Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism

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Ever since the first wave of European armies reached the Mediterranean shores of the last Islamic empire in the late eighteenth century, Western influence has dominated many important aspects of Muslim life, most notably in the areas of trade and finance. Traditional Islamic contracts and financial instruments that once prevailed in Muslim commercial markets have been replaced by Western financial instruments and institutions. The wholesale adoption of the French civil code (or the Napoleonic Code) by most Middle Eastern countries is unambiguous evidence of the magnitude of such European influence. By the beginning of the twentieth century, many pro-independence political movements began to form strong resistance to Western influence and colonial insensitivity to Islamic culture and social values. Some movements, such as the Egyptian Muslim Brothers Movement (Harakat al-Ikhwan al-Muslimin), joined their demands for political independence with demands for adopting homegrown and Islamic-inspired social and economic reforms. One of these demands called for the abolishment of the Western banking system on the ground that it violated Islamic principles, most notably the prohibition of usury. The allegations that Western banking involved usurious practices stimulated important discussions and debates among Muslim jurists and economists over the legitimacy of Western financial institutions and the viability of Islamic financial alternatives. These discussions and debates constitute the underlying theoretical foundation for contemporary Islamic finance practices.

Two main approaches to such discussions can be distinguished. While some writers focused on highlighting the social and economic benefits of an

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* Walid S. Hegazy is a Foreign Counsel in the Houston office of the International Law Firm of Fulbright & Jaworski LLP and an Adjunct Professor at the University of Houston Law Center, where he teaches Islamic law.

1 Napoleon Bonaparte's 1798 Egyptian campaign marks the beginning of a long history of European influence in the Muslim world.
Islamic system ("socio-economic approach"), others adopted a more pragmatic approach aimed at finding the optimal structure of Islamic financial institutions ("IFIs") that could efficiently function as lawful or permissible (halal) platforms for offering conventional banking and financial services ("legalistic approach").

The socio-economic approach was inspired by the writings of the Islamic thinker Abu al-A'la al-Mawdudi\(^2\) and the Egyptian Islamists and leaders of the influential Muslim Brothers Movement, Hassan al-Banna and Sayyid Qutb. The work of these three Islamic activists focused on the overall reform of Muslim societies, covering the political, social, and economic aspects of life.\(^3\) More recently, Muslim economists, such as the Egyptian economists Ahmad al-Najjar,\(^4\) Khurshid Ahmad,\(^5\) and Muhammad Umar Chapra,\(^6\) have reiterated the Islamic economic reform ideas and, in some cases, attempted to implement them.

The legalistic approach, on the other hand, benefited significantly from the influential writings of the renowned Iraqi and Shiite scholar Muhammad Baqir as-Sadr\(^7\) and the Islamic finance scholar and banker Sami Homoud. These two academic approaches define the practice of contemporary Islamic finance. Although most of today’s IFIs fall under the legalistic approach, the Mit Ghamr Local Savings Bank, founded by Ahmad al-Najjar and considered by many to be

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\(^2\) For a comprehensive overview of the life of Mawdudi, see *JI: The Founder*, available online at <http://www.jamaat.org/overview/founder.html> (visited Jan 15, 2007).


\(^4\) Najjar is generally regarded as one of the pioneers of Islamic finance. Among the many positions he held during his career is the Secretary General of the International Union of Islamic Banks. Toward the end of his life, Najjar became critical of the practice of Islamic banks, declaring his skepticism about the future of Islamic finance if Islamic banks continue to ignore their socio-economic role in the society. See Ahmad Muhammad ‘Abd al-‘Aziz al-Najjar, *Harakat al-Bunuk al-Islamiyah: Haqa’iq al-Asl wa-Awham al-Surah* (Sharikat Sprint 1993).

\(^5\) Professor Khurshid Ahmad is the founder and chairman of the Institute of Policy Studies, Islamabad (Pakistan) and the Islamic Foundation, Leicester (UK). He is the editor of *Studies in Islamic Economics* (Islamic Found 1980).

\(^6\) Chapra is an Advisor at the Islamic Research & Training Institute ("IRIT") of the Islamic Development Bank ("IDB") and a former Senior Economic Advisor at the Saudi Arabian Monetary Agency ("SAMA"). Chapra’s publications include: *Objectives of the Islamic Economic Order* (Islamic Council of Europe 1975); *Towards a Just Monetary System: A Discussion of Money, Banking and Monetary Policy in the Light of Islamic Teachings* (Islamic Found 1985).

the first modern Islamic bank, is one of the few examples of the socio-economic approach.

I. SOCIO-ECONOMIC APPROACH

As mentioned earlier, this approach presents Islamic economic and financial ideas as a response to demands for social justice and economic opportunity, while at the same time complying with Islamic legal and moral principles. The proponents of this reform-driven approach claim that Islamic alternatives offer superior social and economic benefits to Muslim society. The two main contributors to this approach are the Muslim Brothers Movement ("Movement") and the Islamic finance pioneer, Ahmad al-Najjar.

A. MUSLIM BROTHERS MOVEMENT'S REFORM INITIATIVES

The Movement was founded by Hassan al-Banna in 1928 and is considered to be the original ideological fountain from which most contemporary Islamic activism sprang. In addition to its political influence, the Movement played an important role in the introduction of contemporary Islamic finance. The leaders of the Movement were concerned primarily with social and economic reform, and often emphasized the importance of following Islamic business ethics and abolishing economic activities not adhering to Islamic law (Shari`ah, literally path). Apart from its demands outlawing usury, futures markets, and integrating obligatory alms-giving (zakat) into the tax system, the Movement's reform agenda addressed specific economic problems relevant to Egyptian society during the feudal era. As early as 1937, the Movement declared what it considered essential steps to bringing economic life in Egypt into harmony with Islamic principles and values. Among other things, these steps included:

1. abolishing all forms of usury, including interest charged or paid by the state;
2. abolishing the futures market;
3. nationalizing the country's natural resources;
4. nationalizing the National Bank of Egypt, the largest bank in Egypt, to further promote the country's economic independence;
5. launching a national industrialization plan, with emphasis on industries that depend upon Egypt's main raw materials;
6. introducing a land reform program whose chief features include limiting individual ownership of real property and protecting

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These objectives represent the Movement's socio-economic agenda, which went beyond mere religious dogma. The Movement's reform program was based on policy-oriented ideas rather than the simple objective of abolishing Islamically-prohibited institutions, and the program proposed practical solutions to Egypt's economic problems at the time. Its calls for nationalizing natural resources and limiting land ownership were not motivated by the desire to comply with the Shari'ah as much as they were driven by popular demands for political independence and social justice. In fact, some of the Movement's ideas, such as limiting land ownership, are considered unacceptable according to many views in Islamic jurisprudence (fiqh). Judging from its objectives, it may be argued that the Movement's economic program has been inspired or influenced by some of its contemporaneous socialist and nationalist movements.

In addition to these proposals, the Movement undertook practical initiatives to prove the feasibility of establishing an Islamic economic order. Between 1937 and 1952, the Movement and its followers established several companies in different industrial and agricultural fields including mining, quarrying, cotton weaving, and farming. In 1938, the Movement established its first major trade company, the Islamic Transaction Company (Sharikat al-Mu`amalat al-Islamiyya) in Cairo. Within a few years of its establishment, the Islamic Transaction Company increased its capital from £4,000 to £30,000, reflecting a positive response from the public. The success achieved by the Movement's trade company led to the foundation of the Movement's first industrial company, the Arabic Company for Mining and Quarries, with an initial capital of £60,000. The Movement's companies continued to grow rapidly until they were confiscated by the Egyptian government in the late 1940s and early 1950s. During the 1950s and 1960s, Egyptian society continued to witness a slow but steady increase in the influence of Islamic activists in the economy. A good example of this phenomenon is Ash-Sharif Company, which started as a modest sole proprietorship in the early 1950s and grew steadily to become Egypt's largest private corporation and a significant economic power in that

9 Mitchell, The Society of the Muslim Brothers at 272-75 (cited in note 8).
10 For an account of Islamic legal views on limiting property rights on public interest grounds, see Abu Zahra, al-Milkiyah wa-Naqarriyat al-Aqd fi al-Shari'ah al-Islamiyyah 142-44 (Dar al-Fikr al-'Arabi 1977).
11 Mitchell, The Society of the Muslim Brothers at 275 (cited in note 8).
12 For details on the long-standing tension between the Muslim Brothers and the different Egyptian regimes, see generally Muhammad Shawqi Zaki and As'ad Sayyid Ahmad, al-Ikwan al-Muslimin wa-al-Mujama' al-Misri, (Yudab min Dar al-Ansar 1980); Mitchell, The Society of the Muslim Brothers at 275 (cited in note 8).
country during the 1970s and 1980s. Ash-Sharif Company was known for its observance of Islamic principles, including the methods it employed in raising capital. In the 1980s, the company raised capital by offering its shares to the public through its Islamic investment fund, which flourished during that period. Ash-Sharif fund and the other early initiatives of the Movement are important landmarks in the history of contemporary Islamic finance.

B. EGYPTIAN LOCAL SAVINGS BANKS: AHMED NAJJAR’S IFI MODEL

Following in the footsteps of the Muslim Brothers and attempting to implement the economic ideas proposed by Mawdudi and Banna, Ahmad al-Najjar founded the Mit Ghamr Local Savings Bank in Egypt in 1963. Despite its Islamic orientation, the Mit Ghamr Bank could not operate openly under the Islamic banner due to the government’s hostility toward Islamic movements. Najjar had to hide the Islamic identity of his project under slogans of socialism. As Najjar put it, the “objective was to initiate an experiment that operates in accordance with the economic teachings of the Qur’an and the teachings of the Prophet (Sunna), even if we had to do so under the slogan of social justice or development, as mentioned in the bank’s charter.” An important factor behind the government’s approval of his Mit Ghamr initiative was the Egyptian regime’s strong inclinations toward socialism during the early 1960s and its encouragement of establishing financial institutions that promote public savings behaviors. Indeed, one of the main objectives of the Mit Ghamr initiative was to encourage savings among middle- and low-income classes. In general, Najjar seemed concerned with questions of social justice, poverty alleviation, economic development, and equal access to credit. He often cited social and economic development as important objectives of IFIs.

13 Ahmad ’Abdel-Fattah el-Ashker, *The Islamic Business Enterprise* 195–96 (Croom Helm 1987). The Ash-Sharif Company was nationalized in 1961 by Nasser’s socialist regime and remains a public sector company to this day. This move did not seem to discourage Mr. Sharif, the founder of the company, from continuing in the same line of business, though on a much smaller scale, by establishing a new company in Cairo specializing in making bottle tops.


15 Mit Ghamr is a rural province located approximately one-hundred kilometers north of Cairo, Egypt.

16 Id at 89.

17 Id.

18 Id at 403.
Najjar had a unique understanding of the role of IFIs in Muslim society and believed in the need for a substantial economic reform through consistent establishment of IFIs capable of fulfilling certain socio-economic functions in the society. In his opinion, IFIs should be more than just interest-free banks; they should participate in rebuilding Muslim societies, not only by financing large projects, but also by promoting entrepreneurship and strengthening small business. Najjar's ideas about the role and objectives of Islamic finance were reflected in his Mit Ghamr experiment and in the “Egyptian Study for the Establishment of Islamic Banks,” which Najjar prepared on behalf of the Egyptian government for the Organization of the Islamic Conference (“OIC”) in 1972.

Najjar’s IFI model was based on a gradual development strategy that begins with small local banks capable of penetrating regions and social classes untapped by conventional banks. Najjar’s model was inspired by the German savings bank model, which he became familiar with during his graduate studies in Germany. He was impressed by the German banks’ achievements, particularly by their ability to promote healthy savings behavior in local communities. Adopting this German model, Najjar structured his Mit Ghamr bank as a small banking unit whose activities were limited to the boundaries of the rural town of Mit Ghamr.

The different activities and operations of the Mit Ghamr bank were Shari’ah-compliant, covering five main areas: deposit accounts, loan accounts, equity participation, direct investment, and social services. Deposit accounts were classified as either savings or investment accounts. The former did not give any financial rewards, but were designed “to develop the habit of saving” among small savers such as students, blue-collar workers, and housewives. The latter

19 Id at 593.
20 Id at 592.
22 Najjar, _Harakat al-Bunuk al-Islamiyab_ at 32 (cited in note 4).
23 Acting as central banks or clearinghouses for these small savings units are several regional savings banks (`Landesbanken-Girozentraleden`), which in turn are supervised by a central bank at the national level called _Deutsche Girozentrale-Deutsche Kommunalbank_. Hannes Schneider, et al, _The German Banking System: An Introduction to the German Banking Regulatory System with the Banking Act, the Principles Concerning the Equity Capital and Liquidity of Banking Institutions, the Directives of the Fed Bank Concerning Minimum Reserves, and the By-Laws of the Deposit Protection Fund of the Fed Ass’n of German Banks: English-German Text_ 14–15 (Knapp 1978).
“were run on the basis of profit-and-loss sharing” ("PLS") structures such as the Islamic contracts of silent partnership (mudarabah) and partnership (musharakah).\textsuperscript{24} Najjar considered PLS financing to be more reflective of Islamic principles than debt financing. He also criticized conventional banks’ heavy reliance on security in granting loans. Najjar believed that the emphasis on security or collateral, as a pre-condition for financing projects, undermines the role of trust in financial relationships. In his \textit{Manhaj al-Sabwah al-Islamiyah}, Najjar stressed that:

\begin{quote}
Trust, as one of the Islamic values, has deteriorated and its reliability, as a form of security, has been weakened because we [financial institutions in Muslim societies] have adopted Western security techniques which depend exclusively on material forms of guarantee without lending any importance to moral guarantees. Nevertheless, our society still believes an individual would normally not deceive others who deal with him relying completely on moral guarantees.\textsuperscript{25}
\end{quote}

Accordingly, the Mit Ghamr Bank did not require clients receiving PLS financing to pledge additional assets as security, even against breach of trust or mismanagement.\textsuperscript{26}

Najjar also argued that PLS financing has the advantage of permitting the financing party, the IFI, to maintain full or partial ownership of the financed assets, thereby giving the IFI more protection and control over the assets.\textsuperscript{27} Contrary to Najjar’s suggestion, however, maintaining ownership of the financed assets does not always provide adequate protection against potential fraudulent activities or mismanagement of assets by the financed party. In the case of mudarabah financing, for example, despite retaining ownership of the financed assets, the capital provider (rabbul-mal) has minimal monitoring rights and cannot, in principle, interfere in the management of the mudarabah investment. He can only give pre-investment instructions to the mudarib (the loan recipient), such as requiring him to limit investment to a certain geographic area or

\begin{footnotes}
\item[24] In addition to current and investment accounts, the bank had a compulsory almsgiving (zakat) account which received zakat payments and other charities from the bank’s customers and distributed them in accordance with the rules of Shari’ah. Ashker, \textit{The Islamic Business Enterprise} at 155 (cited in note 13).
\item[26] Generally speaking, Islamic law permits a capital provider under a PLS structure to obtain a guaranty or asset pledge as security against breach of trust (ta’add) by the person receiving such capital (entrepreneur). However, it is against Islamic principles of liability (daman) for the capital provider, say in a mudarabah contract, to demand security against the potential loss of original capital or failure to achieve a minimum level of return due to an external reason not attributable to the entrepreneur.
\item[27] Najjar, \textit{Harakat al-Bunuk al-Islamiyab} at 47–49 (cited in note 4).
\end{footnotes}
economic sector. Furthermore, ownership of the mudarabah assets will not protect the bank against losses due to unfortunate business circumstances or force majeure. Even in the case of musharakah, where the financing partner has the right to manage and monitor the musharakah assets, it is often impractical and costly for IFIs to exercise such rights. Most IFIs lack the expertise and administrative tools necessary to effectively co-manage or monitor their PLS assets. In practice, many IFIs that offered musharakah and mudarabah financing in their initial operations fell victims to fraud and moral hazard problems. An empirical study of the PLS financing offered by Islamic Banks in Egypt during the 1980s attributed the high risk involved in such financing in the Egyptian market to the dishonesty which characterizes many Islamic banking clients.

What proved effective in monitoring the Mit Ghmar Bank’s PLS assets was the policy of limiting the bank’s activities to a small geographic area. This enabled the bank to adequately monitor its investments, which would mainly be in the form of small local businesses and projects. Indeed, operating within a regional financial system allows financial institutions to have more effective and efficient information-gathering operations, thus reducing moral hazard problems. Also, maintaining a long-standing relationship between a bank and its client helps reduce the agency costs of PLS financing. This approach was emphasized by Najjar in his Mit Ghamr experiment. Najjar and his staff invested great time and effort in order to gather very detailed information about the Mit Ghamr town, its economic problems and needs, unemployment and illiteracy rates, and local traditions and customs. The staff even collected information about the number of coffee shops, TVs, and daily newspapers distributed in the village. The bank also sustained long-term relationships with its clients that usually began with opening a

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30 Paul S. Mills and John R. Presley, Islamic Finance: Theory and Practice 29 (St. Martin’s 1999).
31 Id at 28–33.
32 Some of the monitoring techniques of the Mit Ghamr Bank have been successfully implemented by secular micro-credit institutions such as Grameen Bank in Bangladesh. In addition to adopting a decentralized organizational structure, Grameen Bank used what is known as the ‘repeat game’ incentive. The bank made it clear to its borrowers that granting future loans, which may be greater in size, is conditional on the full payment of all earlier loans on time. Atiur Rahman and Mahabub-ul M. Islam, The General Performance of the Grameen Bank, in Abu N. M. Wahid, ed, The Grameen Bank: Poverty Relief in Bangladesh 65 (Westview 1993). For a general analysis of Grameen’s structure and monitoring techniques, see Syed M. Hashemi and Lamiya Morhsed, Grameen Bank: A Case Study, in Geoffrey D. Wood and Iffath Sharif, eds, Who Needs Credit: Poverty and Finance in Bangladesh 221 (Zed Books 1997).
33 Najjar, Harakat al-Bunuk al-Islamiyah at 47–49 (cited in note 4).
savings account in which the client would deposit small amounts on a regular basis for a certain period of time. In addition, the Mit Ghamr Bank adopted an administratively decentralized organizational structure, which further facilitated management and monitoring of the bank’s assets and investments and improved the overall decision-making process.34

Najjar’s bank was able to improve the lives of thousands of Egyptian villagers and increase savings and financial awareness in its region. It offered low-income individuals real access to credit and financial opportunities.35 Despite achieving outstanding results during its short period of operation, the Mit Ghamr Bank was forced into liquidation in 1967 due to a dispute with the Egyptian government.

In addition to the Mit Ghamr Bank, a number of IFIs oriented towards the socio-economic approach were established during the 1960s and 1970s, particularly in non-Arab Muslim countries such as Pakistan and Malaysia. An example of such institutions is the Muslim Pilgrims Savings Corporation, which was established in 1963 as a savings fund for Muslims planning to perform the religious duty of pilgrimage (hajj). Within two decades the Malaysian pilgrim fund, which became known as Tabung Haji, was able to achieve wide recognition as a successful Islamic investment company in Malaysia. The success of Tabung Haji encouraged the Malaysian government to establish the first full-fledged Islamic commercial bank in the country, the Bank Islam Malaysia Berhad (“BIMB”).36

**II. LEGALISTIC APPROACH**

By the early 1970s, the success of the early initiatives of Islamic finance had caught the attention of the rich Arab countries of the Persian Gulf, which were witnessing an unprecedented oil boom. From their own perspective, IFIs saw in the increasingly wealthy and religiously conservative Gulf countries a new lucrative market. The increase in oil revenues coincided with the rise of political Islam throughout the Muslim world. These circumstances boosted the morale of Islamic movements and increased the demands for the Islamicization of the financial system. For the first time, Islamic finance attracted the attention of policy makers and became an important topic in the public media and the subject of numerous regional and international conferences. Unlike Najjar and

34 Najjar considered the overly centralized administrative and financial systems adopted by the Egyptian government as the most serious challenges he had to overcome during the establishment and operation of his bank. Najjar, Manhaj al-Sahwah al-Islamiyab at 165 (cited in note 25).

35 Najjar, Harakat al-Bunuk al-Islamiyah at 84 (cited in note 4).

36 Mervyn K. Lewis and Latifa M. Algaoud, Islamic Banking 6 (Edward Elgar 2001).
Sharif, Islamic bankers and entrepreneurs belonging to this new era of Islamic finance no longer had to hide the Islamic identity of their projects and were able to practice Islamic finance openly.

IFIs’ objective at this stage shifted from attempting to solve the social and economic problems of Muslims to offering a lawful or permissible (halal) platform for financial products capable of attracting the savings of the more affluent Muslims. The challenge IFIs faced at this stage was to find an IFI model that could offer halal financial products while maintaining, as much as possible, the prevailing structures and tools of conventional finance. The theoretical model which was first proposed by the renowned Shiite scholar, Muhammad Baqir as-Sadr, and later detailed by the famous Islamic banker Sami Homoud proved to be suitable for achieving the new objective of the Islamic finance movement.

A. PERMISSIBLE (HALAL) CONVENTIONAL BANKING: SADR’S IFI MODEL

Muhammad Baqir as-Sadr’s book, the \textit{al Bank alla Rabawi fi al Islam} (Non-Usurious Bank in Islam), first published in 1969, is considered the most original work on Islamic banking.\footnote{Chibli Mallat, \textit{The Renewal of Islamic Law: Muhammad Baqir as-Sadr, Najaf, and the Shi’i International} 165 (Cambridge 2003).} Although this book represents Sadr’s first attempt to address in detail the subject of banking from a Shar‘iah perspective, Sadr’s two other economic books, \textit{Iqfisaduna} (Our Economics) and \textit{al-Usus al-‘Ammab lil-Bank fi al-Mujtama‘ al-Islami} (The General Principles of the Bank in the Muslim Society), are also quite helpful. \textit{Iqfisaduna}, which first appeared in 1961, provides general discussions of economic issues from an Islamic perspective, including the issue of usury, but does not deal with the subject of banking in any detail.\footnote{See Muhammad Baqir as-Sadr, \textit{Iqfisaduna: Dirasah Mawdu’yah Tatanawal bi-al-Naqd wa-al-Bahth al-Madhib al-Iqfisadiyah lil-Marksiyah wa-al-ra’s Maliyah wa-al-Islam fi Ususiha al-Fikriyah wa-Tafaluha} (Dar al-Kitab al-Lubnani 1977).} In general, \textit{Iqfisaduna} represents the mainstream Islamic economic literature of its time, with its balanced critique of both capitalism and communism. Sadr’s second book, \textit{al Usus al-‘Ammab}, describes in very broad terms the different functions of banks in Muslim society.\footnote{Muhammad Baqir as-Sadr, \textit{al-Usus al-‘Ammab lil-Bank fi al-Mujtama‘ al-Islami. Al-Qism al-Awwal} (Dar al-Ta’aruf lil-Matbu’at 1979) (author’s translation).} Sadr distinguishes between the two main activities for a bank operating in any capitalist society: (1) interest-based lending and borrowing operations (capitalist activities), and (2) fee-based services offered by the bank to its clients (service activities).\footnote{Id at 5–6.} He then classifies the first type of
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bank activities into two main categories according to their functions: objective-driven functions and ideology-driven functions. Sadr believes that the objective-driven functions, such as pooling and channeling savings and making them accessible to investors, pertain to any kind of society, regardless of that society’s ideological background. According to Sadr, adopting such functions in an Islamic bank should not pose any conflict with Islamic principles. As for the ideology-driven functions of conventional banks, Sadr suggests that they should be avoided by Islamic banks because of their underlying capitalist ideology. In his view, this capitalist ideology seeks to transform “the scattered savings of the society into not only capital in its objective meaning, but into capital in its capitalist term to further deepen capitalist relationships in the society.”

According to Sadr, savings are transformed into capital in its “capitalist term” and capitalist relationships are deepened by: (1) providing capital owners an interest-based source of income that is capable of perpetually increasing their capital, without their necessarily having to join such capital with labor; (2) providing influential and powerful individuals with access to large amounts of capital, through bank loans, to enable them to form, control, and expand major businesses in the society; and (3) providing risk-averse capital with opportunities to earn a fixed and guaranteed stream of income, not only without engaging in work, but also without being exposed to risk.

After asserting his objections against the capitalist functions of conventional banks, Sadr outlines his own Islamic bank model. He envisions an Islamic bank that works to attract savings and mobilize funds in the society using two main mechanisms: qard hasan (free loans) and mudarabah (silent partnership). Under the free-loan scenario, the Islamic bank receives interest-free loans from its depositors and guarantees to repay the original amount of the loan plus any inflationary loss. According to Sadr, funds received under the free-loan method should be disbursed by the bank in the following ways: (1) offering secured and unsecured interest-free loans to the poor as well as small investors and (2) financing income-producing infrastructure projects on behalf of the

41 Id at 7.
42 Id at 10.
43 Id.
44 Id at 11.
45 Id at 12.
46 Id at 12–17.
47 Id at 30–37.
48 Id at 36–37. Although the concept of interest-free loans may seem utopian or impractical to Western economists, Sadr claims there are many indications that such benevolent economic behavior is already common practice in Muslim countries. Id at 29.
The bank would keep 100 percent of the income produced from the operations of those projects that are financed completely by that bank. As for the projects that are financed by the bank and other parties, the produced income can be shared between the bank and those parties.\footnote{49}

Sadr distinguishes the task of establishing a “non-usurious bank” in an Islamic environment from the task of establishing such a bank in a secular environment. He argues that only the first task can succeed in completely eradicating the society from the ills of capitalism and fully realizing the socio-economic benefits of a usury-free financial system.\footnote{50} The Islamic system, Sadr argues, can only achieve its full potential when all of its integrated aspects are implemented.\footnote{51} By contrast, Sadr believes that the second task, that is, establishing an Islamic bank in a secular or non-Islamic society, is a much less ambitious endeavor whose utmost objective would be to eliminate the legal forms and stipulations that violate Islamic law, but would not be sufficient for eliminating the contradiction between the capitalist economic system and the underlying principles and values of Islamic economics.\footnote{52}

In his \textit{al-Bank alla-Rabawifi al-Islam}, which introduces Sadr’s unique perspective on Islamic banking and contains his daring legal arguments and Islamicization proposals, Sadr begins by stating that his study undertakes the second task only. He only intends to address the establishment of an Islamic bank that can operate within a non-Islamic system and compete with its conventional counterparts.\footnote{53} Sadr’s contribution, therefore, is limited to reconciling the existing conventional financial practices with minimal Islamic requirements. To achieve this “less ambitious” objective, Sadr resorts to his juristic ability to use the legalistic techniques and tools available in classical Islamic jurisprudence. Unlike Najjar, the starting point in Sadr’s model is to define a conventional financial product, which he can then Islamicize using such techniques.

After examining the different operations of conventional banks from an Islamic legal perspective, Sadr concludes that in order for IFIs to succeed in competing with their conventional counterparts, IFIs must offer their depositors the same financial incentives available to conventional bank depositors. As Sadr explains, “[w]e [Islamic banks] must maintain the same incentives that attract

\footnote{49} It seems that Sadr is referring to public infrastructure projects, such as highways or bridges, which are expected to generate income from tolls or other service fees.
\footnote{50} Id at 17–21.
\footnote{51} Id at 20.
\footnote{52} Id at 17–21.
\footnote{53} Sadr, \textit{al-Bank al-la-Rabawifi fi al-Islam} at 8 (cited in note 7).
depositors to put their savings in conventional banks. If we do not maintain such incentives, depositors will take their deposits to the usurious banks.  

These incentives, Sadr believes, are: (1) guaranteeing the principal amount of the deposit; (2) guaranteeing a fixed rate of return on the amount of deposit (interest); and (3) offering depositors the right to withdraw the deposit at the end of its term. While offering the third incentive does not seem problematic under Islamic law, offering the first and second incentives is more challenging. Usurious banks, Sadr suggests, are able to guarantee the principal amount of the deposit by passing the burden of such guarantee to their borrowers through interest-bearing loans. According to the terms of such loans, borrowers guarantee to pay back the original amount of the loan in addition to a variable or fixed rate of interest. In addition, conventional banks are able to offer the second incentive (guarantee of a fixed rate of return) by charging their borrowers interest rates higher than the rates offered on the banks’ deposits.

Islamic banks, however, receive investment deposits under the terms of mudarabah, which impose on the capital provider (Islamic bank depositor) the risk of loss (daman) of the mudarabah capital. The question Sadr tries to address in his book is: “How can Islamic banks offer these two incentives to their investment depositors without violating the rules of daman governing the mudarabah?” In other words, can Islamic banks provide these guarantees to their investment depositors without having the benefit of interest-based loans which guarantee conventional banks both the principal and a fixed return?

As for guaranteeing the principal amount of the deposit, Sadr suggests that it is Islamically-acceptable for the Islamic bank to do so because the bank is not acting as a mudarib but rather as an intermediary between the capital provider and the mudarib. “As an intermediary (wasil), or third party, the bank can guarantee the mudarabah capital on a gratuitous basis.” Sadr explains that because the bank is not a party to the mudarabah, it can voluntarily assume the risk of loss of the mudarabah capital by executing a separate agreement to this extent with the capital provider or by including a provision in the agency agreement between the latter and the bank. In Sadr’s view, although the bank is a trustee (amin) with respect to its possession of the deposits, this trust or amana does not prevent the entrusting party from requiring the amin to undertake to pay up to an amount equivalent to the value of the entrusted property in the case of its loss. According to Sadr, this undertaking does not negate the presumption of trust which the Shari`ah bestows upon the amin. What is contradictory to the established rules of daman, in Sadr’s opinion, is “to stipulate that the [amin’s]
possession (yad) itself is a cause for [his] liability for the risk of loss. Doing so, Sadr argues, contradicts the rules of daman with respect to yad al-amin. However, Sadr claims that it is not against the Islamic rules governing a trustee’s liability that a trustee voluntarily assumes the “legal effects” of the entrusting party’s daman in the event of loss. In general, Sadr’s arguments seem to be more formal than substantive. Substantively, there is no difference between stipulating that an amin is liable for the risk of loss and stipulating that he agrees to assume the effects of such liability.

As for guaranteeing a fixed return on the investment deposits, Sadr suggests that Islamic banks can offer their capital providers a minimum percentage of “profit” to be determined at the outset of the mudarabah relationship.

Since the depositor’s income, in the case of Islamic banks, depends on the outcome of investment carried out by the mudarib [the bank’s borrower] . . . the possibility of making no profit at all is generally very unlikely and can be considered a theoretical possibility only. This is because the deposit of each [capital provider] will not be subject to a separate mudarabah or depend on the outcome of that one mudarabah. Rather, each deposit will be pooled together with the other investment deposits at the bank. Each depositor is a mudarib in the [bank’s] pool of mudarabahs. He has a share in each of these mudarabahs in accordance with the percentage his deposit represents in the total pool of deposits. In order for a depositor not to be entitled to any profit, all of the mudarabah investments created by the bank as well as the projects which the bank finances on the basis of mudarabah will have to lose [or realize no profit]. If only some of the mudarabahs realize profits, such profits would be shared by all depositors, after covering any losses suffered by the other mudarabahs.

Sadr recommends that Islamic banks guarantee their investment depositors a minimum rate of profit comparable or even greater than the prevailing interest rate offered by conventional banks. Sadr suggests that the Islamic bank determine an approximate rate of return in light of market conditions and set a minimum rate of profit on its deposits which should not be lower than the prevailing interest rates.

Given the objective circumstances surrounding the interest-free banks, the percentage of profits that should be designated to depositors should not be lower than the interest rate offered to conventional banks’ depositors. [Otherwise], Islamic banks’ depositors will turn to conventional banks.

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57 Id at 193-94.
58 Id.
59 Id at 188-96.
60 Id at 33-34 (author’s translation).
61 Id at 34.
Sadr also proposes that the rate of profit should increase with the increase of risk or likelihood of realizing no profit.

In order to protect Islamic banks against potential abusive and fraudulent behaviors by their mudaribs, Sadr suggests that there should be a presumption that the mudarabah has realized a minimum amount of profit. The mudarib can overcome this presumption by proving at least one of the pre-determined presumptions of loss agreed upon between the parties. Realizing that his suggestion undermines the presumption of trustworthiness that Islamic law grants to the mudarib, Sadr provides two possible legalistic solutions to justify his suggestion under Islamic law. First, he proposes that the bank and the mudarib stipulate in their contract that if the mudarib claims loss of the mudarabah capital and fails to provide proof of any of the pre-agreed loss presumptions, the mudarib must pay the bank an amount equivalent to the amount of the claimed loss. Alternatively, Sadr suggests that the relationship between the bank and the mudarib be construed as a contingent reward contract (u'ala) under which the bank receives a reward (ju'ala) for identifying appropriate investment opportunities for its depositors.

The mudarib offers the bank such reward for securing the mudarabah capital. Sadr suggests that the bank’s reward be calculated as follows:

(Principal + presumed minimum profit + the fixed fee charged by the bank for his role as an intermediary between the capital providers and the mudarib) – (the remaining amount of capital and profit in the mudarabah + proven amount of loss)

In addition to this fixed reward, Sadr proposes that Islamic banks receive a percentage of their mudaribs’ profit shares. Sadr realizes that according to the general rules of mudarabah, profits are to be shared between the capital provider (Islamic bank’s depositor) and the entrepreneur (Islamic bank’s mudarib). He argues, however, that those capital providers can assign a percentage of their profit shares to their Islamic banks. This percentage should reflect the difference between prevailing interest rates and the percentage of profit capital providers normally receive by investing their money through mudarabah in the relevant markets.

The main conclusion to derive from Sadr’s book on Islamic banking is that Islamic banks can provide almost the same services and products offered by their conventional (usurious) counterparts. He was able to reach this conclusion by employing the legalistic tools of Islamic fiqh. Through his skillful legal constructions, Sadr was able to bring Islamic legitimacy to conventional commercial banking for the first time in history.

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62 Id at 209.
B. FORMALISTIC COMPLIANCE THROUGH LEGAL STRATAGEMS

A driving force in the current prevalence of the legalistic trend in Islamic finance is the use of legal stratagems (biyâl). Jurists distinguish between two main categories: (1) stratagems designed to achieve an outcome or objective sanctioned by the Shari‘ah and (2) stratagems designed to circumvent the substance of an Islamic rule or prohibition.\(^6^3\) In general, stratagems under category (1) are considered legitimate solutions (makharij shar‘yya) if they employ a lawful means to reach an outcome permissible under the Shari‘ah, even if such outcome is not the primary, or default, outcome intended by the Shari‘ah for the use of such a means. A jurist uses makharij shar‘yya to “ease the legal requirements in a given case without turning a prohibited or a reprehensible act allowable.”\(^6^4\) For example, a man might marry a woman for her wealth or prestige, as opposed to marrying her to attain the primary objectives of marriage under Shari‘ah, such as seeking company in life, raising children, and non-promiscuity.\(^6^5\) Another example of such legitimate stratagems is a woman stipulating in a marriage contract that she has the right to divorce her husband if he marries a second woman. However, a stratagem is unlawful (according to most Islamic schools) if it employs an unlawful means or intends to reach an unlawful outcome (biyâl). An example of such a stratagem is the use of false testimony to support a legitimate cause or claim.\(^6^6\)

One of the common examples of stratagems used in contemporary Islamic finance practice is the practice known in traditional jurisprudence as bay‘ al-‘ina, a double sale whose ultimate and sole objective is to circumvent the prohibition of usury and achieve an interest-based loan. Under a simple form of an ‘ina arrangement, an IFI sells an asset to its customer on credit and then immediately repurchases it from the customer for a discounted cash price. The difference between the credit and cash prices represents IFI’s “profit” margin. Neither of the two parties intends to own or even trade in the underlying asset and the sole purpose of the two sales is to provide the customer with a cash amount which he pays back with interest in deferred installments. Today, bay‘ al-‘ina is

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\(^{65}\) Even though it is legitimate, marrying a woman for her wealth is considered a secondary objective for marriage.

commonly practiced by IFIs, particularly in Southeast Asian Muslim countries such as Malaysia where some jurists approve such stratagems.67

A second example of Islamic finance stratagems is the practice of *bay' al-wafa*, a sale combined with a lease-back and seller's right of redemption at the end of the lease period. Under *bay' al-wafa*, one party (borrower) agrees to sell a property to another (lender) for a cash price but reserves the right to repurchase such a property at its original price after leasing it from that lender for a certain period of time. During the lease period, the borrower pays rent equaling interest. Although the practice of *bay' al-wafa* has been condemned by the OIC,68 there were reports of its use in the Gulf region.69

An increasingly popular stratagem throughout Islamic financial markets is the practice of *tawarruq* (monetization) whereby a person in need of cash (borrower) purchases property from another (lender) in installments and immediately resells it to a third party at a cash discounted price. While each of the two sales is valid if viewed separately, an analysis of the two sales combined implies an intention to borrow money at interest. Because one can never be certain of the true intention of a person who resells an item he just bought on credit for a discounted cash price, scholars are hesitant to declare such a practice an outright violation of the Islamic rules of usury. However, many scholars discourage such a practice except in a case of necessity, that is, when a person cannot find other legitimate alternatives to borrow money for his everyday needs.70 Generally speaking, *tawarruq* is considered a stratagem (*hilā*) to circumvent the *riba* prohibition. *Tawarruq* is generally more acceptable under the Hanbali school, which is popular in Saudi Arabia, than under any other school. However, the leader of the Hanbali school, Imam Ahmad Ibn Hanbal, discouraged the practice of *tawarruq*, classifying it as reprehensible (*makruh*).71

Adopting the general Hanbali view, the Fiqh Council of the Muslim World

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70 "[According] to all major Sunni schools, except the Hanbali, *tawarruq* is classified as a type of *'ina* sale that is prohibited for being an alternative *hilā* to circumvent the *riba* prohibition. Even under the Hanbali school, *tawarruq* is reprehensible (*makrūh*) according to Imam Ahmad Ibn Hanbal." Hegazy, *Fatwas and the Fate of Islamic Finance* at 146 (cited in note 64).

League declared that *tawarruq* is valid and does not involve usury.\(^\text{72}\) Thanks to this declaration and other similar *fatwas*, IFIs are able to offer their customers *tawarruq* products to finance not only necessary items but also luxury consumer products, such as cars and vacations.\(^\text{73}\)

**C. MARK-UP SALE (*MURABAHAH*) AS AN EXAMPLE OF ISLAMIC FINANCE LEGALISM**

Perhaps the most significant contribution to the currently prevailing legalistic trend in Islamic finance was the introduction of the widely practiced financial instrument known as the mark-up to purchaser's order (*murabahah il-amir bil-shira*), commonly referred to as *murabahah*. The introduction of *murabahah*, in its modern form, took place in the mid-1970s when Sami Homoud, a well-known Jordanian economist and banker, proposed it as an Islamic substitute for conventional interest-bearing loans.\(^\text{74}\) Today, *murabahah* represents more than 70 percent of all financial structures used by IFIs.\(^\text{75}\)

The original form of *murabahah* typically functioned as a trade instrument whereby a potential buyer desiring to purchase certain goods, usually existing in a remote market or location, places a revocable order with an experienced merchant to purchase such goods and resell them back to the buyer on a cost-plus basis. The potential buyer gives a revocable promise to the merchant to purchase the desired goods from the merchant once the latter acquires them. The traditional *murabahah* transaction did not involve or imply any extension of credit. Also, the potential buyer had the option of rejecting the goods upon inspecting them. Because the potential buyer relies on the seller's representation and disclosures regarding the original price of the subject matter, the shipping or transportation costs associated with its delivery, and the margin of profit charged by the seller, the classical *murabahah* is classified as one of the sales of trust. The price mark-up was justified by the seller's effort in locating and transporting the goods from their original location and bearing the risk of loss of such goods from the time he acquires the goods until they are delivered and accepted by the

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\(^\text{72}\) Hegazy, *Fatwas and the Fate of Islamic Finance* at 146 (cited in note 64) (discussing decision issued by the Council's fifteenth session held in Mecca on 10/31/1998).

\(^\text{73}\) Id.

\(^\text{74}\) Sami Hasan Homoud, *Tatwir al-A'mal al- Masriyya lima Yattafig waal Shari'ah al-Islamiyyab* 497 (Ammai 1982). *Murabahah* is one of three traditional instruments Homoud proposed as Islamically-acceptable substitutes to conventional interest-bearing loans. The two other contracts, which are *mudarabah* (silent partnership) and *musharakah mutanaqisa* (declining partnership), did not receive as much attention from IFIs. Id at 466–84.

\(^\text{75}\) Some estimates suggest that *murabahah* reached 80 to 90 percent of the total financing offered by IFIs. See Mohamed Elgari, *Credit Risk in Islamic Banking and Finance*, 10 Islamic Econ Stud 1, 21 (Mar 2003).
buyer (ownership risk). In addition, the seller faced the risk that the potential buyer may reject the goods or decline to complete the transaction (cancellation risk). Under traditional *murabahah* rules, a buyer was allowed to decline to complete the transaction as he only promised to purchase the goods, and such a promise is revocable according to most recognized *fiqh* views.

After adding a credit component to the *murabahah*, Homoud was able to transform it from a medieval trade instrument into a modern debt-financing scheme that has become the most common Islamic financial instrument. Further modifications were added to Homoud’s *murabahah* to eliminate commercial (non-financial) risks which financial institutions in general are not fit, or allowed by law, to manage. With new functions and legal effects, the modern *murabahah* has completely diverged from the original *murabahah*. In fact, it would not be an exaggeration to say that the only similarity remaining between the two contract forms is the name *murabahah*.

The modern *murabahah* arrangement now functions as a pure financing scheme, whereby a customer approaches an IFI to finance the purchase of certain goods from a particular seller (already identified by the customer), promising to repurchase the same goods from the IFI on credit once the IFI acquires them. Upon acquiring the goods, the IFI resells them to the customer for a mark-up price to be paid in installments. Contemporary Islamic finance jurists have allowed the mark-up margin to be “benchmarked to conventional interest rates.”

Unlike traditional *murabahah*, today’s *murabahah* can no longer be considered a sale of trust because the potential buyer no longer relies on the professional judgment or expertise of the seller. Also, there is no need to rely on the trustworthiness of the seller since the buyer has full knowledge of the different components of the mark-up price, that is, the original price, shipping cost, mark-up margin, and the like. Moreover, unlike the traditional *murabahah*, it is the ultimate buyer, not the IFI, who spends the time and effort identifying and locating the desired goods and even negotiating the price with the original seller. Indeed, it is common practice for an IFI to appoint the *murabahah* customer as the agent to negotiate and purchase the goods from the supplier of such goods on behalf of the IFI.

In the modern *murabahahs*, IFIs are no longer exposed to the ownership and cancellation risks to which a seller in traditional *murabahah* was exposed. IFIs are able to circumvent or shift such risks to the *murabahah* buyer.

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77 In practice the only risks the IFI actually bears are the credit and interest rate risks (financial risks). Id at 68.
First, IFIs are able to minimize the ownership risk "by restricting the time period between the two sales [the sale from original supplier or merchant to the IFI and the sale from the IFI to the customer] to minutes, if not seconds." As an additional form of security, some IFIs require their customers to provide a third-party guaranty for the customer's performance of its obligations under the murabahah arrangement. Furthermore, IFIs tend to build into the mark-up margin the cost of insuring the goods during transportation and during the time period between the two sales, even though in practice this period typically is limited to a few minutes or even seconds. As long as this ownership risk exists, even for a few seconds, then many Islamic finance jurists would consider the transaction to be halal. Some jurists require a minimum period of fifteen minutes between the two sales.

Second, IFIs are able to completely eliminate the cancellation risk after a fatwa issued by the First Conference on Islamic Banks held in Dubai in 1979 ("Dubai fatwa"). Quoting an opinion from Ibn Shubrûma, a Maliki scholar from the second Islamic century, the Dubai fatwa contradicted the long-standing traditional view of all Islamic schools by permitting IFIs to stipulate in their murabaha contracts that the promise (wa'd) of the buyer is irrevocable. Many renowned scholars objected to such fatwa and some authors accused its supporters of performing a controversial juristic stratagem known in Islamic jurisprudence as talfiq (amalgamation). Talfiq is a patching technique that

78 Id at 67-68
80 El-Gamal, Islamic Finance at 67-68 (cited in note 67).
81 The irrevocability of the murabaha promise was not explicitly proposed by Homoud. However, Homoud adopted the view that a promise is irrevocable in connection with his discussion of the issue of line of credit. See Homoud, Tatwir al-'Amal at 306-07 (cited in note 74).
combines opinions from different schools to reach an outcome that is otherwise impermissible under any one school if each were exclusively consulted on the validity of the entire transaction. Specifically, it is argued that the Maliki school, which the fatwa adopted with respect to the issue of the irrevocability of the promise, does not recognize murababah as a valid contract. On the other hand, the Hanafi, Shafi‘i, and Hanbali schools, which recognize the murababah, do not allow the irrevocability of the purchaser’s promise. Arguably, talfiq was performed by selectively combining the views of the Hanafi, Shafi‘i, and Hanbali schools that recognize murabaha as a valid contract with the Maliki view that confers a binding nature on a promise. The logic of the argument is that the murabaha, with its binding promise component, is not valid under any of the above schools. Under the Hanafi, Shafi‘i, and Hanbali schools, the contract would be enforceable, but the purchaser would be able to revoke his order or purchase promise. Under the Maliki view, the contract would not be enforceable at all on the basis of gharar. Despite these objections, this fatwa was confirmed by an opinion issued by the OIC Islamic Fiqh Academy. According to the OIC Islamic Fiqh Academy opinion, the effect of this irrevocable wa’d is that the promisor must either fulfill it or pay compensation for damages caused due to its unjustifiable non-fulfillment.

III. CONCLUSION

Contemporary Islamic finance originated as a grassroots movement led by popular initiatives aimed at implementing Islamic socio-economic values. Najjar’s Mit Ghamr Bank, and the Malaysian Tabung Haji mutual fund are examples of these initiatives, which presented Islamic finance as an alternative approach to the reform and development of Muslim societies. This approach focused on empowering the low- and middle-income classes and building economically and politically active communities. This was clearly the vision of the Mit Ghamr model, which provided credit access to the rural population of Egypt. The Mit Ghamr Bank adopted other socio-economic objectives such as encouraging saving and entrepreneurial behaviors in the society and building a robust financial market that nurtures mutual trust and cooperation among its members.

85 In its fifth conference held in the City of Kuwait in 1988, the OIC Islamic Fiqh Academy declared that wa’d, though ethically binding on the promisor, is not legally binding on such promisor unless it is “made conditional upon the fulfillment of an obligation, and the promisee has already incurred expenses on the basis of such a promise.” See Islamic Fiqh Academy, Resolutions and Recommendations Res No 40-41 (2/5 & 3/5) at 86 (cited in note 68).

86 Id.
The success of these early initiatives caught the attention of financial institutions and investors inside and outside the Muslim world and led to increasing demands among Muslim communities for IFIs and Islamically-acceptable Islamic financial products. In response to such demands, major IFIs were launched, such as the Dubai Islamic Bank and the Egyptian and Sudanese Faisal Islamic Banks, which were established in the mid-1970s. In some Muslim countries such as Iran, Pakistan, and Sudan, growing public support for Islamic finance has led to the Islamicization of the entire financial system. The unprecedented increase in oil revenues in the Gulf region, with its traditional and conservative background, offered a lucrative new market for IFIs. The need to provide Shari’ah-compliant financial products capable of attracting wealthy Muslim investors overshadowed the often celebrated socio-economic objectives of Islamic economics. In this new era of Islamic finance, the IFI model presented by Muhammad Baqir as-Sadr, which aimed at finding interest-free functional equivalents to conventional financial products, proved more suitable.

Najjar’s and Sadr’s models reflect two different understandings of the contribution of Islamic finance to Muslim societies as well as two different approaches towards its implementation. Najjar was interested in a gradual reform program that would introduce micro-finance to Egyptian society through the fusion of the German savings bank idea with the profit-and-loss-sharing principle celebrated by Islamic economists. His objectives were not limited to establishing an institution that adhered to the relevant rules of the Islamic law, but extended to offering better socio-economic benefits to the society. According to Najjar, the Islamicity of his model bank should be measured by its contribution to the development and productivity of its society. As Najjar explains, “our real objective is to establish a financial institution that undertakes a leading role in development.”

Sadr, on the other hand, was preoccupied with the illegitimacy of interest as an “unjustified reward” and focused his effort on purifying the prevailing conventional bank model so that Islamic banks could be implemented in Islamic countries and compete with conventional banks. His strategy focused on establishing an interest-free banking model capable of offering as many of the conventional financial services and products as possible. By the mid-1970s, Sadr’s Islamic commercial banking model was widely implemented by IFIs, particularly in the Arab countries of the Persian Gulf region, which were witnessing a significant increase in savings due to the oil boom. The difference between Najjar’s and Sadr’s models should also be viewed in light of their historical background. Najjar’s experiment was established in a political
atmosphere that was hostile to Islamic ideology, while Sadr's came in the wake of Islamic revivalism and was a response to a demand for a wholesale Islamicization project.

The socio-economic approach is more representative of the values and objectives held by Muslim economists and scholars as distinctive feature of Islamic finance. It could also give IFIs a competitive edge over conventional banks in the area of microfinance and when operating in economically underdeveloped regions. However, in order to successfully implement this approach, IFIs and their regulators need to be more innovative in developing new techniques and measures to address the particular types of risks associated with operating in such communities. The legalistic approach, on the other hand, does not require substantive changes to existing conventional financial practices and allows conventional banks in Muslim countries to easily convert their services to be Shari'ah compliant.