## *Editor's Note*

Developing innovative new financial products is an important area in Islamic finance. Financial engineering is especially important in the context of Islamic financial institutions, because the benefits of increased economic efficiency must be carefully weighed against the potential costs associated with remaining true to the tenants of Islam. Financial innovation has the potential to lead to improvements in the functionality of global financial markets. Innovative financial products can help to link the financial and real sectors of the economy, thereby ensuring a more efficient allocation of capital. However, Islamic financial institutions have a duty to deal in financial products that comply with Shariah law. Most notably, the form and substance of a financial instrument must conform to one another, and the ultimate financial end must be one that is accepted under Islamic law. Thus, it is important for current practitioners and academics to review the modern application of financial innovations in the context of their application in Islamic financial institutions.

In assessing the legitimacy of a financial product under Islamic law, it is important to consider both the form, or means, and the substance, or ends, of a given product. In order for a financial instrument to be considered acceptable, both the form and substance must pass the scrutiny of Shariah law. However, the substance is the more important component. It is very important that Islamic institutions develop products that have goals (substance) that are consistent with those of Islam. If this burden is not met, the package or mechanism (form) that the product takes is irrelevant. Shariah law never forbids the achievement of a goal that will benefit society. Therefore, it is important to focus on the substance or ends of a financial product. If we can ensure compliance in this regard, then there is a way to generate a form that is Shariah-compliant.

We can see an example of this reasoning in the context of the prohibition of pork in Islam. The Qur'ān prohibits the consumption of pork, regardless of how it is prepared. Since the end of eating pork is not acceptable, the means of how it is prepared is of no consequence. Conversely, lamb is acceptable under Islam. It is a legitimate end. However, it must be prepared under Shariah law in order to be fully compliant with the tenants of Islam. Thus, both the form and substance must meet the standards of Islamic law.

While this example illustrates the two broad requirements of Islamic law, it can also illustrate how disagreements over the acceptability of a practice or product may arise. While the cases of pork and lamb are concretely expressed in the Qur'ān, there are certainly cases which are not directly addressed. Therefore, there may be disagreements regarding whether the substance of a given practice is acceptable. Disagreement over the acceptability of certain financial products may, in essence, be disagreements over what class of "animal" the product belongs.

There is a concrete example of this in the context of modern financial transactions when we compare murabaha, and *einah*. Under murabaha, a bank purchases a product on behalf of a customer and subsequently sells it to them for a profit. In contrast, under *einah,* the bank sells a good to the customer and subsequently buys it back or sells it on the customer's behalf (*tawarruq*). The end result of murabaha is a standard sale, whereas the end results of *einah* and *tawarruq* is debt financing. Therefore, from the perspective of Islamic law, murabaha is widely accepted as a legitimate end, while *einah* and *tawarruq* are highly controversial, as it is argued that their ends amount to riba. Indeed, many prominent Islamic scholars have deemed *einah* and *tawarruq* unacceptable. In the context of complete acceptability, we would have to ensure that the implementation (form) of murabaha follows the principles of shariah. However, *einah* and *tawarruq* would not be acceptable, regardless of form.

In the first paper of this issue, Jason West states that the investment profile and horizon of traditional debt financing for projects seldom matches the returns of these assets. The results are particularly strong for the resources and infrastructure sectors. These are areas where assets undergo a lengthy construction phase before realizing a return. It is argued that the mismatch in investment duration and risk-return profile is a key weakness of the Western approach to limited recourse borrowing under project financing conventions. The motives underlying Islamic finance, however, differ from the Western approach by permitting longer-term investments and profit-sharing arrangements. The paper highlights the advantages of Islamic investment practices over traditional approaches in project financing, which can potentially fill a significant gap in funding options for firms in the global resources sector.

In the second paper, Yulizar D. Sanrego and Aam Slamet Rusydiana argue that the transmission mechanism of monetary is an area of critical economic significance in many countries where the financial system links monetary policy and the real economy. Under such an economic regime, events affecting the financial system also affect the monetary transmission mechanism. The study analyzes the transmission mechanism in Indonesia's dual monetary system using Vector Auto Regression (VAR) and Vector Error Correction Model (VECM) methods. The results indicate that the relationship between the Consumer Price Index (CPI) and Sharia Instruments Financing (LNFIN), Bank Indonesia Sharia Certificate (SBIS) and Sharia Inter Bank Money Market (PUAS) are negative. This means that, when sharia financing increases, inflation is lower. Hence, this type of transmission mechanism will create more balanced growth between the monetary and real sectors of the economy. Therefore, it is argues that Islamic (shariah-compliant) financial intuitions and monetary authorities should increase the sharia banking market share in Indonesia.

In the third paper, Salman Ahmed Shaikh analyzes Islamic banking philosophy, principles, and practices and identifies several important areas of interest. The author illustrates a decade long expansion of Islamic banking in Pakistan. This is shown by that fact that there are now 5 full-fledged Islamic banks and more than 15 conventional banks with Islamic banking windows present in Pakistan. The Islamic banking sector in Pakistan has experienced consistent double-digit growth in total assets, and market share rose to 7% by the end of 2011. However, it is important to note that meaningful assessment of Islamic banking also requires assessing the degree to which the banks have contributed to the societal goals of Islam. Additionally, the Islamic banking industry continues to use debt based financing priced using KIBOR. Difference of means tests show that Islamic banking spreads are higher than those of conventional interest rate spreads.

In the fourth paper, Imran Haider Naqvi and Maryam Saeed Hashmi assert that the knowledge of modern economics has evolved over centuries. One of the key elements of the discipline has been its reliant on the practice of usury. However, the recent financial crises have illustrated the potential dangers that this practice induces. Islam constitutes a broad set of guidelines, and it is important to integrate this lifestyle with more traditional economic indicators. To this end, this study integrates the directives of Islam with the concept of Gross National Product (GNP). The study utilizes primary and secondary Islamic sources as well as those of Christianity. The study finds that the existing formula for GNP consists of both legal and illegal elements under Islamic law. It contributes an alternate Islamic formula for GNP, tested in the ancient Islamic regimes. It also presents an modified version of the existing formula for GNP that excludes the effects of usury and other forbidden concepts in Islam.

In the fifth paper, Atikullah Hj Abdullah argues that there is no doubt regarding the prohibition of the elements of qimar or maysir (gambling or wagering) and gharar (uncertainty) in a contractual agreement under the Islamic law of business muamalat. There are, however, still relevant questions regarding whether these elements really exist in a business contract and the degree to which they are involved. Differing opinions surrounding these questions often lead to differing views regarding the legality of certain business contracts. Examples of such contracts are those involving modern insurance. Some claim that the elements of qimar and gharar are problematic from an Islamic finance perspective. However, few people have a clear idea of what qimar and gharar are, and, therefore, there is a need to re-examine the prevailing view that the insurance contract is free of these two elements. This article examines this issue. In addition, it is argued that, while the existence of gharar in the modern insurance contract is real and substantial, the existence of qimar is not founded.

In the sixth paper, Ranjit Singh and Sudeep Das argue that in 2010 the Bombay Stock Exchange embarked on India's first Shariah-compliant Islamic index known as the SHA 50. The study compares the performance of the SHA 50 and the Nifty 50. The data are retrieved from the official website of the Bombay Stock Exchange and the National Stock Exchange. The results show that the returns for the SHA 50 are not only higher, but are also less volatile than those of the Nifty 5o. However, when risk-adjusted returns are used by applying the Capital Asset Pricing Model, the Nifty 50 performs better than the SHA 50. Nonetheless, the Islamic index can be used to develop financial products that are acceptable to customers who avoid investing in the larger stock market due to religious principles.

In the seventh paper, Hela Miniaoui and Gaston Gohou examine the performance of the main Islamic financial institutions following the recent financial crisis. The study compares profitability and productivity measures using balance sheet data for 25 national banks of the United Arab Emirates (UAE). The performance gap between the conventional and Islamic banking systems is assessed using a compensating differential framework. The unconditional and conditional performance differences show that, unlike other Gulf Cooperation Council (GCC) countries, the conventional banking system typically performs better than the Islamic system in the UAE. However, after the crisis, Islamic banks close that difference for most performance measures.

In the final paper of this issue, Mohammad Selim finds a solution to reduce the inerest burden of trade financing among the Muslim countries. It is necessary to find an acceptable solution where all financial transactions including financing trade deficits should be conducted by eliminating interest component into it. As trade deficits continue to climb, the interest costs for financing huge growing deficits also continue to grow at a compounding rate. Selim finds a solution by pursuing and maintaining fully convertible domestic currency with its *k-1* trading partners where *k* is 57 OIC member countries, who will be willing to recognize one another's currencies for trade deficit financing, and agree on fully convertible domestic currencies without any spread. Such guarantee of full convertibility will be the cornerstone in paying for trade deficits by their own domestic currencies and therefore, it will eliminate interest costs burden. It will also increase the volume of trade, output, employment and prosperity for all *k* member countries involved in the group.

I hope that the readers will enjoy this issue of the journal.
Sincerely,

Professor Dr. M. Kabir Hassan, Editor
New Orleans and Philadelphia, USA
March 2013

***Reference:***

Al-Suwailem, Sami and M. Kabir Hassan (2011) "An Islamic Perspective of Financial Engineering", Chapter 18 in Islamic Capital Markets: Products and Strategies, ed. M. Kabir Hassan and Michael Mahlknecht, John Wiley and Sons, London, UK.