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Institutional Economics Relevant to Islamic Finance

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Abstract

The study on the relevancy of institutional economics to mainstream Islamic economics especially in Islamic finance is not widely known. The relevancy issue arises due to: the role of revelation and reason; and the assumption of an ideal Islamic financial institutions; the role of both institutional environment and institutional arrangements on the setting-up of the Islamic financial institutions. Thus, the discussion in this paper provides a brief (and admittedly unbalanced) sketch of the new institutional economics which is relevant to Islamic finance. The literature in NIE is expanding rapidly and gaining increasing adherents and influence in Islamic finance. Our findings show that it is a highly diverse field and its many branches are rich in theoretical insight, relevant for policy and empirically useful.

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1. Introduction

The earlier works on institutional economics (or refer to 'old institutional economics' are normally referred to the writings of Thorstein Veblen, John R. Commons, Wesley C. Mitchell, Clarence Ayres and their followers.² Their work reflects several common themes, mostly criticisms of orthodox economics: (a) a focus on collective rather than individual action; (b) a preference for an 'evolutionary' rather than mechanistic approach to the economy; and (c) an emphasis on empirical observation over deductive reasoning. For a sampling of the secondary literature see Seckler (1975); Gruchy (1972); Gruchy (1987); Rutherford (1983); Langlois (1989); and Hodgson (1998)). Whatever their contributions, the older institutionalists are little known to most contemporary economists. As pointed out by Coase's (1984, p. 230), dismissal is typical: 'Without a theory they had nothing to pass on except a mass of descriptive material waiting for a theory, or a fire'. It shows that institutional economics is a sub-field, that focuses on understanding the role of the evolutionary process and the role of institutions in shaping economic behaviour. Its original focus lay in 'old institutional economics' usually referred to This is a diverse group, but

The new institutional economics (NIE) represented originally by Williamson (1975). NIE, then, began to develop as a self-conscious field in the 1970s, traces its origins to Coase's analysis of the firm (Coase, 1937), Hayek's writings on knowledge (Hayek, 1937, 1945) and Chandler's history of industrial enterprise (Chandler, 1962), along with contributions by Simon (1947), Arrow (1963), Davis and North (1971), Williamson (1971, 1975, 1985), Alchian and Demsetz (1972), Macneil (1978), Holmström (1979) and others. Its best-known representatives are Coase, Williamson and North. For overviews and commentaries see Eggertsson (1990), Furubotn and Richter (1991), Coase (1992), Werin and Wijkander (1992), Pejovich (1995), Drobak and Nye (1997); and annual symposium issues of the *Journal of Institutional and Theoretical Economics*. However, NIE plays a relatively minor role in mainstream economics. A major reason institutional economics has not kept its position as a major paradigm is attributed to the fact that it was less suited to strong mathematical rigor. Developments in evolutionary game theory, and perhaps even dynamic mathematics, might alleviate this problem.

Like its older counterpart, NIE is interested in the social, economic and political institutions that govern everyday life. In understanding those institutions, NIE tries to combine the inter-disciplinary fields such as economics, law, organization theory, political science, sociology and anthropology.³ However, the new institutional economics deviates the holism of the older school. NIE follows strict methodological individualism, always couching its explanations in terms of the goals, plans and actions of individuals.⁴ Of course, NIE appreciates social phenomena like corporate culture, organizational memory, and so on.

The first recorded economic institution in Islam (known as Baitulmal) was established during the Prophet S.A.W and later followed by his four companions. The succesful of this institution had led to the prosperity and the raising of the standard of living in Muslim countries. In several Muslim countries, the Waqf (Endowment) has been instrumental in financing and thus ensuring the smooth running of a large number of public

² See, http://en.wikipedia.org/wiki/Institutional_economics

³ Eric Brousseau and Jean-Michel Glachant (2008) *New Institutional Economics: A Guidebook*. Cambridge:Cambridge University Press

⁴ This is in line with the objective of capitalist system. We should link it with the earlier view of institutional economics which tries to relate both field i.e. law and economics. law and economics has been a major theme since the publication of the *Legal Foundations of Capitalism* by John R. Commons in 1924

and charitable institutions such institutions include mosques, madrassas (educational institutions) orphanages and hospitals.⁵

The study on the relevancy of institutional economics to mainstream Islamic economics especially in Islamic finance is not widely known. The relevancy issue arises due to: the role of revelation and reason; and the assumption of an ideal Islamic financial institutions; the role of both institutional environment and institutional arrangements on the setting-up of the Islamic financial institutions. Since, for example, reason can not be independent of faith and morality; and the core of Islamic economics – the Quran and the Sunnah – provides guidance, thus the dominant aspects of Islamic finance reality and activities partly requires those elements. Therefore, the use of inductive reasonings in the field of Islamic finance becomes crucial.

The institutional environment refers to the background constraints, or ‘rules of the game’, that guide individuals’ behaviour. These can be both formal, explicit rules (constitutions, laws, property rights) and informal, often implicit rules (social conventions, norms). While these background rules are the product of - and can be explained in terms of - the goals, beliefs and choices of individual actors, the social result (the rule itself) is typically not known or ‘designed’ by anyone. Institutional arrangements, by contrast, are specific guidelines - what scholar such as Chapra and Ahmed (2002), Choudhury and Hoque (2006), Grais and Pellegrini (2006), Archer and Rifaat (2007), Asraf-Wajdi (2008) and Hassan (2009) calls ‘governance structures’ - designed by contracting partners to mediate particular economic relationships. Business entity and contractual agreements are examples of institutional arrangements.

In the following discussion, those three aspects will be discussed separately.

2. Revelation and Reason Related to Islamic Finance

As the foundation of Islamic faith is *Tawhid* (among others are to believe what has been revealed in the *Quran and the Sunnah*), the guiding principle in doing the economic activities partly requires those foundations. Therefore, the use of inductive reasonings in the field of Islamic finance becomes crucial. One of the elements in Islamic finance is *riba*. There are several al-quran injunctions and al-hadith condemning and strongly prohibiting *riba*.

Proofs from the al-quran, Allah does not declare war on anyone except the people who deal in *riba*:

“O you who believe! Observe your duty to Allah, and give up what remains from riba if you are true believers. And if you do not, then be warned of war from Allah and His Messenger...” [al-quran, al-baqarah: 278-279]

On the Day of Resurrection, people will rise from their graves quickly, except those who engaged in *riba*. They will stand up and then fall down like epileptics. Whenever they will try to stand up, they will fall down because they devoured *riba* in this world:

“Those who devour riba will not stand (i.e. on the Day of Judgement) except like the standing of a person beaten by Satan leading to madness. That is because they say: ‘Trade is like riba,’ but Allah has permitted trade and forbidden riba. Those who after receiving direction from the Lord, cease, shall be pardoned for the past; their case is

⁵ Refer to our recent Abdul Ghafar Ismail, Mohd Ezani Mat Hassan, Norazman Ismail dan Shahida Shahimi (2010) Proceedings of Seventh International Conference "The Tawhidi pistemology: Zakat and Waqf Economy". Universiti Kebangsaan Malaysia

for Allah (to judge); but those who repeat (the offense) are the dwellers of the Fire. They will abide therein forever.” [al-quran, al-baqarah: 275]

Allah promises prosperity in this world and the next to those who refrain from and cease this abominable practice:

“O you who believe, do not devour riba, doubled and multiplied but fear Allah; that you may really prosper.” [al-quran, al-imran: 130]

Those who devour riba are the rejectors of faith:

“That they took riba although they were forbidden and that they devoured men’s property wrongfully. We have prepared for those among them who reject Faith a grievous punishment.” [al-quran, an-nisa’: 161]

Wealth does not increase but decreases in the long run by dealing with riba:

“That which you lay out of increase through the property of (other) people, you will have no increase with Allah...” [Qur’an, al-rum:39]

Proofs from the al-hadith which explain the forbidden Riba. Everyone who has something to do with riba, whether he is one of the main parties involved or is a middleman or facilitator, has been cursed. The companion Jabir reported:

“The Messenger of Allah cursed the one who accepted riba, the one who paid it, the one who recorded it, and the two witnesses to it.” He said: “They are all alike.” (Sahih Muslim)

‘Aun ibn Hanifa reported from his father that the Prophet SAW had condemned both the receiver of interest and its payer. (Bukhari)

Based on this, it is not permitted to do work that involves writing riba-based contracts and conditions, paying or receiving riba, depositing it or guarding it. Generally speaking, it is Haram or prohibited to be directly or indirectly involved with riba in any way, shape, or form. It is also reported that the Prophet SAW said:

“Avoid the seven sins that doom a person to Hell.” They said, “O Messenger of Allah, what are they?” He said: “Associating others in worship with Allah; witchcraft; killing a soul whom Allah has forbidden killing, unless that is done lawfully; consuming riba; consuming the property of orphans; running away from the battlefield; slandering innocent chaste believing women.” (Sahih Bukhari and Sahih Muslim)

The ugliness of this major sin can also be seen in the following words of the Prophet SAW:

“There are seventy-three types of riba, the least of which is as abhorrent as a man having intercourse with his own mother and worst of which is violating a Muslim’s honour and sanctity.” (Al-Hakim)

Samurah ibn Jundub reported that the Prophet SAW saw in his dream a man standing in a river of blood.

On the riverbank stood a man who had with him stones. Each time the man in the river wanted to come out, the man with the stones would throw a stone into his mouth which drives him back to his position. The Prophet SAW asked about this man in the river at which he was informed he was a man that dealt with riba. (Sahih al- Bukhari)

During the Isra' Mikraj, the Prophet SAW passed by a group of people, whose stomachs were like that of houses. In these houses were snakes that could be seen from the outside. So the prophet asked Jibril about them at which he said:

"They are the ones who deal with riba." (Ahmad)

The prohibition of riba does not just apply to deals between the rich and poor. It is a general prohibition that applies to every person and every situation. Indeed how many rich people and big businessmen have gone bankrupt because of riba. The least harm that riba does is to destroy the blessing of the money, even if a person's wealth is great. The Prophet SAW said:

"Even if riba is much, it will end up being a small amount." (Al-Hakim)

In Trade, riba make in the payment of an addition by the debtor to the creditor in the exchange of commodities of the same kind, such as money for money, flour for flour, rice for rice, etc. The Prophet SAW said:

"Gold is to be paid by gold, silver by silver, wheat by wheat, barley by barley, dates by dates, and salt by salt, like by like, payment being made on the spot. If anyone gives more or asks for more, he has dealt in riba. The receiver and giver are equally guilty." (Sahih Muslim)

An example is found in the hadith collected by Bukhari:

"Once Bilal brought Barni (a kind of dates) to the Prophet and the Prophet asked him, 'From where have you brought these?' Bilal replied, 'I had some inferior type of dates and exchanged two Sa's of it for one Sa' of Barni dates in order to give it to the Prophet to eat.' Thereupon the Prophet said, 'Beware! Beware! This is definitely Riba (usury). This is definitely Riba (Usury). Don't do so, but if you want to buy (a superior kind of dates) sell the inferior dates for money and then buy the superior kind of dates with that money.'"

The setting up Islamic financial institution is not only based on the revealed knowledge but also the reason related to it.....yakni we should argue that interest is prohibited to several reasons besides.

Nowdays we can see that money and financial institutions is more sinonym with riba. We would now take up the issue, what is the reason behind prohibition of riba, insofar as that reason is indicated in Quran. Even though we do not get the reason in the form of a direct statement, a number of reasons can be inferred from the texts read in their context. We single out five such reasons: riba corrupts society; riba implies improper appropriation of other people's property; riba's ultimate effect is negative growth; riba demeans and diminishes human personality; and riba is unjust.

The first reason reveals itself when we read the above mentioned verse from chapter 30, sura Rum, along with some of the preceding and following verses. These read:

See they not that Allah enlarges the provision for whom He will, and straitens (it for whom he will). Lo! Herein indeed are portents for folk who believe. So give the kinsman his due and to the needy, and to the wayfarer. That is best for those who seek Allah's countenance. And such are they who are successful. That which you give in usury in order that it may increase in other people's property has no increase with Allah; but that which you give in charity, seeking Allah's countenance, has increase manifold. Allah is He Who created you and then sustained you, then causes you to die, then gives life to you again. Is there any of your (so called) partners (of Allah) that does aught of that? Praised and exalted be He above what they associate with him. Corruption does appear on land and sea because of (the evil) which men's hands have done, that He may make them taste a part of that which they have done, in order that they may return. (30: 37-41)

The association of charging interest with fasad is significant. Within the framework of the general message that fasad in society results from men's own (wrong) behavior, we can clearly read the sub-message that charging interest is one of those wrong behaviors that corrupt the society. As the experts say, this may have been the first time, chronologically speaking, that riba was mentioned in Quran. It was in the fitness of things to highlight its negative social role long before the practice of charging interest was banned.

What is meant by fasad in the above verse, and in what way charging interest on loans could be related to it? Read some of the numerous verses in which the word has occurred in the Quran and you get an idea of its dimensions. What is interesting in our context is the inclusion, into the concept of fasad, of 'destruction of crops and people' (2: 205), 'severing the ties of kinship' (47: 22), dividing people into classes and discriminating between them (28: 4), 'shedding bloods' (2:30), giving people less than full measure and wronging them in their goods (11: 85; 26: 183), arrogance borne of enormous wealth (28: 77) and sexual perversion (29: 28-30).

The second reason, riba amounting to unlawful appropriation of other people's property is indicated in the verse from chapter four, sura al-Nisa' quoted above. In that verse the Jews are admonished for 'taking usury when they were forbidden it, and of their devouring people's wealth by false pretences' (4: 161). There lies a hint as to a generic connection between riba and akl bi'l batil. Significantly, Quran relates the tendency to appropriate other people's wealth without any justification to some more serious crimes. In (9: 34) it is associated with hoarding and (4 : 29) seems to put it at par with murder.

Considering the serious dimensions of fasad and akl bil-batil to which riba has been related, the message seems to be: charging interest belongs to a mind-set that leads to disruption of civil society.

As rightly pointed out, 'interest on money is regarded as representing an unjustified creation of instantaneous property rights: unjustified, because interest is a property right claimed outside the legitimate framework of recognized property rights; instantaneous, because as soon as the contract for lending upon interest is concluded, a right to the borrower's property is created for the lender'. (Khan and Mirakhor, 1987, p. 4).

The third reason is implied in the declaration that riba is subject to destruction [mahq] (2: 276) which means decrease after decrease, a continuous process of diminishing. That sounds a little odd as it runs counter to the commonly observed fact of people growing rich by doing the business of lending on interest. Once we leave out the improbable interpretation of individual wealth amassed through riba business being subject to continuous

decrease, we have to turn to the social wealth. Riba, even when it is increasing in numerical terms, fails to spur growth in social wealth. That role is played by charitable giving mentioned in the next half of verse 2: 276. Charitable giving transfers purchasing power to the poor and the needy who spend it. The destination of interest is not that certain.

One needs being reminded that the concept of *mahq* or the implied decrease in social wealth may not necessarily refer to national income in dollars. It could very well be referring to some real measure of human felicity. And that takes us to the next reason.

The fourth reason behind prohibition of *riba* is inferred from verse 2:275 quoted above. This verse draws a picture of ‘those who devour usury’ as well as states the reason why they got into that pitiable mould. That reason is their being trapped into a false economics that equates trade—the act of selling and buying - with the practice of charging interest. (However, it would not be far-fetched to surmise that this ‘trap’ was invented for the simple folk as we note below). We intend to discuss the rejection of this economics below at some length. At this stage we would like to draw attention towards the interesting phenomenon of how having your economics wrong can doom you!

We would also like to note that some scholars think the picture painted of the one who takes *riba* belongs to the Day of Judgment, in the hereafter, not in this world. But that still leaves the main question unanswered: what is so wrong about taking interest to deserve that fate? The answer to that question has to be in line with the cause given in the later part of the verse itself: ‘That is because

they say: Trade is just like usury’. It is obvious that the cause lies in the behavior arising from the mindset revealed by that saying, not in the mere act of saying. If that is so, the behavior should show its effect in this world too. It is, therefore, better not to confine the picture to the hereafter. Let it cover both the personality of the *riba*-eater in this life on earth as well as his/her condition on rising from the grave in afterlife to face the Day of Judgment. (Al-Misri, 1991, pp. 42-43).

Regarding the impact of taking interest on personality, the question arises: How can this apply to millions of small savers who receive interest on saving accounts? As we shall see later, a plausible answer lies in the generally rising level of anxiety in modern interest based societies. The fact of the matter is that in the complex modern economy the relationship between the one who pays interest and the one who receives interest is not direct and visible as in the primitive agricultural societies or merchant communities of the old. It is mediated by numerous agencies and institutions, which fact makes it entirely impersonal. Also, it is invisible. It appears as credit or debit entries in one’s bank account. The same person may be receiving interest as well as paying interest in the same period of time. There is no way of understanding the impact of this practice of charging interest on loans taken or of interest paid on loans obtained other than analyzing the system as a whole. It is only with reference to modern interest based system of banking, finance and monetary management as a whole that the effects of *riba* on human personality mentioned in verse 2: 275 or that on society mentioned in verse 30: 39 can be understood.

The last, but not the least important, reason of prohibiting *riba* is its being unjust, as the verse 2: 279 implies. It clearly states that taking an amount in excess of the principal would be unfair, unjust. It also recognizes the right of the lender/creditor to the principal without any decrease as that too would be unfair, unjust. The Quran does not argue further as to why it is unfair to take an excess in case of loan. Presumably it relies on the notions of equality and reciprocity inherent in the concept of justice as indicated in the first chapter above. The unacceptability of injustice and unfairness was never in dispute between the Quran and its audience. It continues to be so in the modern times. What is not acceptable to many is the Quran’s stand that taking any thing in excess of the principal amounts to injustice. To resolve this dispute we have to turn back to the difference between trade and

interest-based transactions. That was the bone of contention between Makkan traders opposing the Islamic injunction and the Prophet, as reported in verse 2: 275.

3. The Institutional Environment

The institutional environment forms the framework in which human action takes place. 'Institutions reduce uncertainty by providing a structure to everyday life', writes North (1990, p. 3). 'In the jargon of the economist, institutions define and limit the set of choices of individuals. Institutional constraints include both what individuals are prohibited from doing and, sometimes, under what conditions some individuals are permitted to undertake certain activities. ... They are perfectly analogous to the rules of the game in a competitive team sport' (North, 1990, pp. 3-4). Unlike the rules in team sports, however, these guidelines often arise 'spontaneously', as by-products of individual choices, rather than deliberately through collective action.

(a) The Legal Environment and Legal Right

Law plays an important role in developing the finance field.⁶ However, the role of Islamic law seems to be left out in the current mainstream discussion in finance. Therefore, the aim of this section is to discuss the basic idea on the differences of law origin, and financial contracts in Islam that may affect the setting-up of financial institutions.

Origin of Islamic Law

The Muslim scholars have unanimously agreed that, when examining any new subject or incident that has no rule or legal value, the provisions of the primary bases of Islamic Law must be referred to. These are the Quran and the *Sunnah* that includes the Prophet Muhammad's (peace be upon him) words, deeds and tacit approvals. In a case where there is no equivalent rule provided by these two non-arguable sources, usually Islamic scholars will subsequently resort to the secondary or dependent sources of law, the *Ijma'* (general public consensus), the *Qiyas* (reasoning by analogy), the *Maslahah mursalah* or *Istislah* (reasoning by public interest), the *Istihsan* (preference), the *'Urf* (customs or common practice) and *Sadd al-dhara'i* (blocking the means).⁷ Thus, when a jurist wants to know the status or legal rule of certain issue or problem, he must refer to the primary sources first, according to the order of the sources. Unless he could not find the legal rule or the right solution to the issue concerned, he may then refer to the secondary sources, whichever relevant.

Financial Contracts

A contract (*'aqd*) is referred to an obligation which arises from a bilateral relationship between two parties. In this context, contract is defined as "the conjunction of an offer emanating from one of the two contracting parties with the acceptance of the other in the manner that affects the subject matter of the contract".⁸ Therefore, a contract is the result of a

⁶ See, La Porta et al. (1998) Levine et al. (2000) and Beck and Levine (2002)

⁷ There are a few other secondary sources that scholars rarely resort to, they are, *Shar' man qablana* (the divine rules of other Prophets) and *Madhhab al-sahabi* (words and deeds of the companions of the Prophet).

⁸ Refer to the Mejjelle (Art. 103), translated by Tyser, C.R., D.G. Demetriades and Ismail Haqqi Effendi. Kuala Lumpur: The Other Press

mutual agreement between the parties irrespective of who initiated the offer and who accepted it.

In addition, for a valid contract to take place in *Shari'a*, certain conditions are to be met. The majority scholars hold that there are three elements of a valid contract namely the form (*sighah*) which comprises of offer (*ijab*) and acceptance (*qabul*); the contracting parties (*al-'aqidayn*) and the subject matter (*al-ma'qud 'alayh*) i.e. the commodities and the considerations (example: deposits).

The Muslim scholars consider that a contract is completely concluded if there is concurrence of offer and acceptance representing the wish of the parties to enter into a contract. Since a contract is a bilateral agreement, thus there must be more than one party who are negotiating for the contract, and they must be qualified persons possessing the legal capacity (*ahliyyah*). In addition to that, the subject matter of the contract must be defined properly that leave no ambiguity to the contracting parties as to the nature of the subject matter. Another important requirement to form a contract is the purpose of the contract. As such, the contract must be for good and beneficial purpose according to the *Shari'a*. Consequently, the subject matter of the contract must also be legally acceptable in the eyes of *Shari'a*.

There are two general financial instruments that could be applied in finance, i.e., investment and means of payment. *Investment* in the form of *mudharaba* is considered as a special form of partnership (*Musharakah*) that has been deployed by modern Islamic financial institutions to provide fund management services. In line with the Islamic principles of risk-sharing and profit-sharing, it is characterized by one party (*rabb al-mal*) entrusting his money to another party (*mudharib*) who is akin to a fund manager and who contributes to the arrangement by providing the necessary experience and management expertise. The *mudharib* will utilize the money in an agreed manner, and will subsequently return the principal and a share of the profit to the *rabb al-mal*, retaining a pre-agreed share of the profit for him.

Some papers observe that the *mudharaba* contract, along with *musharaka* contract which reflects profit-loss sharing characteristic, has a very strong merit in the sense that it relies on the spirit of cooperation. Presley, and Sessions, (1994) have shown that the use of the prevalent alternative method of financier remuneration (i.e. *mudharaba*) will, under certain conditions, lead to an enhanced level of capital investment on account of the ability of *mudharaba* to act as an efficient revelation device. By applying the ideas developed in the Western contract literature by Holmstrom and Weiss (1985) and Meyer (1986) they show that a *mudharaba* contract between a project manager and a syndicate of investors may permit a more efficient revelation of any informational advantage the manager may have over the latter. Nienhaus (1988) emphasizes that theoretically, Islamic banks, through PLS financing, should provide capital to dynamic entrepreneurs who have good projects but cannot offer collateral, and so create new business and thus contribute to the community's economic development.

The important principles to note are: the division of profits must be on a pre-agreed proportional basis; if a loss occurs then the *rabb al-mal* will not usually face liability beyond the loss of principal; and the *mudharib's* liability will generally be confined to the loss of his time and effort only.

Mudharaba may be entered into for a single investment or on a continuing basis with the Islamic banks acting as a fiduciary. *Mudharaba* investments may be made for fixed terms and arranged through negotiable instruments (called investment deposit certificates or *Mudharaba* certificates) and in such situations may have characteristics akin to shares.

The uses of financial instruments as *mean of payment* can be seen from the following definition. For example, Islamic banks act as agent (or *wakeel*) and hence receive fee

payment. The common meaning of the word "payment" is "the action, or an act, of paying; the remuneration of a person with money or its equivalent; the giving of money, etc. The word is also defined as "a sum of money (or other thing) paid; pay, wages; or price". The verb "to pay," from which the noun "payment" is derived, is variously defined as "to give what is due, as for goods received; remunerate; recompense; to give or return as for goods, or services; to give or offer." However, "to pay" have also been construed as meaning "to give money or other equivalent value for; to hand over the price of a (thing); to bear the cost of; to be sufficient to buy or defray the cost of". Thus, although the word payment often connoted an exchange of value for the provision of goods or services, or the provision of value on the occasion of a particular event or condition, it could also encompass bearing the cost. This latter meaning is perhaps the most consistent with the word's use in the context of a provision defining non-performing financings.

Legal Right and Protection under Islamic Finance

From the study done by Tohirin and Ismail (2010) shows that laws varies across countries, in part because of differences in legal origin. Hence, how does Islamic law provide legal right to the contracting parties? Or, in specific, does Islamic law provides both *mudharib* and *rabbul-maal* protection? Do the countries (that adopt Islamic law) have other substitute, mechanism of corporate governance? Because, the differences in legal protections of contracting parties might help explain why firms are financed and owned so differently in different countries. Why do firms practically have no excess to external finance? Why is the ownership of firms so widely dispersed (by contract)? The content of legal rules in different countries may shed light on these corporate governance puzzles.

The effect of contract can be seen in the rights, obligations and legal effects. These effects are not one and the same in all contracts, but they vary from one to another. For example, the effects of the contract of sale are the transfer of proprietary rights in things, obligation of the seller to deliver goods and establishment of his right to demand the price. The effects of rent are the transfer of proprietary rights in usufruct to the tenant. Thus, we find that these effects differ from one contract to another.

It can be said in general that the following effects accrue from the contracts. *First*, the owner has the obligations to perform the transfer of proprietary rights in things or usufruct, commutative or non-commutative, such as sale, gift, rent, and borrowing.

Second, obligation of performing a specified work regardless whether this work is the delivery of fungible property which is a debt which a person owes to another, such as contract of loan, or it is some other work, such as the work of a hiring or agent.

Third, arising the right of security as, for example, in pledge, surety and bail, and transfer of debt.

The general rule is that the above effects accrue only from the contract which fulfils the conditions of its constitution and validity, and with which no attribute which requires the Lawgiver's prohibition against it is associated. But some jurists maintain that some of these effects sometimes accrue from a void contract, and it is one with which an attribute required by the Lawgiver's prohibition is associated.

The general principle is that these effects arise and accrue from a contract after its existence. But there are some contracts whose effects keep away from them till permission is attached to them: According to the Muslim jurists, they are called the suspended contracts or contracts in abeyance.

When these effects accrue from the contract, the general rule is that they are binding on both contracting parties. Neither of them can dissociate itself from it. But there are some contracts whose effect accrues from it when both parties grant the unilateral right of

cancellation, or one of them does so without the consent of the other party. These are called permissible contracts, or contracts that are not binding.

These effects accrue from the contract by making and taking it into consideration by the Lawgiver and the intention of the contracting parties has nothing to do with it. A contract, in the opinion of the Muslim jurists, is a cause of accrual of effects from it. The general rule is that accrual of effects from causes is on account of making, and act of the lawgiver; the intention of the contracting parties has nothing to do with that.

Accordingly, the jurists maintain that every condition which is attached to the contract and deviates from its effects is invalid. They call this condition repugnant or contrary to the essence or nature of the contract. But the conditions that are consistent with the essence or nature of the contract and confirm the effects which accrue from it are permitted according to all jurists, because they strengthen these effects and confirm their execution such as the stipulation of pledge and surety.

There is another set of conditions about which disagreement arose. These are the conditions which neither agree nor disagree with the essence or nature of contract, and set restrictions on the freedom of the contracting parties, regardless whether or not they comprise the benefits of the stipulating party.

The established rule in the *Shari'a* is the obligation of fulfilment of contracts and conditions which do not make an unlawful thing lawful and a lawful thing unlawful. Allah, the Exalted, said: "O you, who believe, fulfil the obligations". (5:1) The Prophet (peace be upon him) said: "The believers are bound by their conditions, except a condition which makes an unlawful thing lawful and a lawful thing unlawful". This shows that the contract is the law of the contracting parties as maintained by modern law.

The application of this rule requires that the contracting parties are bound to execute the obligations that accrue from the contract without having the right of modifying it or dissociating from it, except in cases about which specific texts of the *Shari'a* have occurred. If one of the contracting parties does not execute the obligations which the contract imposes on him of his own accord, the other party can compel him to execute them judicially, as the Lawgiver grants this contracting party the right of abstaining from executing the equivalent or opposite obligation or to demand the annulment of the whole contract.

The general rule in Islamic law is, as is the case of positive law that these contracts are not binding on any other than their contracting parties and no one other than the parties can benefit from them. The fulfilment of obligations that result from the contract is not binding on any person other than the parties to it, as no one except them can benefit from the rights established by the contract.

We shall see that there are some cases, in each of the Islamic law and positive law, in which the effects of the contract are traceable to the persons other than the contracting parties. These contracts are called general or particular discrepancy in positive law. These cases are considered to be an exception to the general rule of relativity of contracts with respect to persons.

As for *mudharaba* contract, the contracting parties are the capital provider (*shahib-al-maal*) and the entrepreneur (*mudharib*). The principal obligation of the capital provider is to provide the capital needed by the entrepreneur, whereas the obligation of entrepreneur mainly to manage the capital in his/her business venture/project in a responsible and trustworthily manner so that the business he/she managed capable of creating value added (profit) that will be shared according to the pre-agreed ratio. The capital provider right mainly is to get the profit share or to born the financial loss without having any control in the management of the business/project. Based on this nature *mudharaba* financing usually be called as trusty financing.

In current development of Islamic banking practices, *mudharaba* contract is widely applied in both sides of intermediary function of Islamic banks, i.e. funding and financing sides. In funding side, *mudharaba* deposits, either in saving account or mainly in investment/time deposit account are the major component of bank's deposits. Even though this is quite similar with those in conventional banking system, profit-sharing nature of Islamic bank's deposit has important advantage to the financial system compared to their conventional counterpart. At this juncture we can compare the depositors and the shareholders in the Islamic banking system. Both are similar in providing financial capital to the banks, even much higher proportion for depositors, but the rights of both capital-givers are quite different. Table 1 below exhibits a comparison between depositors and shareholders in Islamic banking.

Table 1: Depositors and Shareholders Comparison in the Islamic Banking System

	Depositors	Shareholders
Contracts	<i>Mudharaba</i>	<i>Musharaka</i>
Contribution	Financial capital as investment deposits	Financial capital as shared capital
Rights: Rewards	Return on Deposits based on Pre-agreed Profit Share	Dividends
Voting	No Voting Right	Voting Rights
Control	No specific control right	Control rights via Shareholders General Meeting
Obligation	No obligation bounded	Oblige to add capital if deem necessary
Risk	Exposed to all business risk	Exposed to all business risk
Protection	Under Deposits Insurance Scheme only. <u>Need to have a kind of specific protection by providing access to the management</u>	Shareholder protection under the prevailing laws

The existence of *mudharaba* deposits, along with *mudharaba* and *musharaka* financings, under Islamic banking system exposes very different character from that in interest-based deposits. This difference actually has important implication into the financial system, in the sense that it drives the system to be more stable due to a balance between asset and liability sides of the system. In addition, *mudharaba* deposits in fact may be treated as

“equity capital” similar to shareholders funds. Based on these reasoning, it is therefore important to consider specific institutional protection mechanism for *mudharaba* depositors, especially if the system allows Islamic banks to co-exist side by side with conventional banks.

As for *mudharaba* financing from the banks’ viewpoint it is also important to provide specific enforceable regulation mechanism as a truth revealing devices for the financed parties to avoid any miss-reporting of their business ventures. In this regard Gonzales de-Lara (2001) recorded the experience of the Late Medieval Venice that the existence of state enforcer of contract had been effectively used for risk-sharing contract by Venetian merchants. It had driven the shift of contractual agreement from the *sea-loan* contracts (which is debt-based) to the *commenda* contracts (which is profit-loss-sharing based). Applying this spirit into current practices of Islamic banking and finance might drive the implementation of profit-loss sharing financing more significantly.

(b) Evolution in Islamic Finance and Wealth Creation

Attention to the institutional environment has become increasingly common in economic history and it has deeply enriched our understanding of how Islamic financial institutions develop through time. The development is important in creating wealth.

The maqasid shari’ah is aimed to make the distribution of economic resources, wealth and income fair and equitable. Islam discourages concentration of wealth in few hands and ensures its circulation among all the sections of society. It means that the wealth should not be allowed to concentrate in few rich hands; rather it should freely circulate among all the people thus enabling the poor and destitute among the nation to also take benefit from it.⁹ Thus it is the utmost important that the Islamic banking system could bridge the gap between the rich and the poor by modifying the distribution of wealth and economic resources in favor of the less-fortunate.

In this section, the above issues are important to be addressed due to three reasons. First, it will address the wealth creation in Islamic banking system. Second, Islamic economic system ensures fair and equitable distribution of wealth through positive as well as negative measures.¹⁰ Third, by abolishing interest rate, does it mean that Islamic banks are able to distribute the income more equitable?

Therefore, in this section, we will examine the wealth created by Islamic banks. How the money invested by customer (depositors), or money invested by banks or money (as capital) utilized by customers (or economic agents like individual, firm and government) can generate profit and then can be distributed to Islamic banks and depositors and hence would be able to preserve the wealth (mal) of economic agents.

As shown in Table 2, Islamic bank A could meet their primary financial objectives of strong value-added growth. This increased from RM17.6 billion in 2007 to RM20.2 billion in 2008. As a result, the distribution of wealth to employees, government and shareholders increased from RM7.6 billion, RM2.8 billion, and RM1.9 billion in 2007 to RM8.5 billion, RM2.9 billion and RM2.3 billion in 2008, respectively. At the same time, the retained earnings also increased from RM5.5 billion in 2007 to RM6.5 billion in 2008. The figures above show a significant contribution by Islamic bank A to the economy during the period of

⁹ Refer to surah Al-Hashr 59:7, Allah says: “That which Allah give that as spoil unto His messenger from the people of the townships, it is for Allah and His messenger and for the near of kin and the orphans and the needy and the way farer, that it become not a commodity between the rich among you.”

¹⁰ Both measures are introduced via the preservation of mal such Zakat and Sadaqat, laws of inheritance and will; and the identification of things that threaten mal such as payment of interest, prohibition of earning of wealth by Haram (unlawful) means, and prohibition of hoarding

2004-2008. On the average, as shown in Diagram 1, the employees, government, shareholders (all are economic agents) and retentions received about 44.2%, 15.2%, 10.2% and 30.4%, respectively of the total wealth.

Table 2: Financial Summary of Islamic Banks

	2008 RM'000	%	2007 RM'000	%	
Value added					
Profit, commissions and other revenues	51 391		50 368		
Profit paid to depositors and cost of other services	31 191		32 704		
Wealth created	20 200		17 664		
Distribution of wealth					
Employees					
Salaries and other benefits	8 499	42	7 581	43	
Governments	2 914	15	2 770	16	
Shareholders	2 277	11	1 857	10	
Dividends paid to shareholders	2 150		1 753		
Earnings attributable to outside and preference shareholders	127		104		
Retentions to support future business growth	6 510	32	5 456	31	
Retained surplus	5 591		4 625		
Depreciation and amortization	919		831		
Wealth distributed	20 200	100	17 664	100	
Wealth distribution over five years (%)					
	2008	2007	2006	2005	2004
Employees	42	43	46	44	46
Government	15	16	16	15	14
Shareholders	11	10	10	10	10
Retentions	32	31	28	31	30

4. The Institutional Arrangements and the Theory of Islamic Financial Institutions

These rules and customs that make up the institutional environment are primarily economy-side phenomena. Another aspect of the new institutional economics focuses on agreements made by specific individuals to govern their own relationships. Such institutional arrangements - what Williamson (1996b, p. 5) calls the institutions of governance - include contracts and organizations and in particular, the business firm. The study of governance is more dull than the study of the institutional environment. 'Questions of whether to make or buy a component to be used in the manufacture of an automobile or whether to expand the hospital into outpatient and home health services are ones that arise at the level of governance. By contrast, composite economic growth and income distribution are more apt to be the objects of interest in an inquiry into the institutional environment' (Williamson, 1996b, p. 5). However, the study of governance - in particular, the theory of the firm - is arguably more developed than the study of the institutional environment. Therefore, in this section, the institutional arrangements will be linked with the theory of Islamic financial institutions.

The early contributions on the theory of Islamic banking were only discussed as part of the subject in Islamic economic system. For example, the book by Qureshi on *Islam and the Theory of Interest* (Qureshi (1946)) which looked upon banking as a social service that should be sponsored by the government like other public institutions such as public health and education.¹¹ His view was based on the point that the bank could neither pay any interest to account holders nor charge any interest on loans advanced. He also suggests the possibility for both Islamic banks and entrepreneur to create a partnership. No mention was made of profit-sharing.

Then, Ahmad (1952), in Chapter VII of his book *Economics of Islam*, proposes the establishment of Islamic banks on the basis of a joint stock company with limited liability. In his proposition, in addition to current accounts, on which no dividend or interest should be paid, there was an account in which people could deposit their capital on the basis of partnership, with shareholders receiving higher dividends than the account holders from the profits made. Like Qureshi (1946), Ahmad (1952) also suggests of possible partnership arrangements with the entrepreneur who seek capital from the Islamic banks. However, the partnership principle was left undefined, nor was it clear who would bear the loss if any. It was also suggested that Islamic banks should cash bills of trade without charging interest, using the current account funds. From here, Islam banks only charge fee to entrepreneur.

Later, the principle of *mudarabah* was appealed systematically by Uzair (1955). His main contribution lay in suggesting *mudarabah* as the main premise for 'interestless banking'. However, his argument that the Islamic bank should not make any capital investment with its own deposits rendered his analysis somewhat impractical.

Al-Arabi (1966) also suggested a banking system with *mudarabah* as the main pivot. However, he advanced further the idea of a two-tier *mudarabah* which would enable the Islamic bank to mobilize savings on a *mudarabah* basis, allocating the funds also on a *mudarabah* basis. In other words the Islamic bank would act as a *mudarib* in so far as the depositors were concerned, while the 'borrowers' would act as *mudaribs* in so far as the Islamic bank was concerned. In his suggestion, the Islamic bank could provide not only the capital procured through deposits but also the capital of its own shareholders. He also took note that his view with regard to the distribution of profits and the responsibility for losses was strictly in accordance with the *Shariah*.

Irshad (1964) also spoke of *mudarabah* as the basis of Islamic banking, but his concept of *mudarabah* was quite different from the traditional one in that he thought of capital and labour (including entrepreneurship) as having equal shares in output, thus sharing

¹¹Although earlier than Qureshi (1946), there are other publications in Arabic and Urdu which have made significant contributions to the theoretical discussion. A brief description of these in English can be found in the appendix to Siddiqi's book on *Banking without Interest* (Siddiqi 1983a).

the losses and profits equally. This actually means that the owner of capital and the entrepreneur have a fifty-fifty share in the profit or loss as the case may be, which runs against the *Shariah* rulings. Irshad (1964) further suggested two kinds of deposit accounts. The first sounded like current deposits in the sense that it would be payable on demand, but the money kept in this deposit would be used for social welfare projects, as the depositors would get zero return. The second one amounted to term deposits which would entitle the depositors to a share in the profits at the end of the year proportionately to the size and duration of the deposits. He recommended the setting up of a Reserve Fund which would absorb all losses so that no depositor would have to bear any loss. According to Irshad (1964), all losses would be either recovered from the Reserve Fund or borne by the shareholders of the bank.

A pioneering attempt at providing a fairly detailed outline of Islamic banking was made in Urdu by Siddiqi in 1968. (The English version was not published until 1983.) His Islamic banking model was based on *mudarabah* and *shirkah* (partnership or *musharakah* as it is now usually called). His model was essentially one based on a two-tier *mudarabah* financier-entrepreneur relationship, but he took lengthy explanation to describe the mechanics of such transactions in considerable detail with numerous hypothetical and arithmetic examples. He classified the operations of an Islamic bank into three categories: services based on fees, commissions or other fixed charges; financing on the basis of *mudarabah* and partnership; and services provided free of charge. His thesis was that such interest-free banks could be a viable alternative to interest-based conventional banks.

The issue of loans for consumption clearly presents a problem, as there is no profit to be shared. Siddiqi addressed this problem, but he managed only to scratch the surface. While recognizing the need for such interest-free loans (*qard hasan*), especially for meeting basic needs, he seemed to think it was the duty of the community and the State (through its *baitul mal* or treasury) to cater to those needs; the Islamic bank's primary objective, like that of any other business unit, is to earn profit. He therefore tended to downplay the role of Islamic banks in providing consumption loans, but he suggested limited overdraft facilities without interest. He even considered a portion of the fund being set aside for consumption loans, repayment being guaranteed by the State. He also suggested that consumers buying durables on credit would issue 'certificates of sale' which could be ended by the seller at the bank for a fee. It was then the seller not the buyer who would be liable as far as the bank was concerned. However, the principles of *murabaha* and *bai' muajjal* were not invoked. It seems that his suggestion is far from reality.

Strangely, Siddiqi favoured keeping the number of shareholders to the minimum, without advancing any strong reasons. This is contrary to the general consensus which now seems to have emerged with reference to Islamic banks operating on a joint stock company basis, a consensus which incidentally is also in line with the Islamic value attached to a broad equity base as against heavy concentration of equity and wealth. Ironically, Siddiqi (1983b) thought that interest-free banking could operate successfully 'only in a country where interest is legally prohibited and any transaction based upon interest is declared a punishable offence'. He also thought it important to have Islamic laws enforced before interest-free banking could operate well. This view has not gained acceptance, as demonstrated by the many Islamic banks which operate profitably in 'hostile' environments, as noted earlier.

Chapra's model of Islamic banking (Chapra 1982), like Siddiqi's, was based on the *mudarabah* principle. His main concern, however, centred on the role of artificial purchasing power through credit creation. He even suggested that 'seigniorage' resulting from it should be transferred to the public exchequer, for the sake of equity and justice. Al-Jarhi (1983) went so far as to favour the imposition of a 100 per cent reserve requirement on commercial banks. Chapra was also much concerned about the concentration of economic power private banks

might enjoy in a system based on equity financing. He therefore preferred medium sized banks which are neither so large as to wield excessive power nor so small as to be uneconomical. Chapra's scheme also contained proposals for loss-compensating reserves and loss-absorbing insurance facilities. He also spoke of non-bank financial institutions, which specialize in bringing financiers and entrepreneurs together and act as investment trusts.

Mohsin (1982) has presented a detailed and elaborate framework of Islamic banking in a modern setting. His model incorporates the characteristics of commercial, merchant, and development banks, blending them in novel fashion. It adds various non-banking services such as trust business, factoring, real estate, and consultancy, as though interest-free banks could not survive by banking business alone. Many of the activities listed certainly go beyond the realm of commercial banking and are of so sophisticated and specialized a nature that they may be thought irrelevant to most Muslim countries at their present stage of development. Mohsin's model clearly was designed to fit into a capitalist environment; indeed he explicitly stated that *riba*-free banks could coexist with interest-based banks.

The point that there is more to Islamic banking than mere abolition of interest was driven home strongly by Chapra (1985). He envisaged Islamic banks whose nature, outlook and operations could be distinctly different from those of conventional banks. Besides the outlawing of *riba*, he considered it essential that Islamic banks should, since they handle public funds, serve the public interest rather than individual or group interests. In other words, they should play a social-welfare-oriented rather than a profit-maximizing role. He conceived of Islamic banks as a crossbreed of commercial and merchant banks, investment trusts and investment-management institutions that would offer a wide spectrum of services to their customers. Unlike conventional banks which depend heavily on the 'crutches of collateral and of non-participation in risk' (p. 155), Islamic banks would have to rely heavily on project evaluation, especially for equity-oriented financing. Thanks to the profit-and-loss sharing nature of the operations, bank-customer relations would be much closer and more cordial than is possible under conventional banking. Finally, the problems of liquidity shortage or surplus would have to be handled differently in Islamic banking, since the ban on interest rules out resort to the money market and the central bank. Chapra suggested alternatives such as reciprocal accommodation among banks without interest payments and creation of a common fund at the central bank into which surpluses would flow and from which shortages could be met without any interest charges.

From the above discussion, Islamic banking has three distinguishing features: (a) it is interest-free, (b) it is multi-purpose and not purely commercial, and (c) it is strongly equity-oriented. The literature contains hardly any serious criticism of the interest-free character of the operation, since this is taken for granted, although concerns have been expressed about the lack of adequate interest-free instruments. There is a near-consensus that Islamic banks can function well without interest. A study by Iqbal and Mirakhor (1987) has found Islamic banking to be a viable proposition that can result in efficient resource allocation. The study suggests that banks in an Islamic system face fewer solvency and liquidity risks than their conventional counterparts.

The multi-purpose and extra-commercial nature of the Islamic banking operation does not seem to pose intractable problems. The abolition of interest makes it imperative for Islamic banks to look for other instruments, which renders operations outside the periphery of commercial banking unavoidable. Such operations may yield economies of scope. But it is undeniable that the multipurpose character of Islamic banking poses serious practical problems, especially in relation to the skills needed to handle such diverse and complex transactions (Iqbal and Mirakhor 1987).

The stress on equity-oriented transactions in Islamic banking, especially the *mudaraba* mode, has been criticized. It has been argued that the replacement of

predetermined interest by uncertain profits is not enough to render a transaction Islamic, since profit can be just as exploitative as interest is, if it is 'excessive' (Naqvi 1981). Naqvi has also pointed out that there is nothing sacrosanct about the institution of *mudaraba* in Islam. Naqvi maintains that *mudaraba* is not based on the Qur'an or the Hadith but was a custom of the pre-Islamic Arabs. Historically, *mudaraba*, he contends, enabled the aged, women, and children with capital to engage in trade through merchants for a share in the profit, all losses being borne by the owners of capital, and therefore it cannot claim any sanctity. The fact remains that the Prophet raised no objection to *mudaraba*, so that it was at least not considered un-Islamic.

The distribution of profit in *mudaraba* transactions presents practical difficulties, especially where there are multiple providers of capital, but these difficulties are not regarded as insurmountable. The Report of Pakistan's Council of Islamic Ideology (CII 1983) has suggested that the respective capital contributions of parties can be converted to a common denominator by multiplying the amounts provided with the number of days during which each component, such as the firm's own equity capital, its current cash surplus and suppliers' credit was actually deployed in the business, i.e., on a daily product basis. As for deposits, profits (net of administrative expenses, taxes, and appropriation for reserves) would be divided between the shareholders of the bank and the holders of deposits, again on a daily product basis.

However, lately, several authors among others Abdus Samad et. al (2005) raised the agency problem in *mudarabah* and *musharakah* contracts. When a business is run by professional managers, as opposed to the owner or supplier of capital (shareholder), a conflict of interest may arise. A manager is the business owner's agent. As the utility increases, managers will seek to maximize their own utility instead of maximizing the wealth or utility of the shareholders or the business owners. They have an incentive to increase their own salaries, fringe benefits, and other perks, all of which represent a conflict of interest that may lead them to place personal interest ahead of such corporate goals as maximizing the shareholders' profit margin. This conflict is the most common problem in all businesses or corporations managed by agents rather than the shareholders or debtholders.

Given its prevalence, it is important to see how it applies to *mudarabah* and *musharakah*. In *musharakah* mode of financing, a joint venture profit-sharing business of two or more parties in which the Islamic bank is an important partner or shareholder. Under *musharakah*, the bank relies on the other partner(s) to manage the business and make the day-to-day decisions. Even though the bank could monitor the management of the business by hiring external auditors and consultants, such measures would incur additional costs. Therefore, the bank must rely on professional managers or other partners to manage the businesses, even though these managers may have an incentive to maximize their own utility at the business owner's expense.

Under *mudarabah/musharakah* financing, the Islamic bank does not participate directly in management decisions. Rather, it relies completely on the business venture's trustee or entrepreneur. This trustee is clearly an agent of the Islamic bank and, therefore, is inherently subject to the agency conflict of interest. Thus, under both *musharakah* and *mudarabah*, the Islamic bank experiences the agency problem with its associated costs.

The agency problem becomes more acute when banks have little access to dependable accounting information, due to a lack of standardized financial reporting requirements and procedures. The difficulties presented by this agency problem, together with the lack of verifiable financial data, complicate the profit-sharing characteristics of these forms of Islamic financing and actually encourage debt financing (e.g., *murabahah* and *ijarah*) over equity financing (e.g., *musharakah* and *mudarabah*).

To some extent, the agency problem in *musharakah* and *mudarabah* can be reduced by carefully specifying the sharing of profit and performance bonuses between the entrepreneur and the bank. Also, in the case of *musharakah*, the bank participates in the election of the company's board and officers, a factor that should further reduce the agency problem.

5. Conclusion

The discussion in this paper provides a brief (and admittedly unbalanced) sketch of the new institutional economics which is relevant to Islamic finance. The literature in NIE is expanding rapidly and gaining increasing adherents and influence in Islamic finance. Our findings show that it is a highly diverse field and its many branches are rich in theoretical insight, relevant for policy and empirically useful.

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