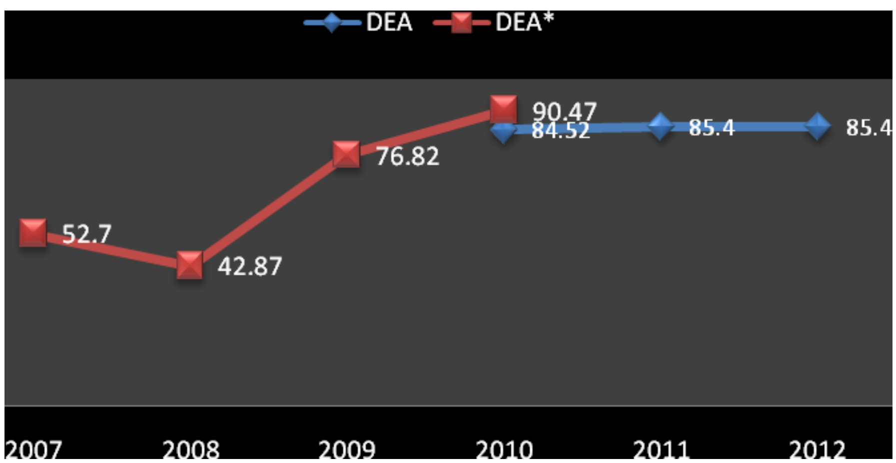

Figure 4. Roadmap of Islamic Bank Efficiency during 2007 – 2012

This study shows a comparison with similar previous studies. With the time difference of the study, Results of measurements DEA for Islamic Banks (BUS) can be shown in a roadmap to describe the pattern of efficiency from time to time. Figure 4 shows the result of efficiency in this study and the results of efficiency in using DEA method made by Shafitranata (2011: 47-48). Differences in these two studies on the times and numbers of BUS observed. In this study, using a 10 (ten) BUS as the object of study by the research period of 2010 to 2012 and research conducted by Shafitranata using three (3) BUS with research time between 2007 and 2010. Figure 4 displayed the data on an annual basis.

Both studies show the results of efficiency within the period 2007-2012. Over the span of a positive trend, it can be seen from the efficiency of Islamic Banks (BUS) in Indonesia. Despite a fall in 2008, but after that the graph shows an increase in the level of efficiency. In addition, there are differences in the results of measurements in 2010. But it is understandable because there is a difference in the number of BUS observed that in this study using the 10 (ten) BUS as the research object, while the study by Shafitranata using three (3) BUS. So that the range of the results of research only at 5.95 in 2010, it can be concluded overall correlation measurement of the efficiency of the second study.

3.2. Results of Second Stage:

The second stage of this research analyzed the factors that affect the level of efficiency of Islamic Banks (BUS) using Tobit models so that the whole procedure in this study was called Two-Stage Data Envelopment Analysis. In the Tobit model analysis, this study was using the software package Eviews 7.2. Results of analysis on Tobit models were used to infer the factors that affect the level of efficiency BUS. The results of the analysis using Tobit models can be described as follow:

Table 4. Results of Tobit Model

Variable	Coefficient	Std. Error	Z-Statistic	Prob.
C	146.3681	13.27391	11.02676	0.0000
ASSET	0.000925	0.000265	3.493988	0.0005
BRANCH	-0.159920	0.034867	-4.586623	0.0000
ROA	37.93153	8.518626	4.452775	0.0000
ROE	6.545031	2.030942	3.222657	0.0013
NPF	-6.381059	2.654531	-2.403837	0.0162
CAR	-5.947760	2.075941	-2.865091	0.0042

Based on the results in Table 4, it can be seen that there are several variables that had a negative impact as well as variables that have a positive influence. However, not all variables have a significant influence or can also be said that there are some variables that do not provide real influence. By using this Tobit model, we can easily see that the asset variables have positive and significant impact on the efficiency of Islamic Banks. This is due to the large amount of assets a company which can more freely to run its operations and achieve the optimization of its resources. In addition, banks that have large assets automatically will be easier to adopt new technologies that can increase profits and minimizing management costs. The results in this study are similar to the results of study conducted by Ismail, Rahim, and Majid (2009: 5).

While the Bank Branch variables are negative and significant influence in other words, the more number of branches / offices of a bank, it will cause the bank increasingly inefficient in managing its resources. That is because Islamic Banks in Indonesia has not yet reached economies of scale and increasing the number of bank branches will only increase the costs incurred by the Islamic Banks. The results in this study are similar to the results of research conducted by Jackson and Fethi (2000: 18).

ROA and ROE variables are representing the level of profitability of a bank there are positive and significant which are because the Bank is able to generate greater profits can be indicated as an efficient bank. The results in this study are accordance with the study conducted by Gupta, Doshit, and Chinubhai (2008: 10).

NPF on variables that indicate the ratio of nonperforming financing occurred at a bank showed a negative and significant effect. This is because the larger the ratio of financing stuck on a bank it will automatically disrupt the operations of the bank, especially in terms of the bank's liquidity. Then it will cause a bank to be inefficient in utilizing all available resources. The results in this study are similar to the results of research conducted by Ismail, Rahim, and Majid (2009: 5).

The CAR variable that describes the ability of a bank's capital to cover risk, suggesting that there is a negative influence to the level of efficiency of Islamic Banks (BUS). This variable is the government's role in determining the level of CAR to be required every bank that is equal to 8%. The results in this research show that the smaller the level of CAR an Islamic Commercial Bank, it will cause the level of the greater efficiency of the BUS or in other words there is a negative and significant effect of the level of CAR with the efficiency of a BUS. Perhaps, it reflects the risk-return trade-off. This may occur because of the tendency for most people who prefer a bank with a lower risk than banks with higher risk but more productive. The results in this study are in line with results of research conducted by Jackson and Fethi (2000: 18).

3.3. Integrated Results of DEA and CAELS Methods:

This stage is to analyze a comparative efficiency between DEA efficiency methods and methods of CAELS during the study period with different test methods Wilcoxon Signed Rank Test. The purpose of this analysis is to evaluate a tool to measure the performance of CAELS method which has been used as a tool in measuring the soundness of a bank that issued by Bank Indonesia and as consideration for Bank Indonesia to integrate computation DEA efficiency measurement and CAELS method.

In Table 5, it can be seen that the results of different test analysis showed that there are significant differences between the results of these two methods. This can be seen in Asymp. Sig. (2-tailed) that shows numbers under 0,05.

Table 5. Results of Test for DEA and CAELS

	DEA-CAELS
Z	-4.174
Asym. Sig. (2-tailed)	.000

If you look at the results, there are two (2) things that can be described on different test results from the above, namely:

1. At CAELS method, the weight given to efficiency measurement using ROA ratio is only 5%. Surely this is not comparable to the meaning of efficiency in a company or in this case is the Islamic banks. That is because efficiency is one of the important indicators to describe the performance of a bank. A bank can be

considered efficient if it had been able to optimize all available resources, has been able to implement strategies to maximize profits or minimize costs. In addition, if the bank has been relatively efficient, then of course the bank has been able to provide greater benefits to customers both customers and clients. This is because the bank has been able to optimize customer funds and maximize its role as intermediary. So that the weight given justification is not comparable with the other components in the measurement model CAELS.

2. In addition, draw attention to the ROA ratios are used as indicators on the efficiency of the method of performance measurement models CAELS. ROA ratio is only comparing operating expense to operating income cannot be used as an indicator to describe the efficiency of a bank as a whole. That is because by looking at the banking business as a production process in which there are input and output, then by definition there will be many combinations of inputs that will produce optimal output and it is not found in the ROA ratio is only comparing operating expense to operating income . While the method is also called the DEA frontier approach, will produce an optimum point where the minimum input which can produce a maximum output by using a combination of input and output. With these advantages, the measurement of the level of efficiency using DEA considered a method of describing the ideal banking business. In other words it can be said that the calculation of the efficiency ratio using partial efficiency BOPO is not reflect whole efficiency of the bank, this is only financial efficiency partially. while calculating the level of efficiency using Data Envelopment Analysis method is believed to be the Comprehensive Efficiency. Therefore, the level of efficiency of DEA can be put in the model instead of partial efficiency BOPO with several scenarios

3. Results of Mapping at CAELS + DEA:

This stage illustrated CAELS modified method by integrating the results of the DEA method of mapping a graph showing the results of measurements before and after the integration of the DEA method the method of performance measurement CAELS.

Prior to mapping, performance measurement methods will be described CAELS with three (3) modifications to the weighting and integration to the DEA method CAELS through tabular method.

Table 6. Method of CAELS before Modification

Component	**Element**	**Weight**
CAPITAL	CAR (%)	25%
ASSET QUALITY	KAP (%)	50%
EARNING	BOPO (%)	5%
	ROA (%)	5%
LIQUIDITY	STM (%)	10%
SENSITIVITY	MR (%)	5%
TOTAL		**100%**

Source: Central Bank of Indonesia at attachment SE No.9/24/DPbs/2007

Table 7. Method of CAELS with Modification1

Component	Element	Weight
CAPITAL	CAR (%)	20%
ASSET QUALITY	KAP (%)	30%
EARNING	DEA (%)	30%
	ROA (%)	5%
LIQUIDITY	STM (%)	10%
SENSITIVITY	MR (%)	5%
TOTAL		**100%**

Table 8. Method of CAELS with Modification 2

Component	element	weight
CAPITAL	CAR (%)	20%
ASSET QUALITY	KAP (%)	30%
EARNING	BOPO (%)	30%
	ROA (%)	5%
LIQUIDITY	STM (%)	10%
SENSITIVITY	MR (%)	5%
TOTAL		**100%**

Table 10. Method of CAELS with Modification 3

Component	Element	Weight
CAPITAL	CAR (%)	20%
ASSET QUALITY	KAP (%)	30%
EARNING	DEA (%)	5%
	ROA (%)	5%
LIQUIDITY	STM (%)	10%
SENSITIVITY	MR (%)	5%
TOTAL		**100%**

Through Table 6-10, it can be seen that there is a change in the weighting of some components where the weight of the components of Capital to 20%, 30% Asset Quality, Earning 35%, 10% liquidity, and Sensitivity to Market Risk 5%. The weight changes are illustrated in CAELS modifications 1 and 3 CAELS modification. While the modification CAELS 2 weighting formula equated CAELS method before modification.

Changes in the weighting are based on the nature of CAELS method is flexible and not based on a fixed rule on the application in all countries. In the discussion at the literature review in this study, the magnitude of the weight of each component is based on justification by regulators in each country. So that modifications to the weighting done in this study may be a matter that is allowed in order for the modifications made in this study may be a consideration to Bank Indonesia as regulators in measuring the soundness of the bank.

In addition to changes in the weighting, changes were also made to replace the ROA ratio DEA efficiency. This is done on the modification CAELS 1 and 3 CAELS modification. While the modification CAELS 2 BOPO but it is used the ratio of the weight has changed. Then, overall modification will be illustrated in three (3) modifications of the method along with the method CAELS and CAELS before modification.

Having drawn illustration of a modification of the method CAELS, the next step will be mapping in the form of a chart to see the results obtained from the method CAELS before and after modification. As it is known that in CAELS method, the performance of a bank is divided into 5 (five) categories, namely: "1" (Very Good), "2" (good), "3" (Good Enough), "4" (Weak), and "5" (Very Weak).

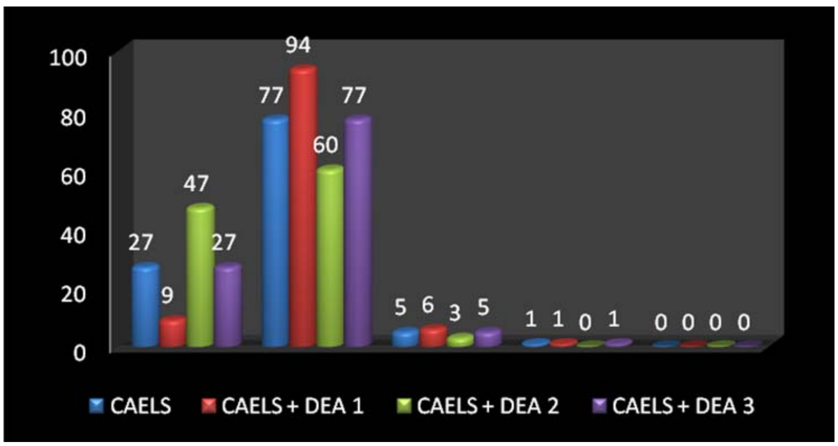

Figure 5. Graph of Map with Normal Method of CAELS and Modification of Method of CAELS + DEA

Figure 5. illustrates graphic and shows the mapping of the measurement results of the bank with the distribution of each category on the method CAELS and 3 (three) + DEA method CAELS modification. Through 4 (four) graphs, measurement differences in sound outcomes with the bank's distribution in each category shown in the modification CAELS 1 + DEA and DEA + 2 CAELS modification. The results of the bank with the same amount of dispersion in each category are shown through charts CAELS before modification and modification CAELS DEA + 3.

With reference to the results of the 4 (four) the graph can be found that the change in the weight portion and replace some components of ROA ratio DEA efficiency method (modification CAELS DEA + 1) will change some measurement results of the bank when compared with the results of measurements of sound bank prior to the modification. Whereas if we do not make changes in the weight of some components CAELS methods (modified CAELS DEA + 3), then the results obtained to be the same as before the modification of the method CAELS even though we had to replace the ROA ratio to DEA efficiency methods. Different things also happen if we just make changes without changing the weight ratio of ROA with DEA efficiency method (modification CAELS DEA + 2), it will show the results of measurements of the bank with a number of banks that are in the category of "1" (Very Good) increased rapidly when compared with 3 (three) other charts.

The mapping is done that the ROA ratio cannot fully describe the efficiency of a bank. As it discussed in the previous analysis, the ROA ratio is only a simplification of the measurement of the efficiency of a bank. In other words the calculation using ROA ratio is considered as Partial Efficiency. In addition, changes in the weighting will also alter the results of measurements of bank soundness. With primary attention focused on the weighting of earnings components in which there are measurements of efficiency, it is necessary to adjust by changing the weights on some components with the aim to increase the portion of the weight on the efficiency measurement. That is because of the imbalance in the weight portion of earnings components, particularly in the measurement of efficiency is only given a weighting of 5%. With the urgency of the efficiency of the bank, such as indicators of achievement in optimizing the performance of a bank that owned all of the resources and the ability of a bank to maintain its survival, then the increase in the weight portion needs to be taken into consideration. Then the last thing that also became a focus in CAELS modification is to replace the ROA ratio DEA efficiency methods, because it is based on mapping done, it can be proved that the DEA efficiency method can fully describe the efficiency of a bank so that it can be filter the results of measurements of the bank with the changing numbers of banks to some categories. Therefore, the policy implication is offered and is expected to be a consideration to Bank Indonesia as regulators focused on the modification of the method **CAELS DEA + 1**.

4. Conclusions and Recommendation:

4.1 Conclusions

The conclusions of this study can be stated as follow:

- At this study measured levels of efficiency using Data Envelopment Analysis approach (DEA). The results obtained in this study were generally rate the efficiency of 10 (ten) Islamic Commercial Bank has a fluctuating trend during the study period. Individually, Bank Muamalat Indonesia has an average efficiency levels are highest with 93.82 score and Bank Victoria Syariah has the average level of efficiency with the lowest score of 72.12.
- In the analysis of the factors that affect the level of efficiency using Tobit models can be concluded that the variable Bank Branch, Non-Performing Financing (NPF), and the Capital Adequacy Ratio (CAR) have a negative and significant effect. While the variable Assets and retune on Assets (ROA) Return on Equity (ROE) have a positive and significant impact.
- In the comparative analysis between DEA efficiency measurement methods to measure the performance of the different test methods of CAELS using Wilcoxon Signed Rank Tests showed that there are differences between the results of both methods. Therefore, as an alternative to that show in this study is to integrate the DEA efficiency method instead of ROA ratio as an indicator in measuring efficiency. This is evidenced by the results of mapping where CAELS soundness of measurement methods that have integrated DEA produces a change in the measurement result of the bank by reducing the number of banks in the category of "1" (Very Good). That is because some banks that are in that category have a

higher efficiency with a low score, of course, it can be happen by increasing the weight of the portion of the earnings components in which there are the results of DEA efficiency measurement methods.

4.2 Recommendation:

For the management of the Bank and Bank Indonesia:

With a map measuring efficiency at 10 (ten) Islamic Commercial Bank generated in this study, this is expected to be subject matters to evaluate soundness of each BUS on the performance achieved, especially in achieving the optimal level of efficiency during the study period. Things to consider in the management of each BUS are the factors that affect the level of efficiency as noted in this study through analysis using the Tobit model. In addition, the results in this study are also expected to be taken into consideration for Bank Indonesia as regulators, particularly regarding the formulation of methods to measure bank soundness. With the modifications in this study is expected to be a suggestion to Bank Indonesia to consider the results of the DEA method as one of the things included in the formulation of the method of the bank, complete with weight adjustment have been illustrated in this study.

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Adoption of AAOIFI Shariah Standards: Case of Pakistan

Mudaraba

Mudarabah is a partnership where one party known as "rabb-al-mal" provides capital for investment while the other party renders the services of working and management of investment and is known as "Mudarib". (Usmani, 2000)

According to AAOIFI Shariah standard no. 13 Mudarabah has been defined as "a partnership in profit whereby one party provides capital (rabb al –maal) and the other party provides labor (Mudarib)."

Shariah Standard of Mudarabah

Scope: AAOIFI Shariah standard No. 13 issued in May 2002 is applicable to Mudarabah both restricted and unrestricted. However, this standard is not applicable to Mudarabah Sukuk or other type of partnership contracts.

This Shariah standard is divided into eleven main clauses9. Brief description of clauses is as follows;

Agreement of Mudarabah Financing: This clause divided into three sub-clauses covers Memorandum of Understanding (MoU) of the contract;

MOU should define the general contractual framework explaining intentions of parties for type of Mudarabah (restricted or unrestricted), type of transaction (revolving or separate transaction) and should also contain the profit ratio and type of guarantees for Mudarib to cover issues like misconduct, negligence and breach of contract. This clause allows concluding a Mudarabah financing of a particular amount and within particular period on the basis of the general framework of MoU, however, contents of MoU will be part of integral components of future contracts, and parties will be required to agree originally if they want to exempt themselves from certain obligations.

Mudarabah Contract: This clause is further divided into four clauses mainly covering the nature of contract and contract conclusion.

Source: Islamic Banking Bulletin March 2013, State Bank of Pakistan.

The clause provides the legal capacity to both parties of having legal capacity to appoint their agents and explicitly mentions that a Mudarabah contract cannot be concluded in the absence of any of contracting parties or of their agents having legal capacity similar to contracting parties. The clause also mentions that the Mudarabah contract can be concluded using the term Mudarabah, Qirad or Mu'amala.

Mudarabah is a trust based contract implying that Mudarib is not liable for losses in investment unless it is because of negligence, misconduct or breach of contract. Moreover, the Mudarabah contract is not binding on any party except two situations; (i) when business has already been commenced , Mudarabah contract becomes binding up to the date for actual or constructive liquidation (ii) the agreement of parties to determine a duration for which the contract will be operational except where parties mutually agree to terminate the contract.

Types of Mudarabah: This clause divided into two sub clauses explains Mudarabah types; (i) restricted Mudarabah and (ii) unrestricted Mudarabah.

According to the clause unrestricted Mudarabah contract is a contract where rabb al-mal does not restrict Mudarib for investment however; Mudarabah must act in accordance to the subject matter of the contract. In case of restricted Mudarabah contract Mudarib's action regarding investment is restricted by rabb al-mal to a particular location or to a type of investment; however, Mudarib's should not be constrained unduly.

Guarantees in Mudarabah Contract: This clause allows capital provider to secure enforceable and adequate guarantees from Mudarib for situations of negligence, misconduct and breach of contract.

Requirements relating to the Capital: This clause having four sub clauses explains capital and all its related requirements. According to the clause capital can be in form of tangible assets along with being cash, however in case of assets their value will be the contribution to Mudarabah capital. The standard prohibits any debt to form part of capital and to avoid any uncertainty or ambiguity makes it mandatory that the values of Mudarabah capital should be known to contracting parties. Furthermore, for the Mudarabah contract to be valid Mudarabah capital either wholly or partially should be at the disposal of Mudarib or Mudarib should have access to capital.

Rulings & Requirements relating to Profit: This clause is further divided into nine clauses explaining all requirements regarding profit; (i) distribution of profit should be on the basis of agreed percentages of profit instead of a lump sum amount or percentage of capital and it is also mandatory that both parties know the profit distribution mechanism. (ii) to earn a profit share along with fee in Mudarabah contract is not principally allowed, however, this can be done through two different agreements (iii) parties are allowed to change the profit distribution ratio at any time and they should define the duration for which the agreement would be valid. However, parties should agree on profit at the time when contract is concluded. (iv) in absence of any specific ratio for profit distribution the profit should be distributed according to customary practice and Mudarib should receive Mudarib fee equivalent to common market price for his services when even customary practice is not available.(v) Mudarabah contract becomes void when a party stipulates a lump sum amount in profit except the situation where parties agree for a varying treatment with profit distribution when it is over certain ceiling (below ceiling the profit will be distributed according to agreed ratio). (vi) this sub clause explicitly disallows capital provider (a) to provide two capital funds to Mudarib with a condition that profit on one of two funds will be taken by him (capital provider) and from other one by Mudarib (b) to take profit of one period and to give the profit of following period to Mudarib (c) taking profit of one transaction while granting profit of other transaction to Mudarib.

(vii) Profit can only be claimed or recognized till the capital is intact. This implies that losses will be deducted from capital and if these are greater than profit and in case of Mudarabah expense equal to Mudarabah revenue the capital provider will receive his capital back and Mudarib will not be entitled to any share in profit as there will be no profit. (viii) However, in case of profit at the time of liquidation the profit will be distributed according to the agreed ratio. (ix) In case of commingling of funds of Mudarib with Mudarabah funds, Mudarib becomes partner with regard to his own funds while a Mudarib for funds of capital provider and therefore the profit distribution in first case will be like partner while in latter case it will be according to the agreed ratio of Mudarib and capital provider according to the contract.

Duties & Powers of the Mudarib: Detailed duties and powers of Mudarib in case of both restricted an unrestricted Mudarabah have been explained through seven sub-clauses of the main clause.

In case of unrestricted Mudarabah, Mudarib is allowed to all activities including (a) attending all permissible and feasible investment subjective to his professional qualification and competency (b) carrying out necessary work like buying a commodity or marketing by himself or by appointing other person (c) choosing apparently risk free places and markets (d) safeguarding Mudarabah funds, these funds can also be deposited with trustworthy person whenever possible (e) sale and purchase on deferred payment basis (f) combining Mudarabah contract and a partnership contract either by permission or by appointing capital provider and may also accept funds from a third party subject to if this does not affect his (Mudarib) investment and management responsibility. In case of restricted Mudarabah the capital provider can restrict Mudarib's operation in terms of time, place and sector etc. However, the restriction should not restrict the Mudarib to achieve the objective of Mudarabah contract.

Third sub-clause clearly disallows the capital provider to stipulate the right to work with Mudarib or to be involved in selling and buying activities or their ordering though Mudarib should not perform any action without his consultation. This further clarifies that capital provider can't even put a condition on Mudarib to be involved in certain partnership or of mixing his (Mudarib) own funds with Mudarib funds.

According to the standard Mudarib should carry out all work according to the custom and therefore is not entitled to any extra fee. However, Mudarib can hire any other agent on Ijara basis but the wage cannot be paid from Mudarabah funds. However, for any work which is not customary Mudarib can hire any other party against Mudarib funds.

Regarding the sale/purchase of any item for Mudarabah operation Mudarib is not allowed to sell any item for Mudarabah operations below the common market price or to buy any item above the common market price unless and until if this is obviously in interest of Mudarabah objectives. Moreover, Mudarib has been disallowed to give any loan, gift and charity out of Mudarabah funds and is also not entitled to waive off right associated with Mudarabah operations; the only exception is when capital provider shows his consent to do so.

The clause also discusses that Mudarib is entitled to receive living and travelling expense from Mudarabah funds according to the approval of capital provider. However, in case of absence of any agreement in this regard he has the right to receive in accordance with reason and custom.

Liquidation of Contract: This clause explains situations of liquidation of contract along with the management of assets at the time of maturity of Mudarabah contract.

The standard mentions five situations for Mudarabah contract to be liquidated; (i) can be terminated unilaterally as it is non-binding contract (ii) with mutual consent of both parties (iii) on the date of maturity where parties had already an agreement to set time limit for it (iv) either Mudarabah funds have exhausted or have suffered losses (v) either in case of death of Mudarib or liquidation of the institution that acts as Mudarib.

Adoption of AAOIFI Shariah Standard of Mudarabah in Pakistan

Shariah Standards are being adopted in Pakistan with customization after consultation with stakeholders and approval from Shariah Board at State Bank of Pakistan (SBP). Standard no. 13 regarding Mudarabah was approved in its original form and has been made mandatory requirement for Islamic banking institutions since 2010.

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Investment of Zakat Fund: Modern Juristic Debate and Modes of Financing

By

Dr. Sayed Sikandar Shah (haneef)[*]

Introduction:

Since two decades some contemporary jurists and economists have been seriously engaged on rethinking of reviving socio-economic role of zakah fund via its productive use for the benefit of its designated recipients. This move has triggered two-dimensional debate: One pertaining to its legislative validity in the frame of Islam and another about the viable operational framework for such end where neither the immediate needs of the poor and needy are neglected nor the original funds are lost. In the pages that follow, we, after spelling out the conceptual framework of disbursing zakah fund, analyze these two issues with the aim of proposing some synthetic positions on the points.

Key Word: Reviving Socio-economic role of Zakah fund via its productive use for the benefit of its designated recipients.

Conceptual Framework:

Contemporary scholars still has been discussing productive use of *zakah* fund (*al-Istithmar al-zakawi*) by way of investing *zakah* fund alone or together with other funds for the immediate or future benefit of the *zakah* recipients. The process, according to Farah, would be to cater for the immediate need of the poor and needy[1].To This end, *zakah* management bodies would determine a portion of *zakah* fund to be paid monthly to the poor, and invest the remaining portion plus surplus of the previous years together with the allocations for non-existent *asnaf*, such as *riqab* (manumission of slave) in secured business ventures. It is held to be a Maqasid-affirming legislative action towards achieving socio-economic goals of *zakah, aside* from its spiritual cum moral[7] objectives.

[*] Author: Dr. Syed Sikandar Shah (haneef) is a Associate Professor Fiqh (International Islamic University Malaysia) E-Mail: haneef75@yahoo.com

[1] bd al-Fattah Muhammad Farah*, al-Tawjih al-Istithmari li al-Zakat* (Dubai : Bank Dubay al-Islami,1997),pp.19-23.

[7] *Zakah* as a pillar of Islam and an act of worship is profoundly spiritually flourishing. Its spiritual effect in terms of cleansing the *zakah* payer from the stinginess and niggardliness is underlined by the Qur`an,al-Tawbah:103.For details see, Ahmad Husayn `Ali Husayn,*Muhasabat al-Zakat* (al-Iskandariyyah : al-Maktaba al-Jami`I al-Hadith, 2006), pp.29-39.

The reasons are: first, it stimulates economic growth in the sense that it either enables the poor and the needy to become economically productive or helps the state to channel the *zakah* fund to profit-accruing business sectors with the view of creating job opportunities for the needy and the jobless.[8] Second, it meets the consumption demand of the poor thereby enhancing their purchasing power for goods and services. Lastly, it checks the tendency for hoarding the idle money, hence leading to production of goods ad service and financing projects such as education, medical care and social welfare again raising productivity of the poor.[9]

I believe it would be a progressive step towards realization the budget needs of the *asnaf* as defined by contemporary *Ijtihad. Asnaf* signify *zakah* beneficiaries as specified by the Qur`an: ``Al-*Sadaqah* (Zakat) are only for the *fuqara'* (poor), and *al-masakin* (the poor) and those employed to collect (the funds); and to attract the hearts of those who have been inclined (towards Islam); and to free the captives; and for those in debt; and for Allah's Cause, and for the wayfarer a duty imposed by Allah. And Allah is All-Knower, All-Wise.[10]``

As to what practically, these categories mean? The Prophet determined them according to the socio-economic condition obtaining at that time and environment[11].The classical jurists[12] likewise detailed the law in the context of their own understanding of the categories. Today, practically they are delineated as follows:

i. *Fuqara'* and *masakin* (the poor and needy) includes : orphan, divorced, old people, handicapped, patients, permanent low income, families of the prisoners and missing people and students.[13] As to how much they should be given, the jurists have differed: Some jurists maintain that they should be given what suffice them and their families for duration of one year.[14] Mainly because if one full year is the unit of time for the collection of *zakah*, by the same unit of time the poor and needy also should be given the *zakah*. The

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8 Ibid., pp.41-42.

9 Imtiazi et al (edits*),Management of Zakat in Modern Muslim Society*,(Riyadh: IDB,IRTI,2000),p.11.

10 Al-Tawbah : 60

11 For instance, the Prophet defined *miskin* as the one who does not turn round men and whom a morsel or two and a date or two turns back, but a *miskin* is he who does not find enough to make him free from want …nor he stands up and beg. See Al-Khatib Tabrizi, trans. Fazlul Karim, Mishkat *al-Masabih* (Delhi: Islamic Books Services, 1994), vol.2, p.61.

12 The classical jurists also defined these beneficiaries. For instance, According to Hanafiyyah, *faqir* is better off than *miskin* as he has but not equal to *nisab* whereas to Shafi`iyyah and Hanabilah the reverse is the case. Abd Allah Ibn Ahmad Ibn Qudamah,*al-Mughni* (Cairo : n.np, n.d), vol.6, p.457-458. See also, Abd al-Hafiz Farughli Ali al-Qarni, al-*Zakah WA Hajat al-`Asr*, (Qairo: Dar al-Sahwah, 1989), pp.113-114.

13 The list shows the practice of Kuwait and Malaysia, see Abdul Qader Dhahi al-Ajeel,``A Study On The Activities of Zakah Institutions That Are Based On Non-Compulsory Payment of Zakat``, A paper presented on the Third Zakah Conference, Kuala Lumpur, May 14-17,1990, pp.11-12. See also Sayed Sikandar Shah (haneef), *Zakat of Salary Through Income Tax Rebate: Understanding its Legal Bases in Islamic Jurisprudence*, Unpublished IIUM Funded Research Project, 2007, pp. 31-33, respectively.

14 Mustafa al-Khin *et. All, al-Fiqh al-Manhaji* (Beirut: Dar al-Qalam, 1996), vol.1, p.323.

payment can be made direct to them especially if they have no expertise or are handicapped, sickly or weak. Or they should be equipped with tools to become productive or helped to become self-employed. That is why the Prophet asked a beggar to take the hatchet and collect wood wire rather being dependent on begging.[15]

ii. The *amil* refers to the employee of the *zakah* department or other *zakah* management organizations as they devote their time and energy in the collection and distribution of *zakah.* In today`s context, such officers are salaried civil servants[16]or staff of charity organization. Thus, this portion may be given by way of another benefit to them or made part of portion to be used in financing.

iii. Those who have been inclined (towards Islam). This covers new converts in order to integrate them into the Muslim community, as they are cut off from their economic resources when revering to Islam. It may be also spent to encourage peace and friendship between Muslims and non-Muslims.[17] It may be also used to rehabilitate those confused about Islam or show tendency to renounce Islam.

iv. Freeing slaves. Today slavery is no more part of social life. Thus this allocation can be used to free Muslims from captivity or oppression and socio - economic domination of the powerful.[18]

v. The insolvent. This category includes those who have incurred debt on account of poverty, wars, economic recession or even *bona fide*[19] loss in business activities. They should be helped to write off their liability.

vi. For Allah's Cause. As to what does it mean? There are numerous interpretations. Some say it assigns a portion for those involved in *jihad* in the real sense of doing it for the sake of Allah as the Prophet explained when he was asked about a man who fought for his tribe, or because he is brave, or to show off: which of them was fighting for the sake of Allah? He said: 'The one who fights so that the word of Allah may be supreme is the one who is fighting for the sake of Allah'.[20] Vast majority of modern jurists, on the contrary, suggest a broader understanding of, the cause of Allah, beyond military engagements. To them, this phrase includes all types of struggle in the righteous cause, such as propagation of Islam, Islamic education,

15 *Mishkat al-Masabih*,vol.2,p.245.

16 Muhammad Abu-Saud, Contemporary *Zakat* (Cincinnati: Zakat and Research Foundation, 1988)*, pp.166-167.*

17 Ibid. See also, Nadiyah Ahmad Hashim, ``Masarif al-Zakat``,in *Abhath Nadwat al-Tatbiq al-Mu`asir li al-Zakat* (al-Azhar: S.A.Kamel Centre for Islamic Economics,2002),vol.3,pp.19-20

18 Abu Al-Hasan Sadeq, *A Survey of The Institution Of Zakah: Issues, Theories And Administration(*Riyad : Islamic Development Bank Islamic Research And Training Institute,2004),Discussion Paper II,,p.40 and also Abu Saud, Contemporary Zakat,p.166.

19 Sadeq, A *Survey of The Institution Of Zakah: Issues, Theories And Administration,* Ibid.

20 Ibid.,

activities to establish Islamic way of life, spending for social welfare programs and economic development projects, manpower training or even education in various scientific and technical fields on the ground that such programs will help the poor who directly participate in them.[21]

vii. The way farers. This category refers to travelers and all those who have lost contact with their local residence and are stranded in a foreign land and want to go back to their countries.[22] Such people may be given enough *Zakat* to enable them to reach their homeland, even if they are rich in their own country.[23]

The above redefinition of asnaf clearly shows that socio-economic aim of zakah in helping the poor and needy in many ways and cannot be realized via cash distribution to the poor and needy. Accordingly, investment would be the most viable tool for implementing God`s command in modern condition. However, we need to thrash out the following fiqhi questions:

1. Does the payment have to be direct to the poor and needy?

Contemporary scholars answer this by saying that it does not have to be necessary so. Mohammad Qutub says it can be used to provide social services including hospitals and schools and also for factories which create employment opportunities for the people.[24] As bu Zahrah also says it can be given to welfare organizations whose core business is welfare work for the poor and destitute. [25]

Nevertheless some like Shahhatah objects to the use of *zakah* in socio-economic structure for public as *zakah* does not belong to general public revenue in the state budget.[26] But exceptions are financing of : 1) Islamic education (2) vocational training and the necessary tools, (3) agriculture and cottage industries, (4) simple fixed assets for small utility and trade projects, (5) working capital to craftsmen, (6) low-cost-housing, and (7) medical facilities, free of charge or at a nominal fee. To him, Islamic moral values and brotherhood requires provision of these goods and services in an Islamic society.

Qureshi also maintains that in principle *zakah* should not be spent for socio-economic structure except if such projects enhance the position of the poor and the needy.[27]

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21 Renowned figures like Maududi, Syed Qutub, Abul Kalam Azad and Shibli Nomani maintain this stand. Ibid.

22 Ibid.

23 For a detailed account of modern interpretation of *asnaf* (*zakah* beneficiaries), see Ahmad `Abd al-Aziz al-Muzayni, *al-Murshid al-Hayran fi Ahkam al-Zakat* (al-Kuwait: Dhat Salasil, 1984), pp.111-176.

24 Ibid.

25 Ibid.

26 Ibid.

27 Ibid,p.40

The Majlis Tahqiq Masail Hadirah totally rejects this idea as it violates the principle of its *tamlik* by the deserving beneficiaries.[28]

2. Non –Muslims as recipients

The scholars are divided on this, some like Shaik and Abu Saud maintain that there is no evidence in the Qur`an nor in the Sunnah to prohibit this provided that the needs of Muslims are met first and the non-Muslims in question do not indulge in hostility against Muslims.[29]

Others like Maududi, on the contrary, held this not to be permissible on the basis the *hadith* "To be taken from your rich people and to be distributed to your poor people." Here "you" refers to "Muslims". The non-Muslims should be helped from general welfare funds.[30]

3. Is it permissible to pay *zakah* only to one category?

This is again debated among the jurists. Some like Abu `Ubayd allow it by saying that there is no limit of paying *zakah* to a single recipient.[31] It is allowed to pay a beneficiary so much that he can buy a house, if he does not have one. This receives support from the implication of the classical jurist's pronouncement. For instance; al-Nawawi is reported to have held that a recipient of *zakah* should be given enough money to make him self-sufficient. According to Malikiyyah and Hanabilah self-sufficiency should be assured for a full-year.[32] But according to al-Shafi`i all beneficiaries must be give their due shares.

4. Should *zakah* be given to all the heads of recipients?

Opinion varies across the jurists. Some like Abu `Ubayd and al-Mawardi, maintain that it has to be spent on all the categories and no category should be encroached upon. Nevertheless according to Ab `Ubayd it does not have to be equally portioned. The ruler has discretion to allocate more to those who are in more need.[33]

Abu Yusuf, on the other hand, does not see this as necessary. To him, the ruler is at liberty to give the *zakah* to anyone of the eight categories. He may spend only on one category if it deems most appropriate.[34]

From the above, by agreeing with the investment –affirming view, we would be confronted with another crucial question of legitimacy of such adventure in Islamic

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28 Ibid.

29 Ibid, Abu Saud, *Contemporary Zakat*,p.176.

30 Sadeq ,*A Survey of The Institution Of Zakah: Issues, Theories And Administration*,p.41

31 This represents the Hanafis position. See Nadiyah Ahmad Hashim, ``Masarif al-Zakat``,p.38.

32 Ibid, p.39.see also Khurshid Ashraf and Iqbal al-Nadwi, ``Masraf al-Fuqara wa al-Masakin: Tatbiqatuha al-Mu`asirah``, in *Abhath Nadwat al-Tatbiq al-Mu`asir li al-Zakat* (al-Azhar: S.A.Kamel Centre for Islamic Economics, 2002), vol.3, pp.6-14.

33 Sadeq ,*A Survey of The Institution Of Zakah: Issues, Theories And Administration* ibid,p.42

34 Ibid. see also Khurshid Ashraf and Iqbal al-Nadwi, ``Masraf al-Fuqara wa al-Masakin: Tatbiqatuha al-Mu`asirah``pp.6-14.

jurisprudence (*fiqh*). To answer this, now we turn to this central point which constitutes the main theme of the paper.

Zakah investment:

The question as to whether, *zakah* fund can be utilized in financing development projects and trade ventures, so as to expand its disbursement base beyond the current need of the recipients especially the poor and needy among them, has invoked two divergent answers[35]. One group maintain[36] that the zakah collections must be disbursed immediately to the recipients, the state has no *locus standi* to invest it with the view of generating more income. Their main arguments are[37]: First, it does not only blur the designated class of beneficiaries. Second, it also contravenes the principle of *tamlik* by the recipients, namely the *faqir*, *miskin*, amil and *mu`allafat al-qulub* among them. The reason being that the Qur`anic use of proposition *li* implies transference of *zakah* from the owner of wealth to these groups. Hence the ruler has no such discretion on the matter. Third, it is against the condition of prompt distribution of the *zakah* to its recipients as held by the majority of the classical jurists who argued that delay might be detrimental to the interest of the poor in the event if the fund is destroyed or lost.[38] Fourth, *zakah* is not supposed to be reserved for future needs, it is primarily designed to alleviate present economic need of the recipients. Fifth, using *zakah* in income earning projects is a kind of accursed innovation in the area of immutable aspect of Islam i.e. legislating on a pillar and religious rite.

On the contrary, majority[39] of modern jurist disagreed and rebutted the opponents `s arguments by saying :First, according to majority of the classical schools, the ruler can spend the entire *zakah* fund for the benefit of one class alone and that also at different rate. Accordingly, it is well within his power to use *zakah* fund for the benefit of recipients in this way if it would be for their *maslahah* thus question of burring categories would not arise. Second, it is also not against t*amlik* (transference of private ownership to the poor) as some jurists like Hanafiyyah and Shi`ah Zaydiyyah regarded feasting and clothing of the poor from the zakatable income of the *zakah* payer as fulfillment of his zakah.[40] Thirdly, *zakah* disbursement does not have to be prompt as maintained by Abi

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35 According to the resolution adopted by the Fiqh Academy, in its third round of discussion on 13 October,1986, there were four different position on the issue: conditionally permissible, allowed on the surplus of the collected *zakah*, permissible to the extent of using the portion allotted to fi sabil Allah (in the cause of God) only and total prohibition. see Husayn Ali Muhammad Munazi`, ``Tawzif al-Zakat fi Mashru`at Intajiyyah `` in *Abhath Nadwat al-Tatbiq al-Mu`asir li al-Zakat* (al-Azhar: S.A.Kamel Centre for Islamic Economics,2002),vol.3,p.8

36 Scholars like Qureshi and Taqi Uthmani represent this point of view. Daud, *Malaysian Zakat System* p.19.

37 Farah*, al-Tawjih al-Istithmari li al-Zakat*,pp.45-46

38 Al-Qaradawi,*Fiqh uz-Zakat*,pp.519- 520

39 Scholars like al-Qaradawi, al-Zarqa, Wahabah al-Zuhayli al-Nabhan, Shahhatah, Munazi` and Farah represents this view. See Munazi` in *Abhath Nadwat al-Tatbiq al-Mu`asir li al-Zakat* (al-Azhar: S.A.Kamel Centre for Islamic Economics,2002),vol.2,,p.4

40 Ibid,pp.17-18.

Bakr al-Jesses of the Hanafiyyah and al-Razi and Shi`ah Imamiyyah. According to al-Razi, it is a well-established principle of *usul al-fiqh* that mere command (to give *zakah*) does not require delayed or prompt disbursement but requiring the disbursement itself (sooner or later).[41] The Hanafiyyah also generally classify *zakah* as an obligation with extended due time (*wajib muwaasa`/bi al-tarakhi*).[42]Accordingly instead of giving the poor recipients their share in lump sum, they could be given monthly stipend from the proceeds of the zakah investment. Fourthly, future financial security is an important element as the Prophet urged Muslims that they should better leave their off springs wealthy rather that leaving them poor to become financial liability on people.[43] Moreover, the very fact that Umar was insistent on given the poor an amount that would suffice them for rest of their life, and the Hanafis and al-Shafi`is agreement on providing the poor with tools of labor from *zakah* fund to become self-reliant are cogent proofs that *zakah* can be used for future security and the need of the recipients.[44]Finally, it is not an innovation of denounced type (*madmumah*) as it benefits the recipients and not harm them, thus belonging to the category of approved /praiseworthy innovation (*mahmudah*) which can be initiated on financial matters, such as *zakah*.[45]

Accordingly, the majority held it to be permissible provided that:

- the ultimate ownership of its return and the capital sum be spent on the recipients
- only the surplus fund should be invested
- Investment activities should be carried out with extra caution and prudent financial planning so as to avoid loss to the pool of *zakah* property.

Nevertheless Qureshi, on the other hand, still contests this idea by maintaining that should not be given a blanket approval and this matter should be left to the to the poor and needy to choose between consumption and investment, since their consumption needs may be more pressing which may be compensated only by very high profits. In the investment that may be defeated if business incurs a loss. Thus, the optimal choice for the poor and needy may be to avoid any investment from *zakah* funds. [46]

In my opinion, the view of the majority is to be credited as it receives support for the Prophet`s permission to a group of people from `Uraynah to drink milk of the *zakah*

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41 Ibid , pp.14-15

42 Yusuf al-Qaradawi, Fiqh *az-Zakat*, Monzer Kahf (trans.), (London: Dar al Taqwa Ltd, 1999), p.519.

43 *Sahih Muslim*, vol.6,p.86.

44 Ibid.,pp.19-21 ; Farah, *al-Tawjih al-Istithmari li al-Zakat,pp.51-52*

45 Farah,ibid,p.52.

46 He commented on investment proposal by expressing his misgiving about it. See Shawki Ismail Shahatah,`` Limitation on The Use of Zakah Funds in Financing the Socio- economic Infrastructure of Society`` ,in Imtiazi et all (edits*),Management of Zakat in Modern Muslim Society*,(Riyadh : IDB,IRTI,2000),p.75.

camels[47]. This according to Ibn Hajar implies that other uses such as riding and leasing would be also permissible, which by extension covers the issue in question. Additionally, his edict that the legal guardian of an orphan must trade with his/her property so as not to be consumed by annual payment of *zakah*[48] is another evidence to support *zakah* investment. More clear evidence was the precedent by `Umar who approved a loan kind of financing (*qirad*) from *zakah* fund by Abu Musa al-Ash`ari in favor of the former`s two sons, `Abd Allah and `Ubayd[49]. Further, it is strengthened with the substance of many jurisprudential rule of *zakah* including the following:

1. it is to benefit the deserving poor recipients by providing them with working capital or tools of profession as was agreed by all the jurists

2. It is in line with the idea behind the territorial disbursement of *zakah* as according to al-Qaradawi was intended to effectively help in the alleviation of poverty.[50] In this process it is also in consonance with giving priority to the poor and destitute as the ruler may deem fit. This definitely also harnesses the proposition for productive use of *zakah* fund to make these segments self-sufficient[51]

3. From the economic point of view, productive disbursement of *zakah*, to the poor and needy would thwart the inflationary effect[52] of *zakah* on Islamic economy. Accordingly from this stand point, it at macro level, should be permissible as a matter of economic necessity within the framework of Islamic fiscal policy. The productive disbursement scheme for this is suggested to be through preparing a surplus *zakah* budget. Then this fund should be mobilized by investing it in industries to provide employment to the poor. The profit out of these investments would be granted in the form of *zakah* certificate, cashable at the option of the holder after a period of three to six months. In this way the poor people propensity to consume more (demand) at least can be dampened for a short period [53].Another dimension is that investment oriented disbursement of *zakah* funds would have cumulative effect on reducing poverty. [54]

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47 *Sunan al-Tirmidhi,*vol.6,p.128.

48 Malik Ibn Anas, al-Muwatta (Beirut : Dar Ihya al-Turath,1985),p.59.

49 Abu Musa al-Asha`ari, handed *zakah* fund to `Abd Allah and `Ubayd and told them that you can purchase with it merchandise from Iraq and then sell it in Madinah. You can retain the profit for yourself and surrender the capital sum to `Umar. For details, see Malik, ibid.

50 Al-Qaradawi,Fiqh uz-Zakat,p.637

51 Quoted in Shahatah*, Limitation on the Use of Zakah Funds in Financing the Socio economic Infrastructure of Society, p.62.*

52 It would be inflationary as the poor have higher tendency to consume than the rich. If they are given direct cash as *zakah*, the result would be increase in the aggregate demand in the economy (push the price higher). It thus further damages the interest of the poor. See Sabahaddin Zaim,``Recent Interpretation of the Economic Aspect of Zakah ``,in in Imtiazi et all (edits*),Management of Zakat in Modern Muslim Society*,(Riyadh: IDB, IRTI, 2000), p.114.

53 Ibid.

54 Ibid.,p.116

Proposed theoretical mechanisms for financing:

The supporters of *zakah* potential for financing have offered various models for *zakah* investments. I had access to the following models.

Shahhatah`s model:

Shahhatah, while proposing a framework for the contemporary use of the *zakah* fund in financing the Islamic socio-economic projects[55], suggests the following[56] :

1. *Zakah* revenues can be used in lawful *Mudarabah* projects, with the *zakah* authority acting as the owner of the capital, and the *zakah* beneficiaries acting as partners by contributing their work. The profits will be distributed between them on the basis of a pre-decided ratio.
2. Loan can be provided to able-bodied beneficiaries who pay the money back; it may generate a new source of finance for the beneficiaries.
3. Giving possession of low cost houses on the basis of rent financing.
4. financing partnership businesses that would culminate in the ownership for the benefit of the *zakah* recipients
5. provision for leasing light fixed assets and production tools with nominal fee or rent to the poor or the needy
6. Interest free loans to those suffer calamities, illnesses or costly surgery.

Anwar`s Model:

According to his model, a jurisprudentially consistent mechanism can be worked out for the purpose of *zakah* utilization in financing development projects. To this end, he proposes the establishment of a special financial institution called, *"Awqaf-Zakat* Investment Fund" (AZIF) from the *zakah* fund. It would be registered as a *waqf* institution and shall operate as profit seeking corporate venture. It may have its branches and affiliate offices throughout the country, investing zakah funds into long-term concerns. Its paid up capital would be distributed in terms of shares to the *zakah* beneficiaries. It in collaboration with Islamic banks would engage in financing activities in accordance with well-known Shari'ah compliant modes in projects that most benefit the poor and the needy/helps the poverty alleviation. For example, financing of building infrastructure in the rural areas, financing of the small and medium –sized industries, such as fisheries and poultries run by poor and for their benefit etc. To manage the loss risk, it would diversify its investment portfolios as well as it builds a loss reserve account from its earnings over time. To him, his model is a Shari'ah-compliant one because : First, it satisfies the juristic conditions of *tamlik* (personal ownership of the *zakah* fund)by the poor and needy as they would be the

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55 He proposes financing projects, such as education, vocational training, rehabilitation facilities, small agricultural and cottage industries, low cost housing, health care etc. For details see Shahhatah, *Limitation on The Use of Zakah Funds in Financing the Socio-economic Infrastructure of Society* ,pp.70-71

56 Ibid,pp.69-73.

shareholders of commercial products by virtue of their shares. Second, it guarantees against the loss and meets it, if incurred, from its built –up loss reserve account. Lastly, it fulfills the condition of immediacy of *zakah* disbursement to satisfy the pressing consumption need of the poor and the needy as it makes arrangement with the prominent outlets to accept their certificates(Zakat House in Kuwait issues coupons), representing shares, at a price not less than their face value when selling them commodities or services. These outlets can redeem them later on from the *zakah* centers.[57]

Farah model:

To him, to accomplish the utilization of *zakah* fund for investment purposes, there is a need for establishing a special *zakah* investment banks (*bank iththithmar al-zakawiyyah)*.This bank in coordination with *zakah* departments can conduct financing activities that any other bank may undertake. [58]

Zaki Badawi`s model:

To him, to tackle the issue of zakah financing, a clear distinction should be made between the utilization of *Zakat al-fitr* and Zakat *al-mal*. The former should be used for the urgent consumer need of poor and needy, the latter should be invested in productive ventures such as textile factories, machine tools of manufacturing and low cost houses as long- term solution to overcome the problem of poverty.[59]

The practical model: the practice of Kuwait Zakat House

After outlining the theoretical framework for investment oriented disbursement of z*akah* fund, it is worthwhile to briefly outline as to what have been happening at the implementation level in the Muslim countries. To this end, we refer to the practice by Kuwait Zakat House as an example[60].

Kuwait Zakat House is a government institution. It has an independent budget, and was established by Law No.5 in 1982. Its aims at collection and distribution of *zakah* fund and other donations and spending them according to the Shari`ah principles. In this pursuit, its investment oriented approach to zakah disbursement is as follows:[61]

i. It keeps zakah fund in two types of account with the bank, namely current and saving accounts. It’s earning on saving accounts increases the original fund deposited with the bank.

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57 Muhammad Anwar, “Financing Socio-economic Development with Zakat Funds” in Journal of Islamic Economics, Vol. 4, 1 & 2, July 1995, 17-18

58 Farah,, *al-Tawjih al-Istithmari li al-Zakat,pp.19-23*

59 Zaki Badawi,`` Zakat - A New Source of Development Finance`` in *Islamic Banker: News and Analysis of Islamic Banking, Finance and Insurance*, Issue: 4, March 1996, 18-19

60 It is regarded as a successful experience so far. See Anwar, ‘Financing Socio-economic Development with Zakat Funds ``in Journal of Islamic Economics, Vol. 4, 1 & 2, July 1995, 17-18

61 al-Ajeel,``A Study On The Activities of Zakah Institutions That Are Based On Non-Compulsory Payment of Zakat`,pp.10-30

ii. It provides free interest loan to people in need of money and secure its repayment by way of installments.

iii. It finances the vocational training for capacity building of people capable of becoming productive citizens (under a scheme called, productive rehabilitation scheme).

iv. It sponsors poor students` education by offering them interest free loans

Conclusion and recommendation:

From the above discussion, it is crystal clear that productive use of *zakah* fund for the benefit of its beneficiaries derives its validity from many arguments as articulated by both, legal and economic scholars. It all the more becomes rationally acceptable on the surplus *zakah* fund lying with the current accounts and even saving accounts of the banks in the case of countries which impose mandatory *zakah* on its citizens [62]. It would not be sensible that such huge amounts would be left idle and not exploited to increase the much needed funds for alleviating poverty and helping other Shari'ah-designated social causes. As for religious legitimacy of such procedure, it suffices to quote the Prophet`s practical guidance of asking the beggar to get the hatchet and collect the wood fire and sell rather than being dependent on begging. Similarly his permission to utilize the camel (collected as *zakah*) for milk and other utility should not leave any shred of doubt on the lawfulness of *zakah* investment and financing. Moreover, since practically some countries have already embarked on this mode of disbursement, the academic debate about its legality should no longer be a subject of academic controversy. What remains ahead of us is the challenge of doing it efficiently so as the twin objectives of seeing people still fulfilling their *zakah* obligations and the poor and needy beneficiaries attaining self-sufficiency are met. Accordingly, to successfully undertake such financing activities at the legal plane, the following *fiqhi* requirements must be met:

i. the investable funds should come from the portions of *zakah* allocated to beneficiaries other than those allotted to the unproductive poor and needy recipients. This should be combined with surplus fund available, if any, with Zakat institutions. To do this, *zakah* collection must be made compulsory on all the wealth whether *Zahir or batin.*

ii. the operational cost should be come from the profits or the organization budget.

iii. financing mechanism to carry out investment activities could be framed within the legal framework of each and every country. The reason is that in most of the Muslim countries, the *zakah* collection and disbursement are carried out by statutory bodies, such as state religious councils though affiliated with the other government bodies, such as Waqf Ministry or ministry of finance .In my opinion, the *zakah* body as such can have an

62 For instance, in Pakistan by 30 the June 1989, over 4 billion rupees of undisbursed *zakah* fund was left idle in a current account. see Muhammad Anwar, 'Financing Socio-economic Development with Zakat Funds ``in Journal of Islamic Economics, Vol. 4, 1 & 2, July 1995, 17-18

entrepreneurship wing to conduct such financing activities, advised by competent Shari'ah experts from an array of fields, such as Islamic law, economics, business, management, sociology etc. This would have the advantage of saving *zakah* departments from being seen as business organization by ordinary folks.

iv. The proper financial planning as highlighted in this paper should be in place so as to forestall avoidable business risk.

v. The immediate consumer needs of the able bodied poor for essential goods and services, via practical mechanism as referred in this paper, are fulfilled .

Consumer Behavior & Marketing: Islamic Perspective

By
*Salman Ahmed Sheikh**

Abstract

Consumer behavior is the focal point of understanding, identifying and estimating the market demand followed up by supply side response with product offerings, design and marketing efforts. It is also the core area of Economic research in microeconomics and recent micro-enriched macroeconomics. In this paper, we explain the normative basis of Islamic economics in general and elucidate consumer theory from Islamic perspective in particular. On the demand side, Islamic worldview based on oneness of God and afterlife accountability greatly influences the decisions, actions and choices of the consumer. We discuss how Islam places certain balancing limits on consumer choice set and budget constraints for greater welfare of the consumer himself and society in general. On the supply side, we explain the guiding principles and norms marketers must follow in product design, advertising and promoting their products. Finally, we discuss the consumerism culture, its relation with credit based monetary system and its contemporaneous and intertemporal effects on environment and distribution of resources.

Keywords Consumer Behavior, Marketing, Advertising, Sales Promotion, Ethics, Utility, Externalities, Consumerism

JEL Codes D11, D18, M31, M37

1. Introduction:

Purpose behind human existence is the basic question which only religion answers. Centuries ago, pioneer philosophers used to study and discuss ‘why we exist’, but after renaissance in Europe and revolt against Church, social philosophers came to the front and raised ephemeral and current issues of society and left the study of ‘why we exist’.

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* Author: Salman Ahmed Sheikh is a Research Associate & Full time member (Economics & Finance) at Institute of Business Administration, Karachi, Pakistan. He heads Islamic Economic Project, written several research papers/ articles in the area of Islamic Economic & Finance. E-Mail: salmansheikh@iba.edu.pk

Then, science developed and material life improved. However, without the core of religion or any comprehensive doctrine, compartmentalization of social science disciplines occurred. Increasingly, we witnessed lack of focus towards interdisciplinary research and integrated approach. As a result, economics became just the study of material progress and how we can achieve it. Overmathematiziation and borrowed notions from physics limited the scope of inculcating normative and more importantly philosophical and moral issues in the study of economics.

Ahuvia (2002) attempted to explain an empirical puzzle on the relationship between consumption and subjective well-being. In literature, it is established in some studies that people in rich countries are, on average, significantly higher in subjective well-being than people in poor countries, which is consistent with a strong link between one's overall level of consumption and one's subjective well-being. However, when individuals within the same country are compared, income has little relationship to subjective well-being above the level at which basic needs can be met, suggesting that higher levels of consumption may not be linked to higher levels of subjective well-being.

In 21st century, we have things that were enjoyed by Kings only in past. But, most of the happiness studies show that in general, a majority of us is not happy. We are not happy as we suffer by comparison. As we compare ourselves with our peers on material possessions, that comparison in any developed capitalistic society shows us huge disparity.

The idea of material progress and well being enabling the people to forget fear and religion and question of 'why we exist', has failed. Ignoring the purpose of existence and trying to replace it with material self pursuit does not and has not solved the fundamental human problem of 'why we exist'.

Peterson et al (2005) conducted a survey from 845 adults. Study measured life satisfaction and the endorsement of three different ways to be happy: through pleasure, through engagement, and through meaning. Each of these three orientations individually predicted life satisfaction. People simultaneously low on all three orientations reported especially low life satisfaction. Hence, lasting pleasure, equity and purposeful existence is essential for durable happiness.

Only religion has the answer to 'why we exist' and hence only it gives complete meaning to life. The basic premise of Islam is that we have been created by One and Only Allah so that we obey Him and that if we do, we will be rewarded by Him in Heaven. Only religion provides the deterministic and absolute justice which is desired by every human being. Only the place in heaven provides us the incentive to have freedom from limitations of this world, to have no regrets of the past and no concerns for the future. Only the belief in life hereafter provides the incentive to do good deeds in all situations and avoid bad deeds in all circumstances as there is good reward for all right things and bad reward for all wrong things. Only Allah has the complete knowledge and complete authority to make it happen in life hereafter.

Economics says that there is a tradeoff in every resource use as every resource has alternate uses. One may feel that striving for success in life hereafter would require a drastic tradeoff between material pursuits and following Allah's will. Indeed, if material lust is preferred over Allah's will, there will be permanent loss in life hereafter, but that does not preclude us from not having the ability to benefit from Allah's blessings in this world.

Islam does not discourage seeking Allah's bounty in the world. One prayer in Quran reads as follows:

"…But of mankind there are some who say: "Our Lord! Give us (Your Bounties) in this world!" and for such there will be no portion in the Hereafter. And of them there are some who say: "Our Lord! Give us in this world that which is good and in the Hereafter that which is good, and save us from the torment of the Fire!"

(Al-Baqarah: 200-201)

In Economics terminology, Islam does not ask us to have a corner solution when the two goods in question are 'worldly benefits' and 'investment for life hereafter benefits'. Islam does not require us to completely abstain from blessings of this world, but to have a balanced life and a balanced composition of the two goods mentioned above.

Afterlife accountability enables observing ethical values which are not easily enforceable through legal systems made by humans after all. Question of fairness and equity can only be sufficiently dealt with and incorporated into the preferences and behavior with belief in religion. Islam besides having a comprehensive perspective on justice, also recommends 'Ihsan' which requires Muslims to bring about fairness and equity with resources they have as blessings of Allah and which they should regard as a trust and act always with spiritual rationality of afterlife accountability.

Resources are scarce as compared to unlimited wants. But, the economics of non-rival ideas creation has proved that resources are ample and that physical resources could be used in ways that keeps fulfilling the basic needs of society through the creation of ideas that augment and bring multiplier effect to the availability of given physical resources.

Another aspect of resource scarcity is completely psychological rather than physiological. Humans compare themselves relatively to their contemporary peers. Indeed, we, as individuals have much more facilities and better standard of living in material terms than even the kings of the past. But, even that does not satiate our hunger and sense of deprivation.

Religion provides such meaningful conditioning which makes us bring the right balance between our aspirations and physical limits. Religion also promises salvage from the limitedness of this worldly life in heaven which will be awarded to the most righteous people. This, in turn, provides a permanent incentive to choose righteous behavior as an end with the hope and fear of deterministic results in life hereafter.

Humans are much more than utility maximizing machines. They are capable of using both material rationality and moral rationality to differentiate right from wrong and need reinforcement to adopt virtues influenced by an inner urge other than just material interests.

This inner urge can be reawakened by looking beyond utility maximization models to re-acknowledge the principal fact that humans are moral being than just an instrument for maximum material advancement for self.

The unbridled pursuit of greed also requires some external source of guidance than mere reliance on material animalistic instincts of a human soul. Religion provides the ethical check and call to balance material pursuits with attention to misery of the underprivileged people.

Islamic Economics and its knowledge sources, i.e. Quran and teachings of Prophet Muhammad (pbuh) providing the foundation for Islamic Economics address directly the heart and remind the human being of his freedom in choosing actions and that he/she is expected to use that freedom in the manner that makes him/her worthy of eternal and complete happiness in life hereafter. This belief provides a permanent incentive to righteous behavior even if it does not get rewarded in this life and it also provides a permanent check on wrong behavior even if it is not codified and prohibited by the worldly institutions and law.

This brings in the dynamic model of life a sea of change and truly impacts a human's heart. It also influences the actions and reinvigorates the spirit of sacrifice and sparkles the moral being in a human.

Everyone that comes in this world is determined to die and then be answerable for his/her actions. There is no error term to subscribe to. The model of this worldly life is in the perfect perusal of the Creator, Who knows everything as He built everything. There is no error possible in Allah's judgment of us. We are the one responsible for our own parameters. These parameters are not exogenous to the model of life. We, performing different roles in our lives, are the ones controlling them.

History of economic man is fascinating. He has used the nature's blessings to find and create new and innovative ways of maximizing utility. But, nonetheless, at all points in time, he does not feel satiated. He remains poor 'relatively' to the limitless desires and nature's limitations. The dream of being absolutely apart only remains a dream in everyone's life. But, then, everyone achieves it one day. There is one place that everyone reaches where he is not accompanied by anyone. It's his or her grave. Belief in life hereafter is the only thing that gives meaning to this world and life and this is the most important pillar of Islamic economics.

2. Marketing from Islamic Perspective:

Explaining the principle of Islamic marketing, Saeed et al. (2001) stated that at the heart of Islamic marketing is the principle of value-maximization based on equity and justice (constituting just dealing and fair play) for the wider welfare of the society.

Hassan et al. (2008) explained that Islamic marketing ethics combines the principle of value maximization with the principles of equity and justice for the welfare of the society.

Anwar & Saeed (1996) argued that the Quranic view about man and his resources should be the basis for designing promotional tools and media strategies. It is necessary to inculcate Islamic values and uphold truth in the society. Advertising and promotions efforts must also be based on strong foundations of Islamic tenets and injunctions. The author also advocated the case for developing an Islamic code of marketing.

In a review of recent cross-cultural evidence on happiness and well-being, Uchida et al (2004) identified substantial cultural variations in (1) cultural meanings of happiness, (2) motivations underlying happiness, and (3) predictors of happiness. Specifically, in North American cultural contexts, happiness tends to be defined in terms of personal achievement. In contrast, in East Asian cultural contexts, happiness tends to be defined in terms of interpersonal connectedness. Hence, this evidence presents importance of understanding heterogeneity of preferences and even underlying definition of happiness and utility in different cultures.

Explaining the implications of this phenomenon, Sandikci (2011) noted that the communities of Muslim consumers are linked by faith but, as with other consumer groups; they are also marked by gender, class, age, nationality, ethnicity, etc. Although Islam is the common description, identities, practices and dynamics are very different in each of these cases.

Highlighting the effects of Islamic ethical principles, Saeed et al. (2001) elucidated that international marketing practices, embedded in a strong ethical doctrine, can play a vital role in raising the standards of business conduct worldwide. This does not necessarily mean compromising the quality of services or products offered to customers. Adherence to such ethical practices can help to elevate the standards of behavior and thus of living, of traders and consumers alike.

3 Mathematics of Consumer Preferences in Islamic Framework:

Modern day neoclassical economics has incorporated mathematics into economic thinking and discourse. Although it has its own merits, but it has made it difficult for the discipline to adequately address normative issues of equity, welfare and distribution. To facilitate and bridge the gap, Zaman (2005) gave a proposal to take the basic utility function of human beings as a lexicographic ordering.

In his model, every bundle of goods x, is evaluated using two functions (U(x),V(x)). Given bundles of goods x and y, comparison between them is done first on the basis of U(x) and U(y). If $U(x)>U(y)$, then x is preferred to y. If $U(x)=U(y)$ then comparison is done by looking at the second component of the utility function, with x being preferred to y if $V(x)>V(y)$.

According to Zaman (2005), 'U' is interpreted as the basic needs function. 'U' will have certain properties to conform to this interpretation. It should have satiation points beyond which additional goods will not add utility. In addition, it should be sensitive only to certain types of goods (basic needs) and insensitive to other types (luxuries).

In his framework, a person is poor when he has a commodity bundle x such that $U(x)<U^*$. He states Pareto Principle in Lexicographic form as follows:

An allocation $(x_1,x_2,...,x_n)$ of commodity bundles to individuals with utility functions (U_i,V_i) for i=l,2,...,n is socially preferable to an alternative allocation

$(y_1,y_2,..,y_n)$ if either (a) $U_i(x_i) > U_i(y_i)$ for all i, with strict inequality for at least one i, or (b) $U_i(X_i) = U_i(y_i)$ for all i, and $V_i(x_i) > V_i(y_i)$ for all i with strict inequality for at least one i.

We introduce another example of how the Islamic principles and norms can be appreciated in the language of mathematics. In the mathematical representation of externalities, it is known in economic theory that if make a joint welfare maximization function of party that is affected and the one who is affecting, then externalities can be 'internalized'. But, in a private market economy, private property is distributed.

However, with the concept of afterlife accountability, Islam immensely influences intertemporal choice and behavior. It helps in private economic agents (consumers, producers etc.) modifying their actions in such a way that takes the externalities into consideration and also their own welfare, both in this world and afterwards. Afterlife accountability stimulate positive change in behavior in a much more comprehensive and permanent manner than any regulation or material incentive could possibly do.

4. Advertising in Monopolistic Competition: Islamic Guidelines:

In the real world, we find many producers for most goods and services. Often, these producers offer differentiated products which means that some of the characteristics of products offered by the producers are different. Each producer can create demand for its products by focusing on specific features like some could focus on producing an economical product while someone else could focus on quality and still others could focus on catering to different taste preferences of different sections of the market etc. In industries like cell phones, restaurant meals, automobile etc, we see many producers supplying differentiated products.

In economics, such a market in which there are many producers serving differentiable products is known as monopolistic competition. In this market type, often producers adopt certain marketing strategies and execute marketing plans to increase their product's appeal, demand and hence increase the sales and thereby profits and create brand loyalty for their products.

Key parts of the marketing strategy include creating awareness about the product, publicizing its main features and present it as more compelling than the other products offered by competitors. From an Islamic perspective, there are certain principles and broad guidelines that must be followed and taken care of while advertising the products.

Below, we explain some of these.

1) First of all, Islam through its divine principles has a filter that disallows production and consumption of certain goods and services such as liquor, obscene content offered through various media and in various forms, such as in some films, video games, music concerts etc.

2) False information must be avoided. 'Kazb' (lie) is condemned in Islam.

3) Persuasive advertising that commits attributes which cannot be provided as promised is wrong. Not acting upon the promise made is a serious sin in Islam.

4) While physiological and aesthetic needs and wants can be targeted through effective presentation, but, the presentation that overly promotes consumerism is to be avoided.

5) Even in halal goods, 'Israaf' (excessive spending) is disallowed. Islamic principles would encourage not using the economy's given physical capital stock, labor force and other resources on the production of goods and services that represent and encourage excessive spending.

6) Islamic principles do not disallow market forces to work, but, Islamic principles encourage observing Adl (justice) and Ihsaan (acting on something in the most appropriate manner). They encourage cooperation, empathy and social responsibility. Hence, using price power to make essential goods more expensive and using quantity restrictions to raise prices are forbidden acts.

7) The presentation must not show shrewdness/smartness on the part of the producer. It is because our belief is that the end result of our actions is not necessarily mechanical, it all eventually depends on Allah's will.

8) Islamic tradition also does not merit creating appeal for products by representing culture that does not signify or match with Islamic social etiquettes. For instance, advertising for perfume by showing how it can create positive image before opposite gender is neither necessary nor in line with Islamic social etiquettes. Likewise, showing how one can stand out and be envied by others if one buys a particular brand of perfume, car, suit etc is also neither necessary nor in line with Islamic etiquettes.

9) Disclosures about products must not be presented in a way to just bypass legal formalities. Rather, the disclosures must be explicit, readable, visible and presented with the belief that if same cannot be put against one's actions in this world by someone in a court of law, then, it will nevertheless be one day put forward before A Judge Who knows it All.

10) By not using sex appeal, status appeal, and envy in human's nature to market products, the consumer protection will be ensured. Moreover, if over commitment will be avoided, there will be much lesser need to expend huge sums on advertising as often, the need to advertise more is there when the firm wants to create demand that does not exist or convince about a product with features which are not 'indispensable' and are only used to create perceived product differentiation.

5. Consumer Culture & Islamic Consumer Finance:

In consumer behavior, there are two important aspects from Islamic economics perspective that must be understood. First aspect is related to the 'choice set' and second aspect is related to the 'budget constraint'.

5.1. Limit on Choice Set:

Islam discourages lavish consumption, i.e. Israaf (extravagance even in lawful things) and Tabzeer (consumption in unlawful things like liquor, free sex etc). Islam encourages modesty and balance.

Islam encourages spending on society with directives for charity. Allah promises great rewards for charity. Belief in afterlife expands the decision making horizon for a consumer and the consumer is promised compounded increase in utility for forgone consumption and charity payments in this world after fulfilling one's own needs.

5.2 Limit on Budget Constraint:

Islamic never encourages one to become indebted unless it is 'necessary'. Following Ahadith show the viewpoint of Islam on indebtedness, especially when it is beyond one's capacity to repay. These Ahadith provide the guidelines as to what extent indebtedness should be avoided and used to meet only one's necessary requirements.

Prophet Muhammad (pbuh) said:

"O Allah! I seek refuge with Thee from sin and debt." [Sahih Muslim]

The Prophet Muhammad (pbuh) said:

"After the grave sins which Allah has prohibited, the greatest sin is that a man dies while he has debt due from him and does not leave anything to pay it off, and meets Him with it."

Following supplication is related to the Prophet Muhammad (pbuh) for salvage from debt:

"O Allah! I seek refuge in You from all worry and grief. I seek refuge in You from incapacity and slackness. I seek refuge in You from cowardice and niggardliness, and I seek refuge in You from being overcome by debt and being subjected to men."

Implications for Islamic Finance

But, the currently practiced Islamic finance contracts used widely are based on debt based financing than equity financing.

Some financial institutions in Islamic countries have developed Islamic credit cards for consumer financing. As a matter of fact, banks want to make profit out of the business of providing finance, even for consumption purposes. Fiat money based monetary system with fractional reserve banking at its core requires consumerism for credit expansion. This is not the preferable path to follow looking at the various principles and philosophy of Islamic faith. Islamic economics and its basis, principles and objectives may very well be increasingly compromised if such path is taken.

Next, we present a few examples of original marketing slogans used by Islamic banks to show some shortcomings in following the above mentioned guidelines.

"Finally, a car that lets you fly. Finance your dream car."

"Live in your dream home."

"Drive your dream car."

"Shariat Mein Barkat." (It means 'blessing is only in Islamic law')

These slogans have contributed their share in promoting consumerism in society and leave behind the Islamic virtues of 'Shukr' (thankfulness), 'Sabr' (patience), ‘Tawakkul’ (steadfastness), ‘Infaaq’ (payment to charity), refraining from ‘Israaf’ (extravagance), ‘hubb-e-maal’ (love of wealth) and ‘hubb-e-dunya’ (love of materialism).

According to Quran, if one does not want to invest money for profit, but has some surplus funds, Islam has encouraged spending in charity over lending for interest (Al Baqarah: 276). Instead of giving some pragmatic means of restoring time value of money alternatively, Allah has encouraged charity, if we have surplus funds.

"They ask thee how much they are to spend; Say: "What is beyond your needs." Thus doth Allah make clear to you His Signs: In order that ye may consider." (Al-Baqarah: 219).

"In their wealth, there is a known right for those who ask for it and those who have need for it." (Al-Muarij: 24-25).

Instead of creating awareness about these virtues with their position as an Islamic institution or an institution working in conformity with Islamic rules and principles, what Islamic banks have been unable to do is to create awareness among the masses about the Islamic virtues mentioned above.

6. Consumer Culture & Environment:

In a World Bank report, it was highlighted that the use of energy per capita in high income countries is more than 5 times as much as in developing countries, and with only 15% of the world’s population, high income countries use more than half of its energy (World development Indicators, 2005).

In Stern Review, it was highlighted that United States is found to be the most polluting country in the world together with Europe which accounts for around 70% of world’s pollution.

Mortazvi (2004) pinpoints the root of the problem and states that the concern over the tragedy of the commons emanates from the fact that Western economics has become a discipline devoid of values. Exploitation of the natural environment can be abated when individuals consider intergenerational welfare and justice to be important factors in their economic decisions. Islamic economics, unlike its Western counterpart, is a value-driven discipline replete with moral values that limits individual’s consumption, and imposes significant social and religious responsibilities on individuals as guardians of the natural environment for future generations.

Khalid (2002, pp. 332) explaining the effect of growth led by fiat money expansion that has speedily deteriorated the environment writes:

> “These tokens of value that we create from nothing and use everyday grow exponentially ad infinitum. But we know that the natural world, which is subject to drastic resource depletion, has limits and is finite. This equation is lopsided and the question is for how long can we continue to create this infinite amount of token finance to exploit the real and tangible resources of a finite world? Looked at from this perspective, money, as the modern world has contrived it, assumes the characteristics of a virus that eats into the fabric of the planet. The consequences of this become visible as global environmental degradation.”

Hassan (2006) shares the same line of thought and states that in the international arena, nothing can help except realization of common danger, discipline and sacrifice for common good. Free riding can hardly be condoned. Instead of preservation and restraint, we are borrowing from the future to consume now via the credit card culture. In a word, we are jeopardizing the future of our children let alone leaving them in at least the same position as ours.

ASTRÖM (2011) explains that one of the problematic points of view of today's generation is that they have the rights of limitless ownership without taking into account the responsibilities towards society and humanity.

Finally, Na'iya (2007) suggests that the effective solution to the environmental problems lies on the overall worldview which spells out the relationship between man, nature and his Creator as well as the implications of one's actions in the hereafter.

Conclusion:

In this paper, we outlined the normative basis of Islamic economics in general and consumer theory from Islamic perspective in particular. On the demand side, Islamic worldview based on oneness of God and afterlife accountability greatly influences the decisions, actions and choices of the consumer. We discussed that Islam places certain balancing limits on choice set and budget constraint for greater welfare of the consumer himself and society in general. On the supply side, we explained the guiding principles and norms marketers must follow in advertising and promoting their products. Finally, we discussed the consumerism culture; its relation with credit based monetary system and its effects on environment and distribution of resources contemporaneously and intertemporally.

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Re-Takaful And Its Corporate Governance

By
Prof. Dr. Mohd. Ma'sum Billah [*]

ABSTRACT

The challenges posed by both neo-modern and postmodern society and their secular cultures are very far reaching. The impact can be felt in every facet of life be it religious, political, social and economical. Following the rapid and strangulating development of the economy of the super other western powers, the insurance sector inclusive, most developing economies especially in the Muslim world feel a pressing need to re adjust their economies in order to meet up with the rapid development and high rate economic growth taking place in these developing economies. The Muslim world among others is in need of access to large and open markets among the different Muslim countries in order to have a high rate economic growth too. A survey of recent Muslim scholarship on western theories and epistemologies reveals an attempt to understand western legacy on modern society so as to liberate Muslim societies from secular and foreign control. This is to ensure that political, economic and other preoccupations of Muslims do not become mere distractions of the world from their care and development for the hereafter. Islam is concerned both with material and spiritual advancement. The Islamic worldview can therefore never be compared to any other worldview.

It is against this background that current Muslim scholarship in the field of finance and economics in general should be viewed. It is an attempt at the total Islamization of the banking and financial sector so as to free the Muslim world from the dominant Western civilizational and ideological value-laden economic, financial and banking principles. Presently, most of the Muslim world like third world countries has under-developed economies suffering enormously under the claws and yokes of western economic and financial interest-based system. One of such key areas of modern financing where the Muslim world need a kind of economic co-operation in order to confront the challenges posed by western interest based financial system is Re-takaful Business which forms the focus of this paper. It is sad that in spite of the

[*] Deputy Vice-chancellor, UCTECH, Malaysia. Personal Blog: www.drmasumbillah.blogspot.com

abundance of human and natural resources in the Muslim world, the Takaful and Re-takaful Business and the entire Muslim world economic sector can still not compete with conglomerate companies like the American Insurance Group and the likes. Though the insurance business in principle was accepted by Islam right from the time of the Prophet when he instituted what can be regarded as ma'qil al-ijtima' or social insurance between the Muhajirun (Muslims who migrated from Mecca) and the Ansar (Muslims who welcomed the emigrants in Medina), yet the insurance business has undergone a lot of developments and innovations since the time of the Prophet.[1] *In view of the Islamic acceptance of insurance in principle as well as the necessity of the insurance scheme in our complex society, there is need to examine for a continuous research into the modern concept of insurance in its entirety so as to bring it in harmony with the rulings and requirements of the Shari'ah. The need to abide by Islamic teachings, guided by Muslim historical heritage and current global insurance and reinsurance indexes cannot be over emphasized. This work therefore is an attempt to examine an aspect of the insurance system in Islam known as the re-takaful business.*

Key Word: Concept, Objectives Challenges and Function of Re-Takaful

What Is Retakaful

The term *Retakaful* refers to the Islamic form of reinsurance. The *Retakaful* business is based on the principles of *Takaful* in Islam. As stated before *Takaful* implies a group of people coming together to be jointly responsible for someone or something.[2] *ReTakaful* therefore means a joint guarantee or pact among clients or cedants who are all the operators of this important work of *Takaful* based on mutual agreement to jointly indemnify themselves from part of the losses and risks that may happen to any of them. It also may also accrue from the policies they underwrite.

It is therefore an attempt by a group of people who are *Takaful* operators to pool resources together so as to share among themselves any loss or damage that befalls any of them. The *Retakaful* business is based on the same human attempt to make provision or protection against any future loss. Just as individuals are motivated to insure themselves with a direct insurer, so also is the insurer also desirous of reinsuring himself against any future loss or damage with a reinsurer. It is this need for reinsurance that brings about *Retakaful*.

As stated above**,** the *Retakaful* business is based on the principles of *Takaful* in Islam. It can be traced to the early days of Islam when the Prophet himself instituted what can be regarded as *ma'qil al-ijtima'* or social insurance between the *Muhajirun* (Muslims who migrated from Mecca) and the *Ansar* (Muslims who welcomed the emigrants in Medina).[3] By that act, he laid the foundation of *Takaful.* This *ma'qil al-ijtima'* or the system of 'aqil is similar to what obtained among the Arabs in the *Jahil* or pre-Islamic

1 See M. O. A. Abdul, The Historical Origin Of Islam, Lagos, Islamic Publication Bureau, 1982.
2 J.M. Cowan, ed. Hans Wehr Dictionary of Modern, pp. 833-834
3 .O.A. Abdul, The Historical Origin.

period during which a group of Arabs undertook to alleviate the burden of any member of the group that was liable to pay any form of compensation.[4]

Though the insurance as well as the reinsurance business has undergone a lot of developments and innovations since the time of the Prophet, it can still be brought into harmony with the rulings and requirements of the *Shari'ah* as explained by Muslim jurists. Unless this harmony is effected, the insurance as well as the reinsurance business will be found wanting in respect of many of its operations in modern society.

Need For Retakaful With Shari'ah Governance

Just as the Prophet recognized the need for *ma'qil al-ijtima'* or the system of 'aqil to protect Muslims against any future loss or damage, so also is there the need to protect the operators of this important work of *Takaful* from part of the losses and risks that may accrue from the policies they underwrite. This will help to spread the losses and risks involved in the *Takaful* business as well as lighten the financial impact of such risks and losses on *Takaful* operators and the financial industry at large.

It is clear that no one is immune from losses and damages against property, business venture and even life itself including *Takaful* operators themselves, hence the need to offer double securities against them. *RETAKAFUL* is therefore part of the general precautions than can be taken against damages, risks and losses. Islam is not opposed to taking such precautions as long as it does not contradict with any Islamic contractual law.

Concept And Nature Of Retakaful Operation

Retakaful or Islamic reinsurance is essentially about handling risk. It is a risk aversion method in which the Takaful ceding company resorts to either a conventional reinsurer or a Retakaful operator to reinsure original insured risks against an undesirable future situation if the risk insured were above the normal underwriting or claim. Thus, a Takaful ceding company may, based on limited financial resources, hedge against possible incapability to meet all Takaful reinsurance protection from a financially capable reinsurer, which will take over the coverage of the large proportion of the risk.[5]

Fathi Lashin, a member of the Syariah Supervisory Board of the Dubai Islamic Bank stated that Retakaful does not, in principle, differ from Takaful operations. The Syariah principles applying to Takaful apply to Retakaful operations as well. The difference, if any, is that in the Retakaful operations, the participants are Takaful operators instead of individual participants. It is argued that the current practice of insurance business has shown that a Takaful ceding company cannot do without Retakaful facility. Therefore, there is a need for Takaful operators to split risks by way of establishing Retakaful operators. By doing so, they share their risks with Retakaful

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4 Mohammad Musleh-ud-Din, "Insurance and Islamic Law, p. 23.

5 Al-Jamal, Garib,al-Ta'min al Tijari wa al-Badiil al Islami (Cairo:Dar al I'tisam,n.d.), pp.340-344; al-Khafif,'Ali Muhammad, al-Ta'min, a paper presented at the 2nd Conference of the Acedamyof Islamic Research, Cairo,1965. Quoted from Mohammed Burhan Arbouna, "The Operation of Retakaful (Islamic Reinsurance) Protection", Journal IIUM, pp.336

companies. The Retakaful operator, on the other hand, assumes the responsibility of managing and investing the premiums of Takaful operators on the basis of Profit Loss Sharing.[6]

According to Dr. Maasum Billah, conceptually, the function of reinsurance is not against the principles of Syariah. However, the operation of the conventional reinsurance companies is not in compliance with the rules and practices of the Syariah as evidence by the Resolution No. (9) Concerning insurance and reinsurance of the Islamic Fiqh Academy which states:[7]

> *"The Islamic Fiqh Academy, emanating from Organization of Islamic Conference (OIC), meeting in its Second Session in Jeddah, Kingdom of Saudi Arabia, from 10 to 16 Rabiul Thani, 1406 H (28th December 1985);*
>
> *And after reviewing the presentations made by the participating scholars during the Session on the subject of Insurance and Reinsurance"*
>
> *And after discussing the same;*
>
> *And after closely examining all types and forms of insurance and deeply examining the basic principles* upon which they are founded and their goal and objectives;

And having looked into what has been issued by the Fiqh Academies and other edifying institution in this regard;

Parties To Retakaful Governance

There are two parties involve in Retakaful operations:

1) The insured (ceding company), that is, the direct insurer, which desires to relieve itself from the part of the risks, insured. This party we call it as Takaful operator

2) The insurer that is the company, which accepts that portion of risk, which is reinsured. This party we call it as Retakaful operator.

As being mention earlier, the competitiveness of Retakaful market is depend on the competitiveness of the direct Takaful market. Thus, Retakaful operators cannot operate without the operation of Takaful operators. In addition, the Syariah laws leading the process of Takaful also apply generally to the Retakaful operator.

Objectives And Functions Of Re-Takaful

Retakaful is "to enhance Takaful activity by distributing risks. It is mainly for covering large risks and large accumulation of risks subject to common loss". It is to

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6 Lashin, Fathi, "Sigha Muqaddama li-al-Sharikat Ta'min wa I'adat al-Ta'min fi al-Islam", Bayt al-Tamwil al Kuwaiti. '*Amal al-Nadwa al-fiqhiyya al-Thaniya*, 28-31 May, pp. 95-122. Quoted from Mohammed Burhan Arbouna, "The Operation of Retakaful (Islamic Reinsurance) Protection", Journal IIUM, pp.336

7 Dr. Ma'sum Billah; "Principle and Practices of Takaful and Retakaful";Manual of FIN 4030 IIUM

ensure that Takaful funds are managed to meet indemnity obligations of the insured and reinsured and to assure the continuity of Takaful operations. This means Retakaful gives the underwriting capacity to the Takaful ceding company. Thus the objectives of Retakaful can be summarized in the following:

1) *Protecting the Takaful operator from the threat of insolvency, underwriting and interest of the participants, forging co-operation among the participants and investing the accumulated fund in an Islamic way*

2) *Provides underwriting flexibility and further consolidating the financial stability of the Takaful operator in order to compete with conventional insurance companies in accepting risks. This means Retakaful "build a very close continuing business interest in common between the Takaful ceding company and the reinsurer because they are both at risk."*

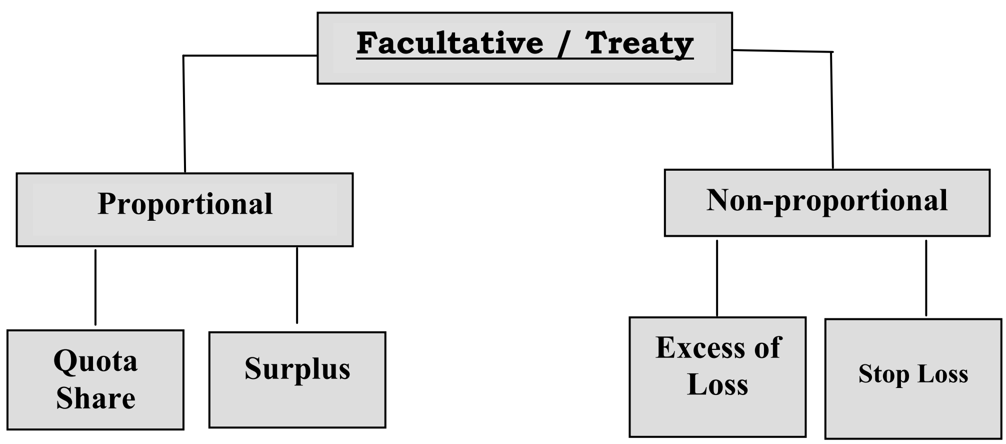
3) *It may allow the Takaful operator to utilize the retained deposit reserves of the Retakaful fund in the interest of its clients without paying interest as a process of making the reinsurance industry an interest free business.*

The Differences Between Retakaful And Reinsurance

DIFFERENCES	RETAKAFUL	REINSURANCE
1) Riba and Gharar	Retakaful operation does not earn commission as a profit or interest, because this commission is subject to riba and dilutes the purpose of setting up a Takaful operation. The Retakaful operation is dependent on actual expenses spent by the Takaful operator in the process of Retakaful	The conventional reinsurance operation is subject to riba and gharar, which are not in line with Syariah principle. For instance, the reinsurance commission which the direct insurance company earned from the reinsurance treaty. It is because this commission is frame in a way that renders the commission ribawi and implicate in a high degree of gharar.
2) Principle of Insurable interest	According to Islamic laws with regards to insurable interest, which is holding specific financial interest in the subject matter of the insurance as a cardinal principle of the legality of the Retakaful, contract. Under Islamic laws, the reinsured party does not get an insurable interest or to reinsure the property of the original insured party	Insurable interest is vested in the reinsured party. The fact that the reinsured party has issued a policy and assumed liability to its original insured party has been held to give it insurable interest sufficient to enable it to reinsure. The point is that although the reinsured party (direct insurance company) has no actual legal interest in the property, the subject matter of

	without permission from the policyholder. However, because the Retakaful operation is based on Mudarabah principle, it vested a right to reinsure on the insurer because the permission from the policyholder is automatically inherent in the contract of Mudarabah	the original insurance policy, it has assumed responsibility in regard to it, and has therefore put itself into a position, recognized by law, in which it would be prejudiced by its loss.[8]

Methods Of Retakaful



Actually the methods apply in Retakaful is also apply for Reinsurance. From the above chart, facultative reinsurance means that reinsurance of individual risks by offer and acceptance wherein the reinsurer retains the "faculty" to accept or reject each risk offered. Then, from the treaty, it is divided into two; proportional and non-proportional.

Under proportional we have quota share and also surplus where quota share is the basic form of participating treaty whereby the reinsurer accepts a stated percentage of each and every risk within a defined category of business on a pro rata basis. Participation in each risk is fixed and certain. Surplus is the excess of assets over liabilities. Statutory surplus is an insurer's or reinsurer's capital as determined under statutory accounting rules. Surplus determines an insurer's or reinsurer's capacity to write business.

8 Mohammed Burhan Arbouna, "The Operation of Retakaful (Islamic Reinsurance) Protection", Journal IIUM, pp.336

On the other hand, non-proportional consists of excess of loss and stop loss. Excess of loss is a form of reinsurance under which recoveries are available when a given loss exceeds the cedant's retention defined in the agreement. While stop loss is a form of reinsurance under which the reinsurer pays some or all of a cedant's aggregate retained losses in excess of a predetermined dollar amount or in excess of a percentage of premium.

Shari'ah Framework Of Retakaful

Basically, the operational framework of Retakaful and conventional reinsurance did not differed much, whereby only certain condition that contrary with each other. As we know, the conventional reinsurance always in opposite with the Shariah regulation as it embodies three strictly prohibited fundamentals known as gharar (uncertainty), maisir (gambling), and riba (interest). These concepts will result in unfair contribution between the participants, including of a participant having an advantage over other's participant disadvantage. Other aspect that strictly prohibited in Retakaful business is the portion of profit commission that being earn from the Retakaful as it resulting in the changes of Retakaful fees.

Mainly, the operation of takaful is started from the process whereby the insured as well as the insurer agreed to pay a certain amount of premium as the contribution to the takaful fund. Then it comes to Retakaful business when part of the contribution is being reinsured either by treaty or by facultative or both. For example, let say that KLCC becomes a client of Takaful Malaysia Berhad (TMB) for a $4 billion insurance. TMB might be able to cover the insurance up to $1 billion only. Therefore it will reinsure part of the contribution to other company. In this case, TMB is the leader operation while other companies will be the follower. It is said to be as the leader because, when there is any problem related to contract, the clients will directly deals with the leading company. However, it doesn't mean that the TMB will have higher portion than the other companies, as there is no specific rules that require such proportion. We assume that the company will retain forty percent of the amount and another fifty percent will be reinsuring under the treaty. Finally, the balance of ten percent will goes to the facultative whereby the amount will be divide to numbers of Retakaful operators according to certain rate. However if there is an exception case, there will be no portion for treaty and all the sixty percent balance will goes to the facultative. The exception case here is referring to the takaful contract whereby the insured person or company does not fulfill the requirement of the agreement.

On the conventional reinsurance, 'treaty is refers to the transfer of liability from an insurer to the reinsurer on a portfolio of policies while the facultative reinsurance is refers to the transfer on a single policy of insurance which is also known as individual risk of reinsurance'.[9] For further operation, treaty can either be by Surplus (case by case) or by Excess of loss. The case-by-case treaty is actually based on the pre-agreed that certain percentage or rate will be passed. For this Retakaful, there will be an underwriter who is responsible to develop certain guidelines or policy, and also in determining the rate. Once the operators agreed with rates provided, then the agreement can be proceed. For the Excess of loss, it is the relief from loss including the one that resulting from natural disaster.

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9 http://www.genre.com/page/0,,ref=ReinsProducts-en,00.html

In case where there are not enough Retakaful operators to continue the business, the takaful company might deals with the conventional reinsurance company as long as the concept being applied is in accordance with the Syariah principles. However, the lead company must at first make an offer to takaful operators. In choosing the operators, it must ensure that the company is from an 'A' list. What it means by 'A' list is that, the company listed is capable in terms of their financial position. In other words, it must be compliance with the requirement in the agreement. Takaful company also should avoid of having a Retakaful business with any company that not reliable with the given condition. However, there are cases where the Retakaful operators are unable to fulfill the obligation of the contract due to the insufficient fund. As a result, the leading company might bring the case to the court for penalized. Such situation will only become a burden to a leading company as it the process always takes times to be settled on. Thus, it is important for the leading company to learn in depth on other operators before making a choice.

In the area of takaful business, there is actually a fund known as general takaful fund, which is earned from takaful contribution paid by the participants. This fund will be invested and the returns will again be credited into the fund. However, the fund cannot be 'touch' by anyone except in the case where the participants are suffering the material loss, then the fund can be used to pay the claim. Other permissible expenditure regarding to the use of the fund is given to the costs that related to Retakaful, which is in the basis of stabilizing the fund and other related reserves. Even for the payment of the salary of the operator's employees, they have to use the money received from the clients. Unless there is an excess profit on the fund then it will distribute among the takaful companies and the players.

The operation of Retakaful might be suspicious in the eyes of the outsider as it is done without the knowledge of the insured. In explaining this, we can refer to the nature of the treaty itself. According to the senior manager of Retakaful Division of TMB, the treaty is actually a blind agreement that doesn't have a specific written form. Besides, there is no definite condition related the agreement. Thus, it is not important for involving the clients with this kind of treatment. Furthermore the objective of Retakaful itself is for the benefit of the clients in ensuring that their rights are fulfilled.

Shari'ah Rulings And Requirements As To Retakaful Governance

In view of the above and the need of the *Retakaful* business in Islam, it is proposed that the same *Shari'ah* rulings and requirements governing the *Takaful* business in Islam should also govern the *Retakaful* business. Both the T*akaful* business and the *Retakaful* business in Islam are in the same business operation, they are both concerned with the management of risks with one insuring against risk and the other reinsuring against it. In line with the resolution of Muslim jurists, *Retakaful* business should therefore be based on the principle of mutuality and cooperation.

Contrary to the conventional contract, the Islamic contract of mutual cooperation will be founded on shared responsibility, charity and indemnity. Islam supports the insurance or *Takaful* companies coming together to cooperate among themselves for the joint sharing of losses and risks. In conformity with the contract of mutual cooperation, the *Takaful* companies will help one another with a defined fund from a joint donation or *Tabarru'* to pay defined damages and losses based on an agreed scheme.

The Takaful companies and operators so as to eliminate the element of uncertainty in the Re-Takaful business generate the defined fund from joint donations. It will be used to assist any of *Takaful* companies that requires compensation against loss without obtaining any benefit or gain at the expense of other *Takaful* operators or companies. It therefore eliminates uncertainty both in the pooling together of joint donation and the compensation of any *Takaful* operator. [10]

The *Re-Takaful* business is also based on the Islamic principle of al-mudarabah (Profit/ Sharing). According to this principle *Re-Takaful* operators serve as the mudarib and accept the premium or in this case the joint donations from the *Takaful* operators known as ra's al-mal, which should be, invested in *Shari'ah* compliant shares, bonds and other money market instruments. The clients, investors and providers of the joint donation, in this case, the *Takaful* operators are termed the rabbul-Mal. This principle of al-mudarabah (Profit/ Sharing) is applied as an alternative to the interest based reinsurance contract.[11]

Re-Takaful operators assume the role of the entrepreneurs or the mudarib and they must specify in the mudarabah contract how the profits that accrue from the *Re-Takaful* business investments will be shared. Certain portion of the profits generated from the investments in *Shari'ah* compliant shares, bonds and other money market instruments can also be accumulated to the defined funds. This relocation will enable the *Re-Takaful* operators to pay contributors who suffer losses or damages.

In other to protect the smooth running of the *Re-Takaful* business investments and to ensure that the *Shari'ah* are always observed, there is need for a *Shari'ah* board in each *Re-Takaful* company *to* monitor its operations. Central banks and the *Shari'ah* boards or councils can majorly be used to regulate these operations as done in Malaysia.[12]

Governing Principles Of Re-Takaful

1. Principles of Contract ('Aqd)

In Islam, 'Aqd is very important element and must present in business transactions. An offer and acceptance (sighah) will make the particular transaction become valid and both parties who entered the contract are bound in the contract.

For insurance policy, a person who entered the contract must fulfill some requirement such as legal capacities of the parties, subject matters, insurable interest, ijab (offer) and qabul (acceptance) and Uberrimei fedie.[13] Once a person entered in a mutual contract, therefore is it an obligation for both parties to fulfill the contract where Allah swt. has commanded:

O ye believe! Fulfill your agreement.

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10 See Takaful (Islamic Insurance), Concept and Operational System, 1996, p. 8.

11 See the principles of al-mudarabah in A.R.I. Doi, Shari'ah the Islamic Law, Lagos: Taha Publishers, 1984.

12 Takaful (Islamic Insurance) op.cit.

13 Billah, Mohd. Mas'um. Manual of Principles and Practices of Takaful and Retakaful. Department of Business Administration, Kulliyyah of Economic and Management Sciences, International Islamic University Malaysia

2. Principles of Liability

A person who buys an insurance policy from insurance company means the person is ready to transfer part of the risk to the insurer. Insurer are willing to undertake the risk and willing to compensate if that is any losses occurs to the policy holders. An insurance policy mainly will cover losses occur from accident, fire, flood, death, disaster, business burglary, property and others losses.

In this situation, concept of ‘Aqilah in ancient Arab tribes and approved by the Prophet s.a.w., if a person was killed by another person from a different tribe either mistakenly or negligently, this would bring a liability to member of his tribe to pay blood money to the heir and slain.

1. Principles of Al-Wakalah (Agencies)

Application of Al-Wakalah principle in insurance (takaful) also important where insurer (takaful operator) will appoint designated agent to deal with insured or customers. The main intention of this appointment is to ensure the transactions and dealings between insurer and policy holder become more efficient and effective. The governing principles for the agents and brokers are laid down in the mejelle as follow:

“Wakalat is for someone to put business of his on another and make him stand in his own place in respect of that business.

2. Principles of Daman (Guarantee):

Principles of Daman had being practiced in takaful where insurer are willing to undertake the risk from the insured where insurer promise to provide material security against unexpected loss or disaster arises in the future and willing to compensate the losses occur.

3. Principles of Al-Mudharabah

Mudhrabah concept is widely used in takaful as an alternative to interest based securities.[63] In practiced, conventional insurance companies will invest in long term bonds or stocks of companies which may or may not involve in non-permissible activities such as gambling, production of alcoholic beverage, and interest based banking.

However, operation of takaful is under Shari’ah principle. It is based on Al-Mudharabah and Al-Musyarakah principle. The takaful operator act as Mudharib will receive sum of investment from sahib ul mal or rabulmal (capital provider) through the premium payments. With this sum of investment, mudharib will conduct investment in productive industry using their skills and knowledge. At the end of the day, when takaful receive return (profit) from the investment; takaful operator will distribute the profit to the capital provider based on agreed portion that they agreed before.

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14 Rosly, Saiful Azhar. 1996. *Islamic Insurance:Takaful* . Business/Focus. The Sun

Shariah Supervisory Council As To Retakaful Governance

One of the important elements that differentiate between conventional reinsurance and Retakaful is the existence of the Syariah Supervisory Council. This council is vital in order to make sure that the operations of takaful and reatkaful is done according to the Syariah principles. Actually the members of the Syariah Supervisory Council (SSC) for Retakaful are the same as for takaful. The main group is refers to the SSC of Bank Negara and each takaful operators have their own SSC. However the members of SSC could involve with not only one company. For example, Y Bhg Ustaz Mohd Bakir Haji Mansor who is the chairman of the SSC of TMB is also in position as the member of SSC for Bank Islam Malaysia Berhad (BIMB) and Asean Retakaful International Ltd (ARIL). Meanwhile Shahibul Al-Samahah Dato' Hj. Md HashimYahya who is the committee member of Bank Negara Malaysia (BNM) and Security Commission is also the member of SSC of BIMB, MBB and some other institutions.

The main role of this council is to evaluate the form or statement provided by each takaful operator. They must ensure that the stated conditions in the agreement are compliance with the Syariah requirements. However, we should realize that there is nothing perfect in this world. Where there is an advantage, there will always be a disadvantage too. We know that usually the member of SSC is more as theorist rather than practitioner. Consequently, there is a disagreement regarding to the opinion of SSC and the employees of the takaful operators. In other case, sometimes the conditions provided in a takaful company might be varied with other company due to the different of SSC. Nevertheless, these problems will not affecting the clients, but it will give quite a bad impression about the company itself. In addition, there might be confusion among the clients regarding to the variety in policy of different Takaful operators. Even though, the company still has to follow the words o SSC as long as it is in accordance with the requirements of the Syariah rules and regulations.

Corporate Paradigm Of Retakaful

The Reinsurance or Retakaful operation is a company-to-company relationship and it is basically about handling risk where the agreement is between the Takaful operator and also Retakaful operator. Thus, the original policyholders are not the party of the reinsurance agreement. Nonetheless, the insured party may want to know that a professional and reliable reinsurer is administering the original policy since this concerns its security. But, the insured party has not and cannot have any direct interest in the reinsurance contract. On the other hand, some legal scholars emphasized that the contract of Retakaful should stay between the Takaful operator and Retakaful operator, whereas the original policyholders of Takaful fund are not involved in the contract in any way. Therefore, the operational and legal relationship of the Retakaful and Takaful operators may be summarized in below:

1) *The Retakaful operator assumes responsibility to invest the fund on the basis of Mudarabah and shares the profits with Takaful operators by mobilizing premiums or contribution of Takaful companies;*

2) *The profit earned will be distributed between Retakaful operator and Takaful operators according to the percentage that have been agreed in the agreement certificates issued;*

3) *If there is any perils occur, The Retakaful operator indemnifies the defined risks and settles expenses of the process of Takaful from the gross premiums, reserves and profits from investment;*

4) *If there is surplus, it should be proportionately accredited into the Takaful operators' account*

5) *In the event of insolvency of the Takaful operators, the Retakaful operator should provide a loan from the Retakaful shareholder's fund by which the Takaful operators settles claims and incoming premiums will cover the loan*.

Takaful And Re–Takaful Operations

Mudarabah contract is applied to *Takaful* and *ReTakaful* operations as an alternative to interest – based securities in which the conventional insurance investment their surplus funds. This account is referred to as Participant Account (P A). Clients are investors and are referred to as *Robbulma*l while *Takaful* operators assume the role of entrepreneur and are referred to as Mudarib. They would invest the pool of funds into *Shari'ah* compliant investments and specified how the expected profit shall be shared among the clients. Ditto for *ReTakaful*.

Mutual help among the clients or investors in a *Takaful* operations is observed through the concept of *Tabarru*', which means to donate, contribute or to give away. In Islam, mutual help and co-operation are ethical values that are promoted among the believers. In *Surah al-Maidah*, Allah commands the believers as follows:

"Help one another in carrying out righteousness and piety, but help not one another in sin and bitterness: Lo! Fear Allah for Allah is very severe and strict in punishment"[15]

At Tabarru'

A certain proportion of the client's installment known as premium is relocated to *Tabarru'* Account to repay his fellow participants who suffer from a defined loss. Thus, each client is able to fulfill his obligation of mutual help and joint guarantee. In the same vein, *ReTakaful* Company requires the *Takaful* Company to pay a certain percentage of their premium to them, which shall be use in partial coverage of their risk in case the Takaful Company could not cover such risk.

Facultative

Since *ReTakaful* Company is jointly sharing the risk that is likely to be faced by any of the Takaful Company there is always a thorough checking on each of the policy before they agree to give coverage. After this examination of the policy has met the necessary requirements, *ReTakaful* Company then agreed to enter into the contract. At least, 20 % of the *Takaful* retention that is they set aside as funds for coverage against risk must be transferred to *ReTakaful* Company according to the minimum requirement of Bank Negara.

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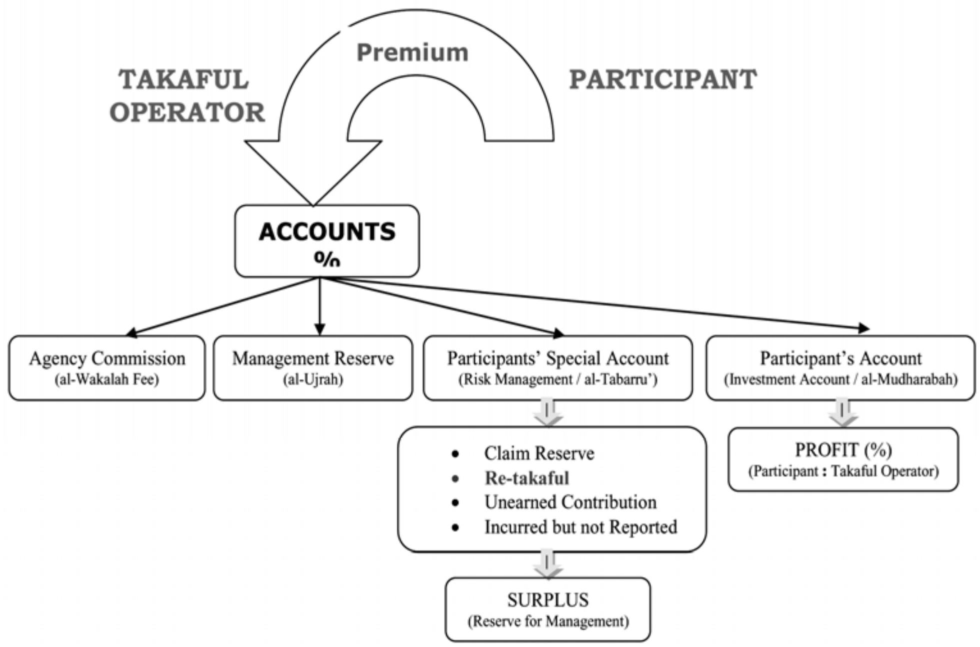
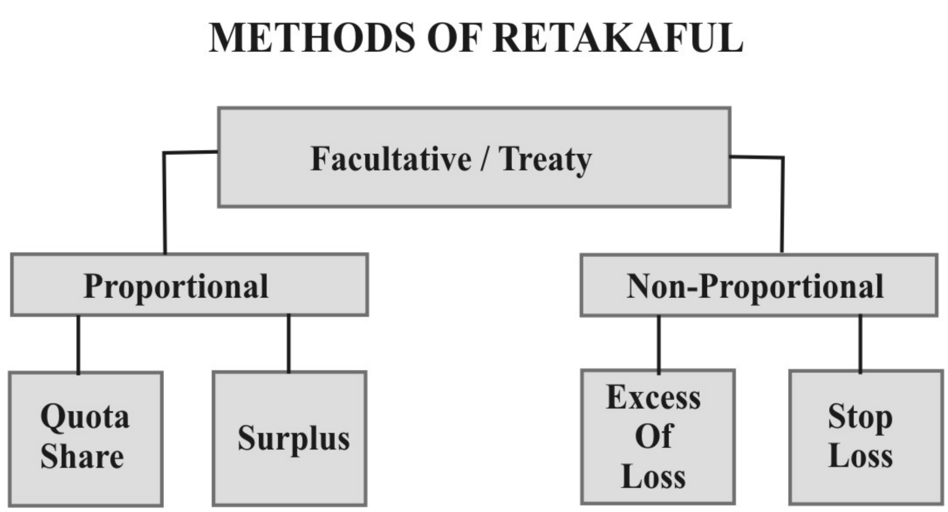
15 Surah al-Maidah verse 2.

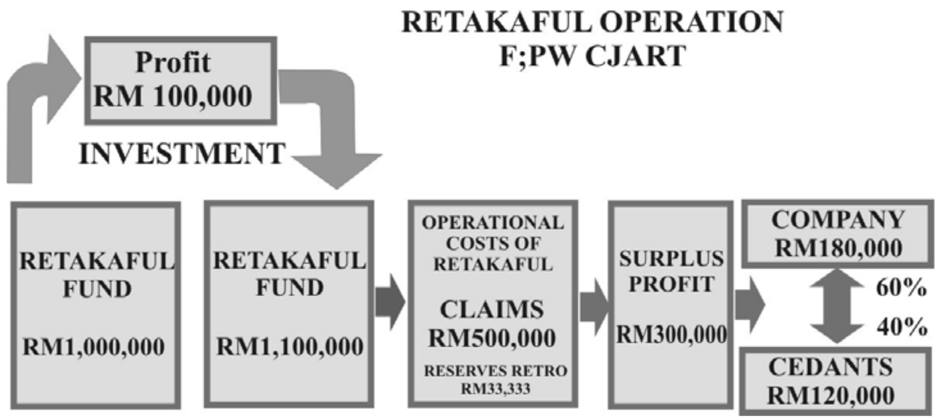
TAKAFUL AND RE–TAKAFUL SYSTEM COVERAGE

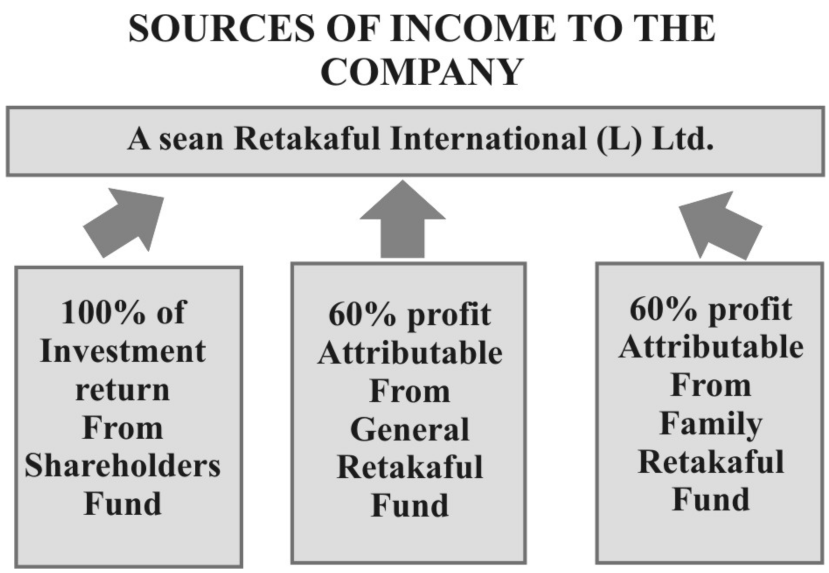


A Practical Example

Asean Re-takaful International (L) Ltd.(ARIL) is the first Retakaful company under Takaful Malaysia Berhad that have been establish recently. The operation of this company is totally based on the Retakaful business. The charts below are showing the overall framework that being applied in ARIL for the Retakaful operation.







From the above charts, it can be concluded that this company has their own methods and way in establishing the business and they obtained the income from three main sources that are the return on investment of shareholders fund, profit from the general Retakaful fund, and the profit from family Retakaful fund.

General Retakaful Products

1) Fire/Property Retakaful

The Fire/Property Retakaful normally covers or protects the policyholder's property from damage or loss due to fire, lightning, explosion (domestic) or any other related perils. The additional coverage is extended also to any damages, which are caused by:

a) Riot,strike, or malicious damage

b) Explosion

c) Impact damage

d) Bursting or overflowing of water tanks or pipe

e) Earthquake or volcanic eruption

f) Flood

g) Aircraft damage

h) Windstorm

This Fire/Property Retakaful policy covers building and/or machine, stocks and also householders.

2. *Misc Accident Retakaful*

It offers coverage for misc accident for individual for instance misc accident on the way to the workplace or traveling, coverage for drivers and also passengers where the skop of coverage are the medical expenses, suffering from physical or mental disability either temporary or permanent and also death.

3. *Marine Retakaful*

There are two types of Marin Retakaful:

a. Marine Cargo Retakaful
b. Marine Hull Retakaful

4. *Motor Retakaful*

It offers coverage for private car or motorcycle as well as commercial transportation.

5. *Engineering Retakaful*

In Engineering Retakaful normally it covers loss of profit due to machinery breakdown, boiler and pressure vessel, erection all risk, storage tanks, and others.

6. *Special Risks Retakaful*

THE OPERATIONAL MECHANISMS OF GENERAL RETAKAFUL PROTECTION

The Takaful operators can establish a Retakaful scheme base on two bases. The first basis is co-operation and the second one is solidarity. It is because, Retakaful operation is needed to strengthen the Takaful sector and since relations of reinsurance with conventional reinsurance may throw hesitation on the genuineness of Islamic insurance as a whole, a co-operative reinsurance is relevant to meet this need. Therefore, in this situation, to strengthen the function of the Takaful operation, co-operative reinsurance mechanisms have to be developed. In doing so, the mechanisms below might function as guidelines for Islamic reinsurance operations:

1) *All Takaful operators must give a portion of money as a donation based premiums to establish a Retakaful fund;*

2) *This payment shall be equal to the defined risks of each Takaful operator. The money may be paid in advance and be submitted to a company purposely established to manage the fund or presented to a professionally capable and*

reliable fund manager for investment purposes in interest of all contributing parties;

3. *The person or individual who manage the fund will be paid on the basis of* ijara *(hire contract) or according to the rules of Profit Loss Sharing (*mudharaba*). This manager is responsible to compensate any Takaful operator who facing with financial difficulties in meeting its original obligation;*

4. *Takaful operators also may defer payment of their premium instead of advanced payment of contributions but with a pledge to settle their financial obligation at a later date. In this case, the established company or professional manager of the Retakaful fund must accept the pledge. In addition, in the case of perils, the Retakaful manager must indemnifies the losses suffered by a Takaful operator and subsequently recoups its expenses from each Takaful operator according to the agreement;*

5. *Initially, the mechanisms of the Retakaful operation above may face with impediments. If there is any immediate extraordinary losses occurs, which have to be paid the indemnities according to the Retakaful agreement, it will threaten the perpetuity of the fund. For instance, a Retakaful operator may issue a reinsurance policy to operate within a certain period of time and the reinsured risk may arise a few days after the inception of the agreement. But the Retakaful operator have no enough fund to settle the claim of the Takaful operators are yet to accumulate substantially. So that, to solve the problem, this situation could be resolved by sorting to Islamic banks for qard al-hassan (interest free loan) to serve as a deposit reserve or Ihtiyati madfu' for the Takaful operator. This fund will be apart of the Retakaful portfolio and be invested in the interest of all participants. This fund will be part of the Retakaful portfolio and be invested in the interest of all participants, the Takaful operators. If there are immediate extraordinary losses arise, the coverage of such losses would be met by this reserve.*

Issues Arise Related To Retakaful Company

Capitalization

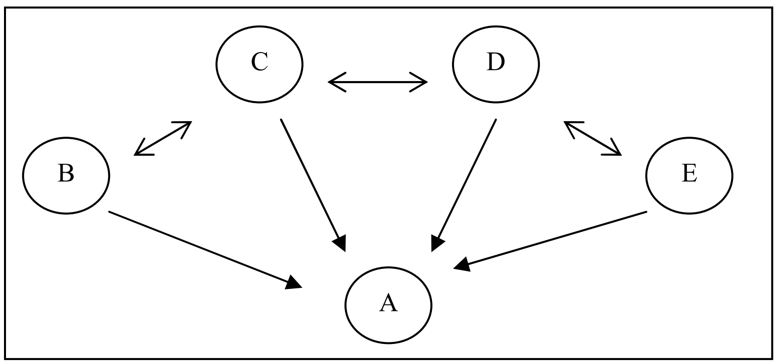
As a Retakaful company, it should have enough fund and capital not only used to settle the claims, but to provide expertists and advance technologies for the effectiveness of the operation. Therefore, serious efforts must be undertaken by all concerned to this takaful industry such as through mergers, investing in profitable projects and contribution of capital through the issuance of shares.

Environment

Takaful industry should be supported by government and regulatory authorities. Related regulatory frameworks on the operation of takaful should be set up in order to introduce and promote the services provided by takaful industry among nation. In addition, since takaful industry is quite new to the public, practitioners and academicians should write and publish more articles or books regarding this subject.

Basis Of Operation

Joint Guarantee



1. Portion of claims can be settled by A as it is a Retakaful company, by using fund gathered from each takaful operators, B, C, D and E.

Mutually agreed participation

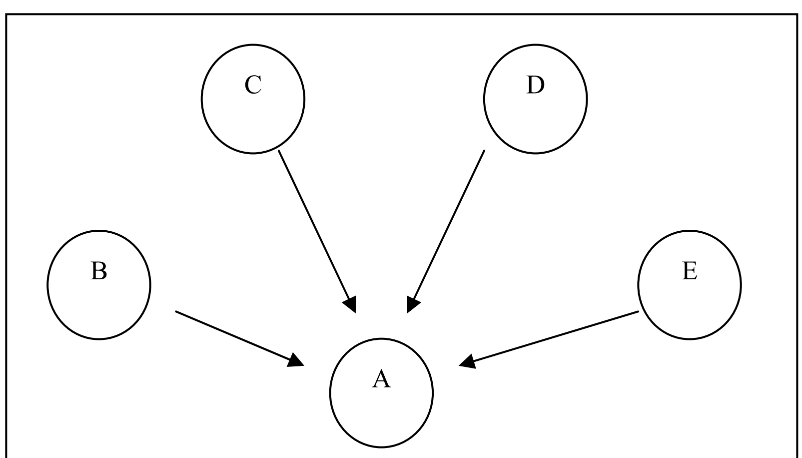
The participation from each takaful operator under one Retakaful company is mutually agreed. Upon this binding, each of takaful operators is willing to help each other in any difficulties.

Tabarru'

1. Each takaful operator, B, C, D and E will contribute some percentage to the Retakaful company, A.

2. A will invest some portion of the total insured in the profitable investment.

3. The profit from the investment then will be distributed to the takaful operators according to their portion of contribution to the Retakaful company.



The Establishment Of Aril As A Retakaful Operator

In 1996, the members of the ASEAN *Takaful* Group during its second annual meeting in Brunei unanimously agreed on the need to establish *a* full fledged *Re-Takaful* entity that would write inward *Re-Takaful* business from them and whose equity they, would share, that is *Takaful* Group companies *or* operators.

The *Re-Takaful* entity known as ARIL as took off and commenced operation on the 2nd of September, 1997 with a paid up capital of USD 4 million as an offshore *ReTakaful* entity in the Labuan Offshore Financial Centre writing both the General *ReTakaful* and family operations. It was allowed to write inward *Re-Takaful* business from ASEAN *Takaful* Group only and may out of necessity obtain outward *Re-Takaful* support from the conventional reinsurance companies.

ARIL, since inception has been struggling to operate a successful and profitable *Re-Takaful* business. It writes both the General *Re-Takaful* business and family *ReTakaful* business operations. It also serves as the pool manager for the ASEAN *Takaful* Group (ATG) business, which was introduced in 1995 by members of the ASEAN *Takaful* Group.

Investments of the various funds of the business are carried out in compliance with the requirements of the ARIL *Re-Takaful* business's Shari'ah Supervisory Council. It invests only through the Shari'ah approved banks and by so doing, using only financing instruments approved by its Sh'ariah Supervisory Council. Its operating expenses are sourced only from the Shareholders funds and it recognizes income on cash basis.

As the pool manager for the ASEAN *Takaful* Group, all ATG business pool is shared at a rate of sharing agreed upon by all members between the cedants and ARIL using the principle of al-mudarabah. All forms of claims and liabilities are based on an accrual basis.

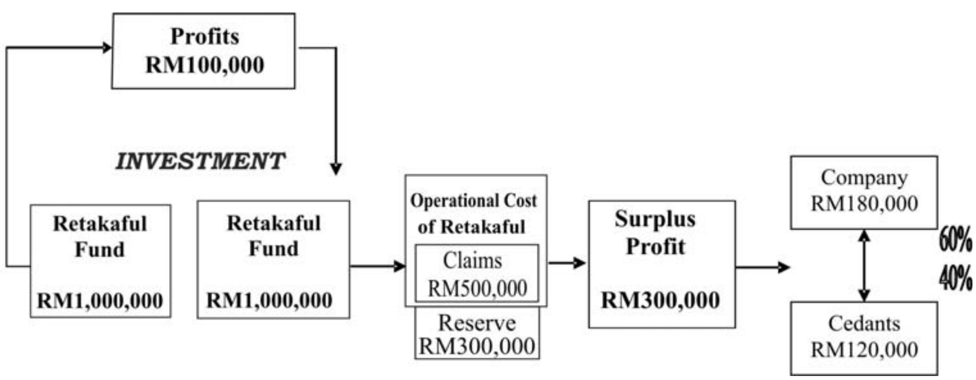
It is clear the ARIL *Re-Takaful* business operations have so far worked well for the mutual benefits of ARIL and the ASEAN *Takaful* Group its cedants. The company operations have great prospects for future growth and it has been able to generate a moderate and reasonable rate of returns on the investments of its shareholders in *Halal* and *Shari'ah* compliant businesses. It has been generating profits from mainly underwriting surplus from the General *Re-Takaful* business, and family *Re-Takaful* business operations as well as investments returns.

At the same time, the services of the *Re-Takaful* business operations can still be improved upon. Generally speaking, the Muslim Ummah still lacks *Takaful* and *Re-*

Takaful business expertise. It is true that are many Muslim scholars today who specialize in the conventional insurance and reinsurance business just as there are many Muslim specialists in the *Shari'ah* principles. Yet only very few Muslims posses or combine both the technical expertise of the conventional insurance and reinsurance business and the *Shari'ah* together. The world is witnessing an ever increasing and fast growth in the insurance and reinsurance business so much that the Ummah's *Takaful* and *Re-Takaful* industry will be adversely affected if not completely swallowed up or taken over by big conventional insurance and reinsurance conglomerates if its policies are not seriously and continuously reviewed.

Similarly, the Muslim populace in all the Muslim countries must be mobilized and educated to participate heavily in the *Takaful* and *Re-Takaful* industry. For instance all the OIC countries should ensure strong capital based *Takaful* business in their countries. By so doing the capital based of the *Re-Takaful* business will be increased and capitalized at least to move close if not up to the assets of the conventional reinsurance industry. This is the only means to protect the *Takaful* and *Re-Takaful* industry from being mere pawns in hands of the conventional insurance and reinsurance conglomerates.

The Example Of Retakaful Flow Chart Operation



The diagram above shows example of Retakaful flow chart operation, which was taken from Asean Retakaful (Labuan) Limited (ARIL). Firstly, the company invests RM1, 000,000 that are taken from Retakaful Fund. Let say the investment brings profit of RM100, 000 to the company; this profit will be added back to the Retakaful Fund. Now the company has RM1, 100,000 in the Retakaful Fund. This amount of money will be use for operational cost of Retakaful to pay for claims up to RM 500,000 and also reserve for RM 300,000. Then, the surplus profit of RM 300,000 will be divided between Retakaful Company and also cedants, which are the Takaful operators. The Retakaful company will get 60% from the profit which is RM 180,000 and Takaful operators will get 40% from the surplus profits which is RM 120,000.

Final Remarks

The challenges posed by modernity and its secular culture to Islam in general and financing and economic aspects in particular and the implications in the Muslim world have been discussed extensively in this paper. There is a wide dichotomy for instance between the Islamic concept of the insurance and reinsurance known as *Takaful* and *Re-Takaful* business or industry and the western or conventional insurance and reinsurance industry. There is a total disparity in the Islamic principles that govern any *Takaful* and *Re-Takaful* contract and the principles of contract in western or conventional insurance and reinsurance.

While the Islamic principles are based on divine and ethical values, the western or conventional principles are based on human-made or mere normative values. This accounts for the way the two industries generate funds, control and utilize the funds. It also reveals the manner in which the two systems the issue of surplus profits such as its ownership and application. For the *Takaful* and *Re-Takaful* business or industry, there is an interest-free financing, profit and risk sharing rates and avoidance of speculative risks.

Islamic Microfinance – Why is it Worth Considering?

By
Prof. Badr El Din A. Ibrahim.[*]

Abstract:

There are some questions regarding the reasons for the meager coverage of Islamic microfinance in Islamic countries, despite the fact that conventional microfinance does not meet the requirements of these countries microfinance clients. In this article we show that Islamic microfinance model is a superior one capable of solving many microfinance challenges, nevertheless, Islamic microfinance (despite its merits) has a very weak spread and not-market-oriented in most cases. What is required is a workable Islamic microfinance model, on the basis of the successes that governed some sustainable institutional Islamic microfinance experiences.

Keywords: Islamic microfinance (model/programmes), microfinance, Islamic modes, rate of return.

Introduction:

Islamic microfinance- challenges and potentials:

In his article published in CGAP (Consultative Group to Assist the Poor) website Mohammed Khaled once asked a valid question: why Islamic microfinance cannot provide what is required by Muslims, as conventional microfinance? It is true that ways of conventional microfinance do not meet Islamic countries' requirements. Moreover, studies conducted few years back shows that about only 2 percent of the microfinance loans provided worldwide were made under Islamic modes.

Most commentators believe that there is an enormous potential for Islamic microfinance market niche, but few Islamic finance providers are working in this industry. While others see the constraints in the lack of understanding of the standard new *sharia'* models, and the lack of support from potential partners and sponsors. A pessimistic view against a large-scale Islamic microfinance was expressed by Malcolm Harper in a crossfire debate with the author of this article when he argued that

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[*] The author is an economist specialized in microfinance and the President of Microfinance Unit, Central Bank of Sudan.

"sustainable application *(of Shariah-compliant partnership finance)* to microfinance is difficult on a large scale, if not impossible". [1] (*Emphasis added*).

A superior model needs to be on the right track.

I do believe that the Islamic microfinance model is a superior one capable of solving many microfinance challenges*, hitherto* the current practices are on a wrong track and they are still undergoing the trials phase. In fact, the Islamic microfinance spread is very weak and not-market-oriented in most cases. The experiments so far (except few limited banking experiments) being set up by donors or religious groups are based on a number of short-lived, non-market models and mechanisms, and are not integrated into the financial system. They have yet a wide room to develop like their conventional counterparts, particularly in volume and type. Up to date, with the exception of Bank Rakyat Indonesia and the Sudanese full-fledged Islamic banks providing microfinance and other few Islamic banks (which apply the best practices and therefore sustainable with no subsidy), most of the Islamic microfinance programmes are using funds of *Sadagat* & *Zakat* (alms)*, Waqf* (endowments), and *Qard Hassan* (interest-free loan), as well as donors and government resources. These non-market models (which are suitable as complementary with the Islamic microfinance in providing needs such as housing and other necessities), grant microfinance at lower interest rates that distorted the local microfinance market and also gave the impression that the Islamic microfinance is not a lucrative business, therefore it should be carried only outside the banking system. [2]

Merits of Islamic microfinance.

The Islamic microfinance, based on a partnership mode, is fair and does not require poor clients' payment, or lead to a loss of the livelihood of the poor in the case of project failure beyond the client's control. It also does not require strong guarantees. Islamic partnership formulae can also avail of the best non-material guarantee such as sustainability of the project, credit records of the individuals and the tied follow-up by the granting institution Moreover, instead of advancing loans to the poor, which can be utilized for another purpose, the Islamic versions dictate buying the assets or the necessary raw materials or enter with the partner in joint closely monitored transactions. Furthermore, Islamic finance also allows the Islamic banking system to bear its social responsibility towards the economically-active poor, and considers treatment of poverty as part of its social responsibilities. [3]

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[1] Ibrahim, Badr El Din and Malcolm Harper, 2011, "Crossfire: Islamic banking avoids interest payments and thus prevents rich investors profiting from the poor", Enterprise Development and Microfinance, Volume 22 Number 4 December 2011, Practical Action Publishing.

[2] Ibrahim, Badr El Din, 2011, " Islamic Microfinance- Challenges and Prospects", The Journal of Islamic Banking and Finance, quarterly Journal publication of the International Association of Islamic banks, Karachi, June 2011 Issue.

[3] *Ibrahim, Badr El Din, 2004, Banking & Finance to SMEs in Sudan – Lessons from an Islamic* Financing System, a book published by the Institute of Islamic Banking & Insurance, UK. Ibrahim, Badr El Din, 1999. "Can Musharakah Financing of SME be Applied to the Interest-Based Banking System? ", Small Enterprise Development Journal, London: Intermediate Technology (IT) Publications.

In addition, the net rewards (and the return on capital) of Islamic partnership arrangement are greater than the net income (and the returns on capital) from paying the typical interest rate. For example, a US$ 100 capital loan to a poor client from a conventional bank charging 36 percent interest per year and generating a 50 percent rate of return on capital ($50 dollar) ends up with total return on capital of $14 per year (14 percent rate of return on capital per year, a little more than 1 percent per month). With total partnership agreement assuming the same capital investment equally shared by the bank and the client, and the same rate of return to the client of 50 percent, the picture is quite different. If the partner gets 20 percent of net profit as a reward of his management and the bank gets 5 percent, then the total non-capital shares out of the net profit of $50 is $12.5 ($10 partner's reward for management and $2.5 for the bank's following up). The remaining profit ($37.5) is distributed equally and the partner gets $18.75 ($37.5/2). The total partner's return therefore is $28.75, and the return on capital will be 28.75 per cent *(2.4 percent per month, compared with a little more than 1 percent for the interest loan).*

A Need for a workable market-oriented Islamic microfinance model.

Despite the huge demand for the Islamic microfinance, banks and financial institutions which apply the Islamic formulae are still slow in meeting it. The Islamic microfinance industry is still required to prove that it is capable of extending finance bridges to the poor on sustainable and market-based oriented manner. With some exceptions, all other Islamic banking and non-banking microfinance experiences have limited outreach, and are perhaps not sustainable.

Despite of merits of a typical Islamic microfinance, there is lack of a workable Islamic microfinance model. I do believe that the past experiences on Islamic microfinance can only be considered as isolated trials in the making of this type of finance. Moreover, the application of *Shariah*-compliant Islamic microfinance has not gone far enough to detect and to solve the constraints facing it. A refined Islamic microfinance system would probably require more time and extensive theoretical and practical efforts.

In the meantime, Islamic microfinance providers can start using and improving the existing opportunities of Islamic microfinance on a large-scale, but this should be on the basis of the successes that governed some sustainable institutional Islamic microfinance experiences via banks. For example, the relative success of government-owned Bank Rakyat Indonesia (via strong outreach, the saving component, avoidance of subsidy, effective leadership, strong commitment and political support) is one experience that can be seen. Moreover, the relative success of the Sudanese experience (as a full-fledged nationally-supported experience that managed to build, organize & coordinate microfinance institutions, councils and units) is also worth looking at.

Country Model

Qatar

Introduction:

State of Qatar, an oil based economy having worlds highest per-capita income and the lowest unemployment rate occupies fifth place in the Islamic banking sector in the world. Share of Islamic banking industry in overall banking industry of Qatar is more than 20 percent while it is 120 percent of gross domestic product (GDP)[1]

Qatar is considered among those countries that have acknowledged the significance of Islamic banking in the beginning; the very first Islamic bank in Qatar was established in the start of eighties. Assets of Islamic banking industry now stand at QR 195 billion (Dec 2012) with a network of four full fledged Islamic banks across the state. Qatar is an active player of global sukuk market with 11 percent share.

Historical Background:

Islamic banking in Qatar started with the establishment of Qatar Islamic Bank (QIB) in 1982 and only full fledged banks were allowed to operate in the country till 2005 when conventional banks were permitted to offer Shariah compliant products and services[2] (see Box 1 for Shariah Governance). Hence, the Islamic banking industry of Qatar consisted of both kind of institutions till end CY 2011 when the central bank of Qatar decided to end the dual regime by disallowing conventional banks to offer Islamic products and services . The central bank gradually introduced this structural change in regulatory framework by first restricting conventional banks to utilize only up to10 percent of their issued capital in August 2010 and then were instructed in February 2011 to close their Islamic banking units. Hence, at present only full fledged banks are operative in the country.

Box 1: Shariah Governance

Salient Features of Shariah Governance of Islamic banks in Qatar are as follows;

- There is no central Shariah Advisory board at central bank; however, the central bank can appoint Shariah scholars in case any problem arises.
- Cases of Clarification can be sent to "Supreme Shariah ouncil" which is attached to Awqaf Ministry
- Islamic banks are self regulated to ensure Shariah compliance by having their independent Shraih boards.
- A Shariah adviser can be member of more than on Shariah board

Source: Bin Hasan,Aznan. "Optimal Shariah Governance In Islamic Finance"

Current Islamic Banking Industry in Qatar consists of four banks; Masraf Al Rayan, Qatar Islamic Bank (QIB), Qatar International Islamic Bank (QIIB) and Barwa bank. All these banks are under huge influence of state as one of these banks (Barwa) is fully owned by state while remaining three have got major share of state.(see Box 2 for Foreign Investments of Qatari Banks).

1 Source : World Competitiveness Report 2013

2 Source: http://www.worldfinance.com/banking/setting-the-benchmark-for-islamic-banking

Source: Islamic Banking Bulletin, March 2013, State Bank of Pakistan

Other areas of Islamic finance like investment banking, takaful and Ijara companies are not as developed as the Islamic banking industry. QInvest and Qatar First Investment Bank (QFIB) are two Islamic investment banks in the country while the market share of Islamic investment banking is 10 percent. QIB subsidiary; National Leasing Company is the only organisation which is offering Islamic leasing (ijarah).Takaful industry though is growing, however, represents 5 percent of GCC takaful industry[73].

Qatar is a very prominent figure in global sukuk market. Being among the world's leading issuers of sukuk, Qatar on average issues two sukuk annually with focus on developing local debt market. The largest sukuk issue of the world is "Qatar Sovereign sukuk 2014", valued at $9.1bn while in terms of share Qatar occupies 11 percent of global sukuk market.

QIB

- The largest bank of Qatar, QIB, has not only got base in the market of United Kingdom but has also got major shares in Asia finance House, Malaysia
- QInvest, the QIB" s investment banking arm, is a partner with India" s leading financial services provider in Ambit QInvest India Fund (a Shraih Compliant Fund). QInvest has got shares of 25 percent and 47 percent in Ambit Corporate Finance Limited (investment bank) and Pamru Gordon PLC (investment bank and stockbroker, UK)

QIIB

- QIIB has invested more than £20 billion in Islamic banking of Bahrain
- Syerian International Bank has founded by QIIB

Both QIB and QIIB have shares in Pak Qatar Takaful operating in Pakistan since 2007

Source: GIFR 2011, Website Pak Qatar takaful

Future Growth:

Islamic financial industry is growing strong in Qatar and is expected to grow substantially in future. Rising demand of Islamic finance on the basis of growing economy; advantage of having more than 77 percent Muslim population, emphasis on diversification and investment on skilled and trained human resource[4] all contribute to the growth of the industry. Moreover, the well developed regulatory framework of Qatar along with its customer centric banking principles create conducive environment for sustainable growth of the industry.

Sources:

- S& P. Islamic finance Outlook. September, 2012
- Islamic Finance in Qatar; www.islamicfinancenews.com. 2011
- Qatar Islamic Financing New Circular: Closing the Islamic Window for Conventional Banks, Client Alert, LATHAM & WATKINS, February 2011
- The BANKER; http://www.thebanker.com/World/Middle-East/Qatar/ Conventional -banks-face-sharia- restrictions-in-Qatar?ct=true
- https://www.cia.gov/library/publications/the-world-factbook/geos/qa.html
- http://www.qiib.com.qa/qiib/en/qiibcms.aspx?qcid=6
- http://www.gulf-times.com/qatar/178/details/343320/qatar-has-potential-to-become-major-islamic-finance- platform,-says-qiib-ceo
- UKTI Digital, for UK Trade & Investment expertise.

3 Source: Global Islamic Finance Report 2013

4 Islamic banks in Qatar specially QIB and Masraf Al Rayan are investing considerable amount on Qatarian education and their trainings.

NEWS MONITOR

Pakistan

Meezan Bank conducts Zakat awareness and education session for NGOs

12-Jul-2013

Meezan Bank, Pakistan's leading Islamic Bank, recently conducted a detailed session focused on educating welfare organizations about the proper collection and utilization of funds collected through Zakat contributions.

The session was conducted by a team of Shariah research scholars at Meezan Bank headed by Mufti Bilal Ahmed Qazi and Mufti Naveed-ul-Alam. Also present at the session was Mr. Ahmed Ali Siddiqui, Head of Product Development and Shariah Compliance at Meezan Bank.

Representatives from numerous prominent not-for-profit organizations including, SIUT, LRBT, HAWA Trust, HOPE, Green Crescent Trust, Rashid Memorial Welfare Organization, Child Life Foundation, Muslim Aid, Marie Adelaide Leprosy Centre, Omair Sana Foundation, Memon Medical Institute, Burns Centre, Afzaal Memorial Thalassemia Foundation and The Medical Aid Foundation attended the session.

During the session, the participants benefitted greatly from the informative discussions with the Shariah research scholars about matters pertaining to the proper collection and management of Zakat funds. The session was followed by a detailed question and answer session to clarify the numerous case-specific questions of the participants

SOURCE: WWW.MEEZANBANK.COM

President & CEO Of Meezan Bank Sees Pakistan As Hub Of Islamic Finance In The Region

27th August, 2013

The 4th Islamic Finance News (IFN) Pakistan Roadshow was held in Karachi. The event was proudly hosted by the central bank of the country, State Bank of Pakistan. The event kicked off by an encouraging keynote address by the Governor of the State Bank of Pakistan, Mr. Yaseen Anwar on the Islamic Finance industry of the country.

The most important panel discussion of the event was on **"Advancing Pakistan's Sustainable Growth and Development in the Islamic Finance Market".** The highly powered panel included Mr. Irfan Siddiqui - President & CEO, Meezan Bank Limited, Mr. Hasan bilgarami - CEO, Bank Islami, Mr. M.A Mannan - Executive Director, Silk Bank and other leading personalities.

Mr. Irfan Siddiqui talked about inroads which the Pakistani Islamic Banking Industry has made over the decade and how much Pakistan as whole has to offer to the other foreign countries in terms of the skill set and expertise that the industry has developed. In an answer to a question of Mr. Zulfiaqr Khokar, Additional Director Islamic Banking Department, State Bank of Pakistan, Mr. Irfan Siddiqui shared his views of seeing Pakistan as the hub of Islamic Finance in the region in the future as Pakistan is much ahead in terms of Shariah Compliance when compared to the other counterparts. He also emphasized on the importance of investing in R&D by giving the example of Meezan Bank which has a team of more than 35 professionals.

Source*: meezanbank.com*

Akuwat visit to Meezan Bank Head Office Karachi

Dr. Amjad Muhammad Saqib Executive Director, Akuwat visit to Meezan Bank Head Office Karachi. Meezan Bank agreed to provide Shariah Compliance and Islamic Product Development Advisory to Akuwat for launching Musharakah based Islamic Micro finance in Pakistan. Meezan Bank also agreed to support Akuwat for Shariah Compliance Certification and development of a Shariah Compliant System for collection, investment and disbursement of Zakat for Akuwat.

https://www.facebook.com/ahmedali.siddiqui1?hc_location=stream

SECP expands Sharia Advisory Board

The Securities and Exchange Commission of Pakistan (SECP) has decided to include two more members in its Sharia Advisory Board (SAB), as the mudaraba sector has positioned itself as a stable form of Islamic financial institution despite ongoing economic recession.

http://www.dailytimes.com.pk/default.asp?page=2013%5C04%5C07%5Cstory_7-4-2013_pg5_1

Rising partner: A Turkey-Pakistan alliance for Islamic banking

Turkey is on track to becoming the next hub for Islamic banking and finance. Given the Ottoman legacy, the last seat of the Islamic viceregency, the government of Turkey was only required to show its commitment to Islamic finance before other players in the industry were going to join her in building a vibrant Islamic banking and finance industry.

http://tribune.com.pk/story/451643/rising-partner-a-turkey-pakistan-alliance-for-islamic-banking/

ADB provides grant to promote Islamic banking in Pakistan

The Asian Development Bank (ADB) has provided a $750,000 grant to promote Islamic banking in Indonesia, Pakistan, Bangladesh and Afghanistan. The money will be shared between those countries. governments to help their banking systems to meet regulatory standards set by the Islamic Financial Services Board, the ADB said.

http://dawn.com/2012/12/11/adb-provides-grant-to-promote-islamic-banking-in-pakistan/

SBP five-year strategic plan

The State Bank has evolved a five-year strategic plan for the development of Islamic banking industry this plan lays down the future roadmap of the industry, highlights areas of improvement in legal, regulatory and taxation environments, emphasises diversification of products and markets covering non-traditional, but strategically important sectors of agriculture and SMEs and increasing Islamic banking market share to over 15pc of the country's banking.

http://www.brecorder.com/top-stories/0/1189987/

Global

Iran holds 42.7% of total global Islamic banking assets

KFH-Research issued a report that stated that Iran's Islamic banking assets contributed 42.7% of the total global Islamic banking assets in 2012, followed by Persian Gulf Cooperation Council (PGCC) (34.1%) and Malaysia (10.0%).

http://tehrantimes.com/economy-and-business/106521-iran-holds-427-of-total-global-islamic-banking-assets

Dubai plans central Islamic finance regulatory board

Dubai plans to set up a central sharia board to oversee all Islamic financial products used in the emirate, and will encourage government-linked entities to issue and list sukuk on the local bourse. The government announced last month that it wanted to become a global centre for Islamic finance and other businesses based on Islamic principles.

http://www.reuters.com/article/2013/02/27/islamicfinance-dubai-idUSL6N0BR6DV20130227

First Oman Islamic bank starts operations

Bank Nizwa, Oman's first dedicated Islamic bank, has opened its doors to the public to start a new era for banking in the sultanate. The launch was announced after the release of the Islamic Banking Regulatory Framework by the Central Bank of Oman. Sayyid Amjad Mohammed Ahmed Al Busaidi, chairman, Bank Nizwa, said: "The Islamic Banking Regulatory Framework, laid down by the CBO has positioned the economy of the nation towards achieving greater success."

http://www.arabianbusiness.com/first-oman-islamic-bank-starts-operations-485300.html

SCB launches Islamic Euro Nostro Account

Standard Chartered Bank (SCB) announced the launch of the industry's first Islamic Euro Nostro Account. Islamic banks across the world will now be able to earn Shariah-compliant profits on their account balances at Standard Chartered Bank, Germany Branch, in Frankfurt.

http://www.brecorder.com/money-a-banking/198/1243881/

CBO revises banking law to include Sharia operations

The board of governors of the Central Bank of Oman (CBO) has revised the legal framework of the sultanate's banking system for the implementation of Islamic banking activities in the country. According to a statement issued, the board decided to introduce amendments to the existing banking law in relation to Islamic banking.

http://www.muscatdaily.com/Archive/Business/CBO-revises-banking-law-to-include-Sharia-operations-1w8a

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http://www.arabianbusiness.com/first-oman-islamic-bank-starts-operations-485300.html

Azerbaijan's largest bank to develop Islamic insurance and leasing

International Bank of Azerbaijan (IBA) is going to develop Islamic insurance (takaful) and Islamic leasing (ijara). "Islamic insurance does not contradict the legislation of Azerbaijan, today creation of funds to cover risks is possible. It is not against the law if an insurance company will work within any requirements.

http://www.individual.com/storyrss.php?story=166771363&hash=dec42fe4cbca916b863e2a93e51c83fc

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Glossary: Islamic Terminology

fatwa
A ruling made by a competent a Shariah scholar on a particular issue, where fiqh (Islamic jurisprudence) is unclear. It is an opinion, and is not legally binding.

fiqh
Islamic jurisprudence. The science of the Shari'ah. This is an important source of Islamic economics.

gharar
Lit: uncertainty, hazard, chance or risk. Technically, sale of a thing which is not present at hand; or the sale of a thing whose consequence or outcome is not known; or a sale involving risk or hazard in which one does not know whether it will come to be or not.

halal
Activities; which are permissible according to Shari'ah.

Haram
Activities, which are prohibited according to Shari'ah.

ijara
A leasing contract under which a bank purchases and leases out a building or equipment or any other facility required by its client for a rental fee. The duration of the lease and rental fees are agreed in advance. Ownership of the equipment remains in the hands of the bank.

ijara sukuk
A sukuk having ijara as an underlying structure.

ijara wa iqtina
The same as ijara except the business owner is committed to buying the building or equipment or facility at the end of the lease period. Fees previously paid constitute part of the purchase price. It is commonly used for home and commercial equipment financing.

istihsan
In Islamic jurisprudence, it refers to departure from the application of a ruling on an exceptional basis by taking a lenient view of an act that may otherwise cause unfairness or distress.

istisna
A Contract of acquisition of goods by specification or order, where the price is fixed in advance, but the goods are manufactured and delivered at a later date. Normally, the price is paid progressively in accordance with the progress of the job.

maysir
Gambling – a prohibited activity, as it is a zero-sum game just transferring the wealth not creating new wealth.

mudarabah
A form of business contract in which one party brings capital and he other personal effort. The proportionate share in profit is determined by mutual agreement at the start. But the loss, if any, is borne only by the owner of the capital, in which case the entrepreneur gets nothing for his labour.

mudarabah sukuk
A sukuk having mudarabah as an underlying structure.

mudarib
In a mudarabah contract, the person or party who acts as entrepreneur.

murabaha
A contract of sale between the bank and its client for the sale of goods at a price plus an agreed profit margin for the bank. The contract involves the purchase of goods by the bank which then sells them to the client at an agreed mark-up. Repayment is usually in instalments.

musharakah
An agreement under which the Islamic bank provides funds which are mingled with the funds of the business enterprise and others. All providers of capital are entitled to participate in the management but not necessarily required to do so. The profit is distributed among the partners in predetermined ratios, while the loss is borne by each partner in proportion to his contribution.

Rab-al-maal
In a mudarabah contract the person who invests the capital.

Retakaful
Reinsureance based on Islamic principles. It is a mechanism used by direct insurance companies to protect their retained business by achieving geographic spread and obtaining protection, above certain threshold values, from larger, specialist reinsurance companies and pools.

Riba
Lit: increase or addition. Technically it denotes any increase or addition to capital obtained by the lender as a condition of the loan. Any risk-free or "guaranteed' rate of return on a loan or investment is riba. Riba, in all forms, is prohibited in Islam. Usually, riba and interest are used interchangeably.

sadaqah
Charitable giving.

salam
Salam means a contract in which advance payment is made for goods to be delivered later on.

Shari'ah
Refers to the laws contained in or derived from the Holy Quran and the Sunnah (practice and traditions of the Prophet Muhammad (PBUH).

Shari'ah board
An authority appointed by an Islamic financial institution, which supervises and ensures the Shari'ah compliance of new product development as well as existing operations.

shirkatulmilk
Partnership by ownership, which could be automatic as in the case of inheritance by two brothers, or optional such as two persons purchasing a property jointly (not for a commercial purpose).

shirkatulaqd
A contract between two or more persons who launch a business or financial enterprise to make profit, Generally it is termed as 'shirkah'. Specifically, it has to be distinguished from shirkatulmilk, in which two or more persons become partners in the ownership of an asset not for business.

sukuk
Similar characteristics to that of a conventional bond with the key difference being that they are asset backed; a sukuk represents proportionate beneficial ownership in the underlying asset. The asset will lie leased to the client to yield the return on the sukuk.

ta'awuni
A principle of mutual assistance.

takaful
A form of Islamic insurance based on the Quranic principle of mutual assistance (ta'awuni). It provides mutual protection of assets and property and offers joint risk sharing in the event of a loss by one of its members.

Wakala
A Contract of agency in which one person appoints someone else to perform a certain task on his behalf, usually against a certain fee.

Waqf
An appropriation or tying-up of a property in perpetuity so that no propriety rights can be exercised over the usufruct. The waqf property can neither be sold nor inherited nor donated to any one.

Zakat
An obligation on Muslims to pay a prescribed percentage of their wealth to specified categories in the society, when their wealth exceeds a certain limit. Zakat purifies wealth. The objective is to take away a part of the wealth of the well-to-do to distribute it among the poor and the needy.

arboun
An Islamic version of option, a deposit for the delivery of specified quantity of a commodity on a predetermined date.

bai al-ina
This refers to the selling of an asset by the bank to the customer on a deferred payments basis, then buying back the asset at a lower price, and paying the customer in cash terms.

bai bithaman ajil
Sale of goods on a deferred payment basis credit sale, another term used for such sales is bai muajjal. Equipment or goods requested by the client are bought by the bank which subsequently sells the goods to the client at an agreed price which includes the bank's mark-up (profit).

Hajj
Pilgrimage to Mecca. Hajj is a duty on every Muslim who is financially and physically able to carry it out, at least once in his lifetime, Hajj is performed in the month of Zulhajjah the last month of the Islamic calendar.

ibaha
Lit: permissibility. Ibaha refers to the rule that every economics transaction is mubah (permissible) unless expressly and specifically forbidden by shari'ah.

Kafalah
Lit: responsibility or suretyship. In kafalah, a third party becomes surety for the payment of debt. It is a covenant/pledge given to the creditor that the debtor will pay the debt or any other liability.

qard hasana
An interest-free loan given either for welfare purpose or for fulfilling short-term funding requirements. The borrower is only obligated to pay back the principal amount of the loan.

qimar
Lit: gambling. Technically, an agreement in which possession of a property is contingent upon the occurrence of an uncertain event.

Rahan
Collateral; technically, it means to pledge or lodge a real or corporeal property of material value as security for a debt or pecuniary obligation so as to make it possible for the creditor to recover the debt, in case of non-payment, by selling the pledged property.

Ramadan
It is the ninth month of Islamic calendar, during which Muslims fast; it is also a time for reflection, intensive prayer and self-restraint.

tabarru
A donation covenant in which the participants agree to mutually help each other by contributing financially.

Tawaruq
A sale of a commodity to the customer by a bank on deferred payment at cost plus, profit. The customer then sells the commodities to a third party on spot basis and gets instant cash.

Umra
Lit: visiting or attending. It is a mini-pilgrimage to Mecca which is not compulsory, but highly recommended, and can be performed at any time of the year.

Musharakah, diminishing
An agreement which allows equity participation and sharing of profit on a pro rata basis, but also provides a method through which the bank keeps on reducing its equity in the project and ultimately transfers the ownership of the asset to the participants.

Amanah
Lit: reliability, trustworthiness, loyalty, honesty, Technically, it describes a business deal where one party keeps another`s funds or property in trust.

Usufruct
A legal right to use and derive profit from property belonging to someone else provided that the property itself is not damaged.

Wa'ad
A promise to buy or sell certain goods in a certain quantity at a certain time in future at a certain price. It is not a legally binding agreement.

mufti
An Islamic scholar, who interprets or expounds Islamic law and gives fatwa.

Wakil
In a wakala contract, a representative (agent) who acts on behalf of the principal/investor.

Sunnah
It refers to the sayings and actions attributed to Prophet Muhammad (PBUH).

All complaints should be addressed to the Karachi Secretariat where the complaints handling process has been centralized.

For any information or enquiries, please email us at *info@bankingmohtasib.gov.pk* or write to us at the Karachi Secretariat address given below. Details including complaint filing procedure, printable complaint form and FAQs are also available at our website *www.bankingmohtasib.gov.pk*

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Karachi Secretariat
Banking Mohtasib Pakistan Secretariat
5th Floor, Shaheen Complex
M R Kiyani Road, Karachi
Telephone: 99217334-38 (5 lines)
Facsimile: 99217375
Email: info@bankingmohtasib.gov.pk
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Lahore Regional Office
Office of the Banking Mohtasib Pakistan
c/o SBP, Banking Services Corporation
Shahrah-e-Quaid-e-Azam, Lahore
Telephone: 99210444
Facsimile: 99210421

Peshawar Regional Office
Office of the Banking Mohtasib Pakistan
c/o SBP, Banking Services Corporation
Saddar Road, Peshawar
Telephone: 9213438
Facsimile: 9213439

Quetta Regional Office
Office of the Banking Mohtasib Pakistan
c/o SBP, Banking Services Corporation
Shahrah-e-Abbas Ali, Quetta
Telephone: 9203144
Facsimile: 9203145

Rawalpindi Regional Office
Office of the Banking Mohtasib Pakistan
c/o SBP, Banking Services Corporation
The Mall, Rawalpindi
Telephone: 9273252
Facsimile: 9273253

Multan Regional Office
Office of the Banking Mohtasib Pakistan
c/o SBP, Banking Services Corporation
Kalma Chowk, Multan
Telephone: 9201482
Facsimile: 9201481

Note to contributors

Journal of Islamic Banking and Finance is an official publication of International Association of Islamic Banks Karachi, Pakistan. It is a refereed quarterly journal, as well as a pioneer in the field of Islamic banking and finance being published since 1984. It provides a forum for researchers, particularly in Islamic Banking and Finance, wishing to share their expertise with a vast intelligentsia in the form of articles, research and discussion papers and book reviews. Major areas of interest for the journal include: (i) Theoretical issues in banking and financial industry specially from Islamic perspective; (ii) Empirical studies about the Islamic banking and financial institutions; (iii) Survey studies on issues in Islamic banking and financé; (iv) Analytical studies of applied Islamic banking; (v) Comparative studies on Islamic and conventional banking systems; and (vi) Short communications and interviews investigating the perceptions of leading bankers and banking experts as well as policy makers.

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The contributors are requested to observe the following rules.

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Main Clifton Road, Karachi (Pakistan)
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