



METHODOLOGY ISSUES IN ISLAMIC FINANCE: THE
“BLACK SWAN” AND THE ZANN PERSPECTIVES

BY

ILDUS RAFIKOV

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ABSTRACT

The study explores the issues of methodology in Islamic finance from the perspectives of unforeseen random events, called “Black Swan,” and weak conjecture, referred to as *zann*. The thesis asserts that the methodology of modern Islamic finance, being a part of the conventional financial system, suffers from weak conjecture and, therefore, it puts the achievements and future development of the industry in danger of crises. Muslim economists and some industry professionals for decades have been warning about this inherent weakness of the present system, which this study confirms and highlights some issues within the methodological framework employed by many researchers and practitioners to advance the Islamic finance industry. The study employs a qualitative research of the discourse, analysing literature on methodology of economics and finance from the conventional and Islamic perspectives, reviews the present state of the financial industry, both conventional and Islamic, their weaknesses and reasons behind crises that have been plaguing the financial system with increasing frequency, and argues that if the Islamic finance industry continues to follow in the footsteps of the conventional finance, it may soon face “Black Swan” type negative large-scale events. Consequently, an alternative methodology based on a multidisciplinary approach is proposed. It promotes a collaborative framework for research and development based on existing methodologies of the *Shari’ah* and social sciences with the aid of guiding principles, designed to offer simpler, scalable, and sustainable solutions. The methodology was verified by a panel of experts in finance, *Shari’ah*, economics, law and business. Their reviews and analyses are then incorporated into a modified methodology, which argues for greater collaboration between various stakeholders, including experts in natural sciences and ICT, while the guiding principles are more precise. Hence, it is argued that by following the collaborative multidisciplinary methodology, Islamic finance can avoid large-scale “Black Swan” events, strengthen the real economy and enhance its position in the financial milieu.

مُلخَصُ البَحْثِ

يستكشف البحث قضايا المنهجية المالية الإسلامية الحديثة من حيث الأحداث العشوائية غير المتوقعة؛ المسماة "البجعة السوداء"، ومن حيث التخمين الضعيف المشار إليه بـ(الظن)؛ لتأكيد أن المنهجية المالية الإسلامية الحديثة - لأنها جزء من النظام المالي التقليدي - تعاني من الظن، ومن ثم؛ تُعَرِّضُ الإنجازات والتطوير المستقبلي للصناعة المالية لخطر الأزمات، وقد حذر الاقتصاديون المسلمون وبعض المتخصصين في الصناعة المالية منذ عقود من هذا الضعف المتأصل في النظام الحالي، وهذا ما يؤكد البحث، كما يُبيِّن بعض القضايا المنهجية التي استخدمها عدد من الباحثين والمهنيين لتطوير الصناعة المالية الإسلامية، ويوظف البحث المنهج النوعي بمراجعة الدراسات السابقة في موضوع منهجية الاقتصاد والتمويل من المنظورات التقليدية والإسلامية، ويستعرض حال الصناعة المالية الراهنة، التقليدية والإسلامية في آن معاً، ولا سيما نقاط ضعفها وأسباب الأزمات التي يعاني منها النظام المالي في تواتر متزايد، ويحتج الباحث بأن إذا استمرت صناعة المالية الإسلامية في السير على خطا التمويل التقليدي؛ فقد تُواجه قريباً أحداث "البجعة السوداء" على نطاق واسع؛ لذا يُقترح اتباع منهجية بديلة تستند إلى نهج كثير التخصصات، ويشجع الباحث وَضْعَ إطار تعاوني للبحث والتطوير بناءً على مناهج الشريعة والعلوم الاجتماعية، وبمساعدة المبادئ التوجيهية المصممة لتقديم حلول أيسر قابلية للتوسيع والاستدامة، وقد تحققت من المنهجية لجنة من الخبراء في المالية والشريعة والاقتصاد والقانون والأعمال، ثم دُمجت المراجعات والتحليلات الخاصة بها في منهجية معدلة تدعو إلى تعاون أكبر بين مختلف أصحاب المصلحة، بما في ذلك الخبراء في العلوم الطبيعية وتقنية المعلومات والاتصالات، بينما أصبحت المبادئ التوجيهية أكثر دقة، ومن ثم؛ يقال إنه من خلال اتباع النهج التعاوني كثير التخصصات؛ يُمكن للمالية الإسلامية تجنُّب أحداث "البجعة السوداء" الواقعة على نطاق واسع، وتعزيز الاقتصاد الحقيقي، وتعزيز مكانتها في الوسط المالي.

APPROVAL PAGE

The thesis of Ildus Rafikov has been approved by the following:

Mohamed Aslam Haneef
Supervisor

Aznan Hasan
Internal Examiner

Mohamad Akram Laldin
External Examiner

Adlina Binti Hj. Ariffin
Chairperson

DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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All praise is due to Allah, the Most Beneficent, the Most Merciful. He is All Knowing, the Wise and the Guide. Peace and blessings are to the Seal of the Prophets, Muhammad Ibn Abdullah. It is only with Allah's Permission and Blessings I was able to complete this thesis. I sincerely hope this to be counted as a humble effort to contribute to greater understanding of Islamic economics and finance from a multidisciplinary perspective.

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LIST OF ABBREVIATIONS

AAOIFI:	Accounting and Auditing Organization for Islamic Financial Institutions
CAPM:	Capital Asset Pricing Model
CIBAFI:	The General Council for Islamic Banks and Institutions
DCR:	Displaced Commercial Risk
EMH:	Efficient Market Hypothesis
FV:	Future Value
GCC:	Gulf Cooperation Council
GDP:	Gross Domestic Product
GNH:	Gross National Happiness (index)
GWP:	Gross World Product
IAH:	Investment Account Holder
IBF:	Islamic Banking and Finance
IBFIM:	Islamic Banking and Finance Institute Malaysia
ICIJ:	International Consortium of Investigative Journalists
IDB:	Islamic Development Banks
IE:	Islamic Economics
IF:	Islamic Finance
IFI:	Islamic Finance Industry
IFSB:	Islamic Financial Services Board
ISRA:	International Shariah Research Academy
IRTI:	Islamic Research and Training Institute
LIBOR:	London Inter-Bank Offered Rate
LPB:	Limited Purpose Banking
OECD:	Organization for Economic Cooperation and Development
OIC:	Organization of Islamic Cooperation
OPEC:	Organization of the Petroleum Exporting Countries
PBUH:	Peace Be Upon Him
PV:	Present Value
R&D:	Research and Development
SME:	Small and Medium Enterprise
SOP:	Standard Operating Procedure
TVM:	Time Value of Money
VaR:	Value at Risk

CHAPTER 1

1.1 INTRODUCTION

The Islamic banking and finance industry is experiencing a rapid growth and many multinational banks are jumping on the bandwagon. Media coverage is particularly favourable. Numerous international conferences have been taking place across the globe on regular basis where bankers, economists, politicians, religious leaders and legal professional are trying to find financial solutions to present economic problems taking into account the requirements of the *Shari'ah* and reconciling these requirements with contemporary law. There is, however, one very alarming tendency in the way this industry is being presented in the media, discussed in conferences and seminars, taught at universities and at professional courses, and that is overly optimistic and simplistic mainstream view of Islamic banking and finance.

On the one hand, it is very encouraging to see such a multitude of professionals of all sorts being interested in promoting Islamic banking and finance (IBF)¹, in practice as well as in academia. Every year, a plethora of books, articles and theses is being produced, speeches delivered, and specialized talks organized all over the world. Many of the works in this area are focused on certain technical issues, such as the *sukūk*, Islamic banking operations on both sides of the balance sheet and Islamic micro-finance instruments and practices, and recently, the “fintech” industry has been getting more attention. Indeed, despite its forty-year-old status, the field is still in its infancy and there are plenty of technical issues to write and talk about.

¹ The foregoing discussion will be more focused on Islamic banking and finance industry, but relevant concepts, ideas and methodologies of the broader Islamic economics field will also be presented.

On the other hand, there is a faint but growing voice of people on the other side of the fence, who are increasingly worried about the future of Islamic finance. Their voices are also quite diverse as some of them call this industry a fraud, while others are trying to point out certain problems, which threaten to become grave mistakes in the future, leading to crises resembling those that plague the conventional financial system. Also, in this category are scholars and academics who would want to see the convergence of Islamic finance (IF) and Islamic economics (IE), leading to an 'ideal' state of affairs promoted by early IE scholars.

Hence, members and voices of the first group, which could be called mainstream, tend to be optimistic, focused on current trends, technical challenges, and other issues pertaining to going forward. Thanks to the media, these voices are amplified and presented along with favourable journalistic analyses to a receptive audience. The second group, however, is more cautious and tends to comprise academics and professionals, who are able to question the status quo and come to less optimistic conclusions. Members of this group are able to analyse the issues independently and are not influenced by the mainstream views.

The picture above is normal for the development of any industry, as there always will be drivers with their followers, as well as doubters and "reality checkers". However, this thesis asserts that much of the research in the industry, both professional and academic oriented, has methodological problems that point to weak conjecture. Moreover, the existing financial instruments are vulnerable to "Black Swans," which could damage the whole industry.

The thesis is going to be constructed based on the concepts of *Zann* and the "Black Swan" with an aim of showing how uncertain suppositions or conjecture may lead to fallacious conclusions about a phenomenon, while rare but major events are

usually unexpected but rationalized afterwards. Both of these concepts could have significant effects not only on individuals, but possibly on entire societies and civilizations. Therefore, the industry of Islamic finance should also be wary of anything that could result in significant erosion of trust or even lead to its collapse and may be requiring a rescue package, like the Western banking industry was rescued after the 2008 global financial crisis.

Such a claim warrants a bit of explanation right from the start. As will be explained in more detail in subsequent chapters, IF research and application is mainly industry-oriented operating within the limits of the existing law. Innovation is expected to take place within the framework of *fiqh* (known contracts) and the prevailing contemporary legal system, often in conflict with the *Sharī'ah*. Hence, because of this limitation, objectivity suffers. Notwithstanding the fact that social sciences are based on value judgments and, therefore, tend to be more or less subjective, a methodology should be proposed that will ensure the minimization of uncertainty in research arguments, as well as more rigorous risk strategies based on expecting the unexpected.

In order to better understand the issue of conjecture and the effect of rare events, the thesis will seek guidance from the primary sources of Islam: the Qur'ān and the Hadīth, as well as some secondary sources.

1.1.1 *Zann*

When referring to conjecture, assumption or some uncertain knowledge, the Qur'ān uses the word *Zann*. Even though its meaning in the Holy Book is wide, in the majority of verses this word has a negative connotation. According to Kassis the word with the root of Z-N-N in the Qur'ān as a verb means “to suppose, to think (without certain knowledge), to deem, reckon, assume, surmise, suspect,” and as a noun it means “a

surmise, opinion, thought (without certain knowledge), suspicion, one who thinks evil thoughts, who surmises, who assumes.”² Meanwhile, Osama writes that the word *Zann* with the meaning of “conjectured, thought, believed” is mentioned twenty seven times in the Holy Book, and with the meaning of “guess, imagination, suspicion” is mentioned fifteen times.³ Interestingly, according to Kassis there are sixty nine entries for *Zann*,⁴ while only twenty eight for Y-Q-N (*yaqīn*, certainty, certain knowledge).⁵

Also, Prophet Muhammad (PBUH) condemned suspicion (*Zann*) in the following *hadīth* related by Abū Hurairah:

Beware of suspicion, for suspicion is the worst of false tales; and do not look for the others' faults and do not spy, and do not be jealous of one another, and do not desert (cut your relations with) one another, and do not hate one another; and O Allah's worshipers! Be brothers (as Allah has ordered you!)⁶

Edward William Lane (1874) gives the following translation of the word *Zann* into English:

...signifies thought, opinion, supposition, or conjecture; or preponderant belief, with the admission that the contrary may be the case; or a preponderating wavering between the two extremes in indecisive belief; an inference from a sign, or mark, or token; when strong leading to knowledge, and when weak not exceeding the limit of WAHM; doubt or uncertainty; sometimes put in place of or used in the sense of ‘ILM or YAQĪN (knowledge or certainty); also means suspicion, or evil opinion.⁷

Accordingly, this word’s usage and frequency in the Qur’ān signify its importance that weak assumptions lead to something unwanted or unexpected. Therefore, Muslim scholars, particularly in fields of science that have a strong effect on people’s lives,

² Hanna E. Kassis, *A Concordance of the Qur’an* (US: University of California Press, 1983), 1347-1349.

³ Syed Muhammad Osama, *The Encyclopaedic Index of the Quran* (India: Goodword Books, 2011), 189-192.

⁴ Hanna E. Kassis, *A Concordance*, 1347-1349.

⁵ *Ibid.*, 1309.

⁶ Saḥīḥ Al-Bukhārī, Volume 8, Book 73, no. 90.

⁷ Edward William Lane, *Arabic-English Lexicon* (Edinburgh: William and Norgate, 1874). Book I, part 5, 1925.

whether individually or collectively, must be aware of conjecture as opposed to certainty of knowledge.

What are the consequences of conjecture or weak assumption? When it comes to making important decisions, especially in human interactions at various levels, including business and finance, conjecture leads to bad decisions, which may bring about undesired and unwanted events. According to Taleb:

...our world is dominated by the extreme, the unknown, and the very improbable (improbable according our current knowledge) – and all the while we spend our time in small talk, focusing on the known, and the repeated... in spite of our progress and the growth in knowledge, or perhaps because of such progress and growth, the future will be increasingly less predictable, while both human nature and social “science” seem to conspire to hide the idea from us.⁸

1.1.2 “Black Swan”

“Black Swan” denotes an event that is rare in nature, carries an extreme impact, and low predictability. So, any event that has shaped the course of history may be called a “Black Swan”. We can place in this category such events as inventions, wars, crises, catastrophes and disasters. For example, the October 1973 Arab-Israeli war led to the oil embargo against the United States of America and other Western European states by the Arab OPEC members. As a result, the Gulf countries suddenly became awash with liquidity. Later, we witness the appearance of Islamic banks in the United Arab Emirates, followed by Kuwait, Egypt, Sudan, Jordan and Bahrain. Was the establishment of Islamic banks a direct result of that war and the embargo? One may certainly see the connection between the two.⁹ So, the war was a “Black Swan”.

⁸ Nassim Nicholas Taleb, *The Black Swan: The Impact of the Highly Improbable* (Great Britain: Penguin Books, Ltd., 2007), xxvii.

⁹ Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh: Edinburgh University Press, 2000), 74-80.

In connection with the “Black Swan” problem, we see the rise of “experts”, who are called by the media to provide analyses of critical events after the fact. Their analysis many a time makes one believe that the event could have been avoided if... Explanation of this “if” by experts is pure rhetoric. Taleb asserts that:

Our inability to predict in environments subjected to the Black Swan, coupled with a general lack of the awareness of this state of affairs, means that certain professionals, while believing they are experts, are in fact not. Based on their empirical record, they do not know more about their subject matter than the general population, but they are much better at narrating – or, worse, at smoking you with complicated mathematical models. They are also more likely to wear a tie.¹⁰

As the world becomes more and more complex, more and more interrelated, with an increasing number of variables and outcomes, it is becoming more difficult to keep scholarship true to its objectives. Despite an unprecedented access to information, the quality of analysis of human interactions is not increasing in quality at the same rate. Likewise, quality of decisions that affect humans’ daily lives are also deteriorating whereby the decision makers, whether in politics, finance, business or academia, base their choices on interest, personal or national, rather than on truth. Likewise, much of the research in various sciences is based on economic interests of the researchers rather than for the love of science or desire to attain the truth. It is, therefore, imperative to point out some of the philosophical problems in epistemology, analyse the current state of scholarship in Islamic banking and finance (it is important as far as the people’s welfare is concerned), and attempt at offering an alternative methodology in the study of this industry. Hence, the aim of this thesis is to point out weaknesses in methodology of Islamic banking and finance and offer alternative solutions with an emphasis on collaboration and multidisciplinary.

¹⁰ Nassim Nicholas Taleb, *The Black Swan...*, xx.

1.2 PROBLEM STATEMENT

Every scientific work stems from the scientist's background, worldview or paradigm. In other words, any scientific analysis, claiming to be positive in nature, actually works from within a normative framework. Many researchers in the field of Islamic finance employ a very narrow scope of research, which is quite technical in nature and thus cannot provide full picture of the whole industry and its real as well as imagined challenges. Often, such a view leads to a distorted image of Islamic finance, either too optimistic, whereby focusing on recent developments and introducing new seemingly practical solutions, or negative, whereby the very existence of Islamic banking and finance industry, or its main postulates, is severely questioned. What is missing in this body of research and of an array of practical solutions is an elaborate multidisciplinary methodology, which emphasizes not solely on technicalities and financial engineering, but on the possibility of building an Islamic financial system that is beyond resilient and robust. Hence, to better understand, analyse and propose better solutions, a more holistic approach to methodology of IF is necessary.

Thus, this thesis is aimed to demonstrate the consequences of weak assumptions (referred to as *Zann*) about the present state of the Islamic banking and finance and to call for greater rigour in formulating and following a multidisciplinary theoretical framework for the whole industry.

1.3 SIGNIFICANCE OF THE STUDY

The study is significant for the following reasons.

Firstly, rapid rise of the Islamic banking and finance industry is partly due to financial engineering in compliance with the *Sharī'ah*. However, such engineering is limited to legal, financial and *fiqhi* issues, and is usually done by the technique of

reverse engineering whereby the conventional financial instruments are dissected into smaller parts, analysed from the Islamic legal perspective and assembled back without the clearly forbidden elements, primarily the banking interest. The practitioners of IBF (bankers, *fiqh* scholars, lawyers, accountants) are certain that this is the correct way to practice Islamic banking and finance. However, Muslim economists believe this approach to be quite dangerous for the industry's future as it does not address the inherent problem of the present financial system, which is creation and sale of debt¹¹. The study suggests that it is due to weakness of methodology in the process of research and development of Islamic financial instruments, particularly from the risk perspective. Hence, enhancing the R&D methodology is essential for the industry's very survival.

Secondly, as the industry is rising, it gives rise to education that is specific to the Islamic finance. New institutions are being established and new courses are being introduced to the public for the advancement of the industry.¹² Yet, if the teaching methodology is restricted to technical and legal issues without considering the industry's link with other social sciences,¹³ it greatly diminishes the quality of discourse and as a result the present condition of the industry will remain the same. The thesis aims to suggest the significance of strengthening the foundation of the discipline by injecting it with the knowledge derived from various behavioural sciences, as well as

¹¹ For example, see writings by Ahamed Kameel Mydin Meera, Abbas Mirakhor and Saiful Azhar Rosly. More discussion in chapter 3.

¹² For example, Malaysia boasts the most number of educational institutions offering Islamic finance courses. They are: International Islamic University Malaysia (IIUM), International Centre for Education in Islamic Finance (INCEIF), University Utara Malaysia (UUM), Islamic Banking and Finance Institute Malaysia (IBFIM), University Sultan Zainal Abidin (UNISZA), University Sains Islam Malaysia (USIM), University Malaysia Sabah, University Malaysia Kelantan, UCSI, LimKokWing University, Asia Pacific University, International University of Malaysia-Wales.

¹³ The majority of Islamic banking and finance courses offered in the Malaysian universities are under departments of economics, management, business administration or as standalone institutes. The courses are highly specialized, have no links with behavioural sciences and taught by faculty who specialize in economics, finance, law, or *fiqh*.

philosophy of knowledge and logic. Also, the scope of the present risk management in Islamic finance may have to be re-examined for the system to be able to anticipate the unexpected.

Thirdly, the study aims to challenge the status quo of the Islamic financial system as part and parcel of the conventional one. Even though the IBF industry claims to be different, it, nevertheless, draws its pool of expert knowledge from the same Anglo-Saxon financial industry that is responsible for dozens of banking crises in the last one hundred years. Consequently, the Islamic finance is influenced by the worldview, which is outside of the realm of Islam. It is therefore suggested that continuing with the same problematic paradigm may result in unwanted systemic effects for the whole Islamic banking and finance industry.

1.4 RESEARCH QUESTIONS

The present thesis aims to answer the following questions:

1. What is the historical and theoretical background of the economic thought and how it shaped the financial industry?
2. How did Islamic finance evolve over the years and what relationship does it have with conventional finance?
3. What are the issues and challenges facing the Islamic finance industry?
4. How can we apply the concepts of the “Black Swan” and Zann to the analysis of the current Islamic finance industry?
5. How to build a methodology of Islamic finance that will help propel the industry beyond resilience and robustness?