

Islamic finance as a model of the sustainable financial system: Lessons from financial activities in the pre-modern Islamic world

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“This short essay examines the distinctive features of Islamic finance and clarifies its universal aspect in the context of economic theory while reconsidering the proposition that conventional finance is taken to be the universal financial system.”

It is a well-known fact that the commercial practice of Islamic finance emerged in the 1970s as a “new” financial system different from interest-based conventional finance. Some of the bankers even called it “ethereal investment” based on religious belief. However, when examining the distinctive feature of Islamic finance and reviewing the history of the pre-modern Islamic and Mediterranean world, it can also be observed that Islamic finance shares its features with financial activities in the pre-modern era. When we consider that these activities supported and sustained the golden age of the pre-modern Islamic and Mediterranean world in the long term, we may get a clue from Islamic finance regarding how we should reconstruct the world or regional financial system immune to the crisis. Based on such a motivation, this short essay examines the distinctive features of Islamic finance and clarifies its universal aspect in the context of economic theory while reconsidering the proposition that conventional finance is taken to be the universal financial system.

Discovering the distinctive feature of Islamic Finance

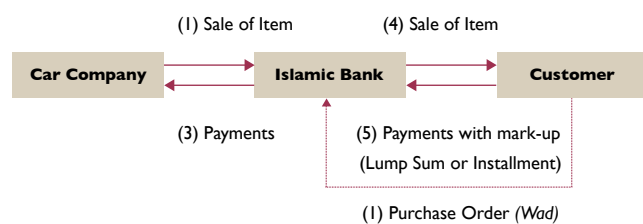
The current practice of Islamic finance deals with varieties of financial products. *Murabaha* is the most popular products among them; therefore, we will examine the scheme of *Murabaha* to understand the distinctive feature of Islamic finance. *Murabaha* is a form of a contract wherein a seller sells a product to a buyer at a price comprising of its cost and the seller’s margin, approved by both parties. The settlement is generally made in lump sum payment or in installments. *Murabaha* had been used as an instrument for commodity transactions in the pre-modern era. The general procedure of *Murabaha* provided by Islamic banks is as follows (see **Figure 1**): a bank’s customer primarily specifies a product that he/she wishes to purchase before the contract award of *Murabaha* by using “the Purchase Order” (*Wad*) scheme. According to this order, the Islamic bank buys a product specified by its customer on his/her behalf from the market, and then, sells it to its customer at a price that comprises the product’s cost and the bank’s profit, which is called ‘mark-up.’



Since the 1970s, *Murabaha* has been the most popular financial product in the asset side of Islamic banks as an alternative financial instrument for interest-based short-term loans. With regard to the share of *Murabaha*, a majority of Islamic banks in both the Middle East and Malaysia exhibit a widespread preference for *Murabaha*. For example, in Dubai Islamic Bank, which was established in 1975 as the world’s first commercial Islamic bank, *Murabaha* has occupied higher shares, even if the annual shares in the 2000s are smaller than those in the 1980s and 1990s. In Bank Islam Malaysia, established in 1983 as the first commercial Islamic bank in Southeast Asia, *Murabaha* (including *Bay Bi-thaman Ajil* which is similar to *Murabaha*) has also occupied the highest share of total financing on its asset side every year. According to a certain estimation, 80–90% of financial instruments on the asset side of Islamic banks were *Murabaha* from the 1970s through the first half of the 1990s.

However, *Murabaha* in Islamic finance is a controversial product in light of Islamic jurisprudence. Those who are sceptical about the current practice of Islamic finance point out that the nature of ‘mark-up’ is similar to ‘bank interest,’ which is prohibited in Islam and is regarded as *Riba*. In contrast, those who support its practice approve the use of *Murabaha* by issuing the legal resolutions (*Fatwa*, *Fatawa* in the plural). According to the most consistent resolution which was issued at the first Al-Baraka Symposium in 1983, its logic behind their approval of the aforementioned products is as follows: firstly, the resolution that the actual involvement of the real good in the relevant transac-

Figure 1: Scheme of *Murabaha* in Islamic Finance



Source: Prepared by the Author

tions is strongly required. This requirement implies that *Murabaha* is legitimized because it neither includes 'monetary', nor 'nominal' transactions, but consists of transactions based on the 'actual buying and selling of goods.' Secondly, the resolution also mentions the source of the legitimacy of profit in these products. It requires that any profits should be expressed as a function of supply and demand in the real goods market. This statement implies that the source of legitimacy of profit in *Murabaha* is considered to be an opportunity cost of the real goods in the relevant market. In contrast, it can be considered that the source of prohibition of interest in conventional interest-based loans is regarded as an opportunity cost of the monetary good. In terms of economics, it can be stated that any profits in the scheme of *Murabaha* is legitimized because it appropriately bears the market risk of the relevant real goods.

What can we know regarding the distinctive feature of Islamic finance from the above analysis of *Murabaha*? Both implications show that the financial instruments in Islamic finance consist of the schemes so that all the relevant parties appropriately bear the market risk of the relevant real good or business. And then, this is the source of legitimacy for each instrument. Considering this insight from the perspective of the economic system as a whole, it can be said that the financial system highly depends on the real domain in the economic system. Karl Polanyi, who is known as an economic anthropologist, criticized the modern economic theory, and stated that economy is not autonomous as it must be in economic theory but subordinated to political and social relations. He expressed this statement as "the human economy was always embedded into the society." Paraphrasing his idea and concept, the distinctive feature of Islamic finance is described as the "embedded" system in the real domain of the economy.

Universal aspect and modern novelties of Islamic finance

Following on from the preceding analysis, we examine the universal aspect and modern novelty of Islamic finance in the context of economic history. It is well known that the pre-modern Islamic world did not have anything like the comprehensive financial systems such as structured banking that are available in today's world. However, it was not as if the Islamic world operated without a financial sector at that time. The *Sarraf*, for instance, played the role of moneychangers and were a crucial cog in the money-transmitting business by virtue of their management of bills and checks. Although some of them put their own money into businesses, they were not allowed to receive

deposits and use them as seed money for their investments. Instead, *Wadia*, which was known for arranging custody agreements, provided the deposit service. These facts imply that there was no credit creating function in those days, something that is common in the modern banking system. This is one of the primary differences between the financial activities in the pre-modern Islamic world and those that are commonplace in the modern banking sector.

In addition to the role of the money brokers mentioned in the last paragraph, it is also well known that merchants in the pre-modern Islamic period used certain trade instruments that were approved by the Islamic jurisprudence; these functioned as the financing instruments of the time. For instance, Genizah which is a collection of almost all the Jewish manuscript fragments found in the storeroom of the Ben Ezra Synagogue in Cairo, Egypt shows that the trade merchants of Cairo during the eleventh and twelfth centuries were given the use of the Islamic partnership instruments for the purposes of financial trade. As another example, the rich merchants of Cairo in the sixteenth and seventeenth centuries also used them to finance their businesses. These historical facts illustrate that there was a situation in which various sectors overlapped to create a financial system. Abraham Udovitch who is the prominent historian of Islamic history terms the financial situation of the pre-modern Islamic world as one of "Bankers without Banks".

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What was the situation with regard to interest-based loans in the pre-modern Islamic world? According to one popular theory, money-lenders lending at a usurious rate of interest was quite common in the pre-modern Islamic world; therefore, the prohibition of *Riba* became increasingly irrelevant at the time. Indeed, several empirical studies seem to exemplify this proposition. For example, there were interest-based loans known as *Istighlal* in Bursa during the seventeenth century. Further, there were litigation documents in Damascus and Tehran in the nineteenth century, which explain the existence of interest bearing transactions between a guardian and a ward. Although the empirical studies conducted by the researchers cited above refer to these instruments as 'interest-based' loans without any reservations, a detailed review shows that the schemes involving these instruments were different from transactions based on interest-based loans. This is because these instruments were based on *Bay Ina* transactions.

Bay Ina literally implies double sales, and is basically an alternative financial arrangement for a customer who needs immediate cash. The complete procedure is outlined as follows. First, a prospective creditor buys an asset from a customer (prospective debtor) who needs immediate cash, and then, the customer immediately buys back his asset from the creditor by means of *Murabaha*. The initial trade is a spot transaction, while the subsequent trade is a deferred transaction with a higher price than that in the initial trade. Herein, the creditor



provides the customer with financial liquidity and earns profit from the price gap between the initial and subsequent trades. As pointed out by the critics, it can be held that *Bay Ina* is merely a fictitious instrument engineered to sidestep interest-based loans. However, a *Bay Ina* transaction is not entirely the same as an interest-based loan because the former is conducted in the form of an exchange of real goods for money. Then, which system can we classify *Bay Ina* into: the interest-based or “embedded” financial system?

The prohibition of interest is not peculiar to Islam. If we were to trace back through history, a number of examples of such prohibition can be found, from Aristotle to Michael Ende. Among them, the doctrine of Christianity was the most influential on the subject of avoiding interest in medieval Europe. There are many verses in the Bible that mention the prohibition of interest. For example, the Gospel of Luke talks about a steward who wastes his employer’s goods in order to prevent the debtors of his employer from paying interest on their loans. Then, the Gospel continues, his employer commends the steward because he has done wisely [Luke, 16: 1-8]. In the Middle Ages, Thomas Aquinas formulated a theory on the prohibition of interest, and the canon law, based on his theory, condemned all interest bearing transactions.

Therefore, it is said that medieval European locals were obliged to use the peripheral Jewish moneylenders with their high rates of interest, or developed the alternative instruments which avoid interest bearing transactions. The latter case can be classified into two trends; firstly, they used partnership-based instruments known as *Commenda*, which shares the same origin as the Islamic partnership instruments, to finance their business. Secondly, they invented debt-based instruments which did not include interest bearing transactions. For example, the House of Medici earned profits from money lending by means of a system of bills of exchange in which the exchange rate varied from one region to another. To present another example, the merchants of Calais in the fifteenth century raised their funds by using buy back transactions of the commodity, which were very similar to *Bay Ina* scheme in Islam. These instruments enabled them to earn profits from money lending without deviating from the canon law.

On the basis of a study of the existing mainstream literature, it is evident that nobody has ever doubted the proposition that the interest-based financial system, which is today regarded as the way of “conventional finance,” should be accorded the status of the universal financial system. However, if we were to revert to the ancient and medieval financial activities outlined above, it would become clear that such a financial system was by no means always prevalent. Instead, the “Embedded” financial system is found to have existed in many regions in the pre-modern world, even in Europe. In addition, recent studies show that the dawn of the interest-based financial system was not the result of deviation from the Christian doctrine of the prohibition of interest due to the spell of economic development that swept through Europe during the late medieval period. The seeds of the interest-based financial system unexpectedly originated in the relentless effort by merchants to balance its doctrine with commercial success.

Therefore, if we were to discard this prejudice, we would be in a position to state that the abovementioned proposition with regard

to the interest-based financial system is merely a dogmatic view, that is, the interest-based financial system has not necessarily been a universal one; rather it has been, radically speaking, a peripheral system. Furthermore, paraphrasing the term used by Kenneth Pomeranz, who challenges the typical framework of the European economic development by using the term “the great divergence,” it can be said that the rise of the interest-based financial system in Europe is not a result of the linear development of the financial system, but a result of “the great divergence” from the true universal financial system that was embedded in the real domain of the economy.

Under this new framework, and divested of our prejudice on the subject of the interest-based system, the controversial *Bay Ina*-based instruments can be classified as an instrument of the true embedded instruments. This clarification implies that the historical dynamics of the financial activities in the pre-modern Islamic world can be regarded as a universal experience in economic history, and that the distinctive feature of “embeddedness” can be shared by the financial activities in the pre-modern world and Islamic finance in the modern world. Therefore, it can be concluded that Islamic finance has had a universal aspect in economic history in terms of the “embeddedness.”

The emergence of Islamic finance opens a new page in the history of both Islam and finance. As has been already overviewed above, the comprehensive financial systems did not exist in the pre-modern Islamic world. Therefore, the current practice of Islamic finance is an unprecedented experiment in the history of Islam. On the other hand, a structured banking system without interest has never existed in the history of finance, too. Therefore, although Islamic finance stays on the genealogy of the “embedded” universal financial system, the modern novelties of Islamic finance can be observed.

Most instruments adopted by Islamic banks were not necessarily used as financial instruments in the pre-modern era. For example, *Murabaha* was originally a trade contract to assist a buyer who was not familiar with business customs in the market. The formulation of Islamic finance as a modern banking system required the innovation of such a trade contract for using as a financial instrument. New interpretations by *Sharia* scholars also enable trade contracts to function as new financial instruments. *Murabaha* is renewed as a short-term loan instrument by the new approval of *Sharia* scholars, which allow adding *Wad* procedure before the original *Murabaha* as explained above. Thus, financial activities in accordance with Islam are refurbished in the modern world with a new design of the modern banking structure, which is called “Islamic finance.” Therefore, one of the modern novelties of Islamic finance is the above innovation (or renovation) by combining and transforming erstwhile Islamic trade contracts.

The other novelty of Islamic finance is its coexistence with conventional finance. Although many interactions were observed in Mediterranean trade in the pre-modern and early modern world, financial systems in both the Islamic world and Europe were separated by region. However, the current practice of Islamic finance not only provides services within the Islamic world but also expands its businesses to Europe and the international financial markets. Therefore, although Islamic finance in principle is embedded in the real domain of the economy, its practice is heavily influenced by the conventional financial system. For example, a mark-up rate of *Murabaha* is



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theoretically determined by the supply and demand balance of the relevant real goods. However, in reality, the mark-up rate tends to be adjusted to coincide with an interest rate of short-term loans through arbitrage. In another instance, the newly developed financial instrument in Islamic finance tends to be a recycled design of the leading products in conventional finance like financial derivatives and highly liquid instruments. Obviously, these situations are the outcome of the growing competitiveness of Islamic finance with respect to the conventional finance. From the aspect of economic history, these situations of Islamic finance implies that the embedded financial system in the modern world can come to exist with the support of an external system such as the conventional system of finance; this is the second modern novelty of Islamic finance.

Towards the sustainable financial system

This essay clarifies the distinctive feature of Islamic finance as the “Embedded” financial system, wherein the monetary domain of the economy is embedded into the real domain, and reverts to the history of the pre-modern

Islamic world and Europe to show that the rise of the interest-based financial system in Europe is not because of the linear development of the financial system but because of “the great divergence” from the universal financial system that was embedded in the real domain of the economy. It shows that then, Islamic finance stays on the genealogy of such a universal financial system. On the other hand, it clarifies two modern novelties of the system of Islamic finance. One is the innovation of Islamic trade contracts for using as financial instruments by combination and transformation of them, which results from the formulation of Islamic finance as a modern banking system. The other is the dependence on an external system such as conventional finance, which is due to the coexistence of two financial systems in the modern world. On the basis of these implications, it can be concluded in the context of economic history that Islamic finance is one of the universal financial systems with a novel design having a modern banking structure.

The current financial crisis questions the superiority and stability of the conventional financial system and makes bankers focus on Islamic finance. As a result, a number of banks

in conventional finance are now on the way out from speculative and vague financial transactions which are “not embedded” into the real domain of the economy, and are going back to the “embedded” transactions. To the contrary, Islamic finance maintains the pace of its growth despite the global recession that was caused by the financial crisis. Radically speaking, these current situations, which occur in both international and regional financial markets, can support my conclusion, which is that the “embedded” financial system is universal. Although Islamic finance is not necessarily very robust and stable against financial crises, Islamic finance, which shares its feature with financial activities in the golden age of the pre-modern Islamic and Mediterranean world, can give us a good idea of the more sustainable financial system.

About the author

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