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Islamic Finance at Crossroads

Mabid Al-Jarhi*

Abstract: After more than 40 years of practice, the Islamic finance industry is composed of products with claim of Islamicity but questionable on their Shariʿah credentials. The industry is increasingly exposed to cynicism and decline in popular interest. This paper restates the essence of riba prohibition from an economic perspective. It evaluates the Shariʿah scholars approach to validation of contracts as well as the monetary authorities' attitude towards the Shariʿah content of Islamic finance transactions. It points out the advantages of Islamic finance within an Islamic macroeconomic environment. It looks into the problem of convergence of Islamic finance to conventional finance, and reasons behind the convergence. This study finds that several violations of the true paradigm of Islamic finance are because of its advantages being all external and impossible to internalize. The paper concludes with some proposals for checking the convergence.

Keywords: The Shariʿah, Islamic finance, conventional finance, IBFIs (Islamic banking and finance institutions), CBFIs (conventional banking and financial institutions), riba, interest rate, real and nominal transactions, Islamic finance regulation.

Abstrak: Setelah lebih daripada 40 tahun, industri Kewangan Islam terdiri daripada produk yang mengaku keislaman namun masih boleh dipersoalkan dari segi kepatuhan Shariʿah. Industri ini semakin terdedah kepada pandangan sinis dan minat umum yang mungkin merosot. Kertas kerja ini menyatakan semula intisari pengharaman riba dari perspektif ekonomi. Ia menilai pendekatan ilmuwan Shariʿah dalam pengesahan akad, dan juga sikap penguatkuasa monetari terhadap kandungan Shariʿah dalam transaksi Kewangan Islam. Ia mengetengahkan kelebihan Kewangan Islam dalam

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persekitaran makroekonomi Islam. Ia melihat kepada masalah penumpuan dalam Kewangan Islam kepada kewangan konvensional, dan sebab-sebab di sebalik penumpuan itu. Kajian ini mendapati beberapa pelanggaran terhadap paradigma sebenar Kewangan Islam adalah kerana kelebihannya- kesemuanya luaran- dan agak sukar/mustahil untuk dihayati secara dalaman. Kertas kerja ini menyimpulkan bersama beberapa cadangan untuk menyemak penumpuan itu.

Kata Kunci: Shariʿah, Kewangan Islam, kewangan konvensional, IBFIs (Perbankan Islam dan institusi kewangan), CBFIs (perbankan konvensional dan institusi kewangan), riba, kadar faedah, transaksi sebenar dan nominal, peraturan kewangan Islam.

1. Introduction

After more than 40 years of practice, the Islamic finance industry is largely composed of products that have a camouflage of Islamic form but lack the Shariʿah validity of purpose. The increasing tendency to mimic conventional finance is seriously threatening the industry with growing cynicism and popular decline in interest. This paper restates the essence of riba prohibition from an economic perspective along with how popular monetary theory looks at a positive rate of interest with disfavor (section 2). It takes note of some factors that played a critical role in the evolution of Islamic finance, i.e. the general approach on the Shariʿah side, the Shariʿah validation of transactions and the attitude of monetary authorities towards the Shariʿah content of Islamic finance transactions (section 3). It reviews the macroeconomic advantages of Islamic finance within an Islamic macroeconomic environment (section 4), and seeks to explain why, despite the said advantages, managers of Islamic banking and finance institutions mimic conventional products leading to the convergence of Islamic finance to conventional finance, and puts some evidence on record in this regard (sections 5). Reasons are recorded as to why the dream of Islamic finance is fading away, in particular, roles of bankers and the Shariʿah boards and the Shariʿah governance matters (section 6). Last but not least, attention is drawn to some other challenges that confront Islamic finance, namely, Islamic subsidiaries of conventional banks, sukuks (Islamic securities), company classification and role of monetary authorities (section 7). The paper ends with some proposals for arresting the trend toward convergence (section 8). The main finding of this study is that IBFIs violate the true

paradigm of Islamic finance because of their inability to internalize its various advantages, and, in the absence of some urgent remedial action, the risk of total convergence to conventional finance is real.

2. Economic meaning of the prohibition of riba

Muslims struggled with the meaning and the implications of the prohibition of riba in the 2nd half of the last century. The Islamic awakening dawned during this period while all Muslim countries had interest-based monetary and financial systems, established through contact with the West. In particular, most of the newly independent Muslim countries inherited commercial banking system that prevailed in Anglo-Saxon countries. Even those colonized by countries with universal banking, like North African countries and Indonesia colonized by France and the Netherlands, respectively, opted for commercial banking.

During the early 1950s, economists struggled with how to introduce money into the theory of value, as the theory at the time did not have anything that would allow for a medium of exchange. It was, therefore, understandable that the Muslim world did not ask the right questions with regard to the prohibition of riba, as economists did not have any clue about it.

The debate among Muslim scholars during the said period focused on whether or not "interest" was riba. The majority deemed riba as a sort of benefit accruing to the lender from providing a loan. This conforms to the Textual prohibition of riba – any loan that brings benefit to the lender is riba. Hindsight suggests that perhaps Islamic scholars asked the wrong question at the wrong time. Being interested in establishing Islamic finance, the right question to ask would have been what the prohibition of riba meant, not whether riba was interest or not. After forty years of Islamic finance, we return to the fundamental question: what does it mean to prohibit riba?

Friedman (1969) observes that a positive rate of interest causes people to economize on the use of money in transactions in order to increase interest earnings. To do so, they substitute real resources for money in transactions. An illustration would be if a supermarket were to be faced with an increase in interest rates, it would attempt to collect cash faster from its tellers and rush it more often to the bank, using

more labor (people who collect cash as well as security guards) and capital (armored cars). Obviously, the withdrawal of real resources from production to transactions reduces total output and efficiency.

Friedman's theory of the optimal supply of money attempts to avoid such inefficient behavior by deflating the economy at a rate equal to the real rate of interest, in order to bring the nominal rate of interest down to zero. This appeared to be a clever solution indeed, especially since it contained no institutional changes in the contemporary market economy. The interest-based monetary and financial sector continues to operate, but with a zero nominal rate of interest.

However, this solution brought in a bombardment of articles that indicated serious difficulties in adopting Friedman's optimal monetary policy rule. A zero-bound interest rate is something that is yet to find any workable policy (Ullersma, 2002). Our major objection is that a policy rule that puts the economy on a deflationary path, would result in a variety of inefficiencies due to deflation. That, of course, would not be acceptable prima facie.

This is where Islamic finance comes into the picture with its institutional changes. We can use the model of Al-Jarhi (1981) to outline such changes. According to Al-Jarhi's model, the proposed institutional change replaces the lending basis for creating money with productivity basis. In particular, the central bank stops lending money created by it to the government for covering the budgetary deficit. Instead, the central bank regains its exclusive right to issue money through total reserves, and places all newly issued money in investment accounts with its member banks. In addition, the classical loan contract is replaced by many an investment and finance contracts.

Friedman's optimal monetary policy rule raises two often missed points. Firstly, the interest-based monetary system cannot be efficient, because a zero-interest rate would be a necessary and sufficient condition for its efficiency. Since Friedman's rule brings up more questions than it answers, the system must be restructured in order to avoid trading present for future money. Secondly, it casts doubt on those in Islamic economics, who contend that Islamic finance may work through benevolent (interest-free) loans.

The real issue here is that the meaning of the prohibition of riba is essentially the prohibition of trading present for future money at a

premium, which is called the rate of interest. The prohibition of riba, therefore, calls for a radical institutional change, i.e. a reform of the prevailing system. However, that may only be the first step. A deeper understanding of the prohibition of riba reveals that the real culprit in the system is what we call nominal transactions.

Nominal transactions have nominal (monetary) counter values. One example of a nominal transaction is when spot money is traded against future money. This is a case of debt trade. Another example is when the price of a gamble is paid as present money against the payoff of the gamble which is usually paid in the future. This happens in the case of derivatives, including futures and swaps.

It is also clear when both counter values are deferred, market authorities set safeguards to ensure that both parties to the gamble pay their obligations. Such transactions are carried out in the financial sector, with effects on the real sector that depend on the resulting wealth redistribution between winners and losers of zero-sum games. Whether nominal transactions are carried out in an organized financial market or in a gambling casino, their ultimate results are distributional for the gambling parties. Winners spend more on commodities as well as gambling games. Losers curtail their spending.

The macroeconomic effects of nominal transactions take two forms. In the first form, the growth in the volume of nominal transactions is likely to encourage investments in the gambling industries and associated services. More investment may also be directed toward accounting, clearing mechanisms, strategic trading mechanisms and enforcement mechanisms usually associated with this type of transactions. In the second form, the redistribution of wealth has effects on the consumption pattern in the economy, and motivate reallocation of resources that caters to the tastes and preferences of the social group that gains wealth against the rest of the society.

What is important is that trading present for future money is always done through nominal transactions. Whether a debt instrument or a pure risk (associated with some gamble) is traded in the financial market, the related transaction has two nominal counter values, one on each side.

We can, therefore, interpret the prohibition of riba from the economic perspective as the prohibition of trading present nominal (monetary) values against future nominal (monetary) values. This is equivalent to

the prohibition of all nominal transactions, which would encompass both debt and risk trading.

Real transactions, on the other hand, have only one nominal or monetary counter value, while the other is always a commodity. Such transactions provide important indicators for the allocation of resources. In economy where only real transactions are allowed, an increase in the rate of monetary expansion passes its effects exclusively through the real sector. Real transactions become the chariot of the transmission mechanism from the changes in money supply to commodity markets directly. Such markets move to a new equilibrium quickly.

When the supply of money increases, financing increases. In Islamic finance, finance is provided only through real transactions, which would have direct bearing on the real sector. Both supply and demand sides get financed. The speeds of adjustments of quantity and price are balanced in a way that inflation can occur only when full employment output is exceeded. In contrast, conventional finance has only a remote relationship with the real sector. Its immediate effect is on the demand side. Speed of price adjustment is higher while speed of quantity adjustments lags behind. Inflation is the ultimate result, even when the economy is below full employment.

Nominal transactions on the other hand do not carry the transmission mechanism of changes in the money supply to the commodity markets. They represent something like a leakage from the system that reduces the speed of adjustments in the commodity markets.

We can therefore summarize that the prohibition of riba is tantamount to the prohibition of nominal transactions, which includes the trading of spot against future monetary values in addition to all transactions related to risk trading.

3. Critical factors in the evolution of Islamic finance

Three things have played defining role in the evolution of Islamic finance: general approach on the Shariʿah side, the Shariʿah validation of transactions and the role of monetary authorities.

3.1 The general approach on the Shariʿah side

The Qur'an tells the story of some of the early Israelites, when they were tested by God who prohibited them from working on Saturdays

(*Sabt* or Sabbath). On weekdays, fish went completely absent from the seashores. On Saturdays, fish came in flocks. The command of God, not to work on Saturdays, meant that fishing was made impossible. They chose to develop a clever ruse by which they could fish on Saturdays without appearing to do any work at all. They dug holes next to the seashore on Fridays. When the tide carried the fish to the shore on Saturday, it fell into the holes they had dug. God condemned them in the Qur'an (2: 65) for doing so, because the ruse they developed implied an indirect violation of the Saturday prohibition as well as an attempt to deceive the Almighty God, who is by nature undeceivable.

This is a lesson for Muslims. To adhere to the prohibition of riba, Muslims must avoid transactions that lead directly or indirectly to nominal transactions. Indeed, members of the Shariʿah boards of Islamic banks developed several ingenious ruses that construct transactions that appear formally adherent to the prohibition of riba, but ultimately lead to some type of nominal transactions. They use artificial sale contracts that are not intended to transfer titles of commodities to trading parties, but only a stepping stone to trade one nominal value for another. Such ruses are obviously equivalent to fishing on Saturday by the ancient Jews.

One type of ruse is *'enah* sale, where a purchaser of present money buys some commodity in which he/she is not interested, on credit. Then he/she sells it back to the seller against spot payment. Apparently, the provider of money carries out a purchase followed by a sale of some commodity. In reality, however, the ultimate result is trading present money for future money.

Another type of ruse is more sophisticated, because in contrast to the person committing *'enah*, the trader does not sell the commodity bought on credit to its original seller but, he/she sells it to a third party. This is called *tawarruq*. It ultimately leads to the sale of present money for future money. A third type is practiced through international *murabaha*, which is a sort of reverse *tawarruq*. The person who wants to "lend" money in return for a premium, uses funds to buy commodities, usually in a metal exchange, and sell the same commodities against future payment, which would exceed the present value. Neither buyers nor sellers in this case take delivery of the goods involved. The transaction of international *Murabaha* becomes a camouflage of interest-based loan.

3.2 The Shariʿah validation of transactions

The children of Prophet Jacob had their own clerics who were designed and implemented ruses for them. So do the Muslims of today. Although we know that Islam has no clergy since it assigns no holiness or infallibility to anyone except the Prophets, our Islamic Shariʿah scholars have acquired a de facto right of the interpretation of the Holy Texts. They have developed a discipline under the title of "Fiqh," meaning scholarly understanding, that is claimed to provide authentic interpretations of the narrations of the Prophet's sayings and deeds. They use the authenticated narrations, together with the relevant Qur'anic verses, as evidence from which to draw Shariʿah rules, according to a well-defined methodology. The Shariʿah scholars have never explicitly claimed that they are clergy, and they also do not act like one. However, through time, they established schools of thought and had followers who revered them immensely. Their Fiqh heritage is a substantial wealth of rigorous intellectual effort that justifies their claim to intellectual authority, at least by specialization, in the Shariʿah matters.

Of special interest in this context is their methodology for validating transactions. The general rules they apply are of great value, which can be summarized as follows:

1. In principle, everything is permissible, unless there is a Divine Text or evidence that makes it impermissible;
2. What ultimately leads to impermissibility must be impermissible;
3. Harm, *gharar* (gambling), *ghabn* (deceit) and riba render transactions invalid;
4. Every transaction contract, e.g., sale, collateral or guarantee, has its own conditions for its validity of form;
5. Ultimate consequences are the guide to the validity of purpose. They must be judged against the five general objectives of the Shariʿah, namely protection of faith, life, lineage/progeny, intellect and property/wealth.

The methodology of Shariʿah scholars does not seem to be faulty. On the contrary, it involves a great deal of intellectual discipline. However, it must be applied consistently. The Shariʿah scholars generally do apply such methodology with sufficient consistency. But, ruses in Islamic finance mentioned above are not acceptable for the majority of the

Shariʿah scholars, other than a very small minority who are members of the various Shariʿah boards. The majority of the Shariʿah scholars are mostly academic.

The Shariʿah board members seem to hold opinions that differ from what is accepted by the majority outside their membership. A sympathetic understanding reveals the following:

1. They fall under the pressure of the top echelon in IBFIs.
2. They consider the Islamic finance industry as an infant industry which requires facilitation and magnanimity rather than tough restrictions.
3. In the said spirit, they provide the industry with licenses that would not usually be acceptable in ordinary circumstances. Perhaps such licenses should be provisional, until the industry comes of age.
4. The said licenses are, however, not temporary. They seem to assume the status of permanent rules. They are usually issued with no time limit, to be modified as the industry develops.

Officials in IBFIs have been originally trained in the conventional (commercial banking) school. They find Islamic finance procedures to be more laborious and costly than the direct and simple use of the classical loan contract. While they would be willing to accept any claim of the macroeconomic benefits of Islamic banking properly applied, they would recognize only such benefits that have direct bearing on their financial statements. Since most of such benefits are far removed from their financial statements, they prefer to focus on maximizing their profit. Their pressure on the Shariʿah boards is merely to provide patterns of transactions that mimic the classical loan contract, in order to cut costs and maximize profits.

Conventional banking has gained a reputation, perhaps undeservingly, that the industry leans on safety, even though profits would be low. Getting a margin between lending and borrowing interest rates would do if the volume of transactions is sufficiently large. Business risks are shunned, and information asymmetry is addressed with the use of collateral. Islamic finance meanwhile immerses itself in business risk, handling the lemon problem with feasibility studies and financial analysis, and information asymmetry with product structuring

and governance. While this can be understood, at least partially, by universal banks, it appears as a remote practice for commercial bankers. Therefore, shunning Islamic finance and mimicking conventional finance is based on an illusionary perception that the latter has a bigger promise of profit with less risk.

Theoretically, the Shariʿah boards in IBFIs are independent and cannot be pressurized. However, transactions and contracts requiring approval are usually presented to the Shariʿah board meetings by one of the senior bankers, usually the CEO or the head of investment or treasury department. Presentation involves discussions and persuasion. The dialectics between the leadership in Islamic banks and finance institutions and the Shariʿah-board members result in a strong push to mimic conventional financial products. This is only a rational choice, not motivated by any ill feeling towards Islamic finance.

3.3 Monetary authorities and Islamic finance

In conventional finance, monetary policy tools include direct instruments, like fixing profit rates on Islamic finance contracts in a fashion similar to fixing the rate of interest. While the rate of interest is a price administered by the central bank, the rates of profit on Islamic finance contracts should be market determined. Administering them would be contrary to the Shariʿah rule. Central banks in mixed conventional and Islamic finance systems lack the monetary policy tool for Islamic banking that can play the same role as government debt.

We have proposed in other places that the central bank issue central deposit certificates (CDCs) whose proceeds would be placed in investment accounts with banks, in addition to placing some of the money supply, in proportion to the Islamic finance market share, in investment accounts. Monetary policy would be conducted through open market operations in CDCs. The rate of return on CDCs would be market determined in contrast to the rate of interest. This issue becomes even more critical in countries like Iran and Sudan that claim to have totally Islamic financial systems.

In Iran, the central bank takes more liberty in issuing rules that could run contrary to the formal validity of Islamic finance contracts, e.g., fixing the profit rates of *modarabah* or *murabaha*. According to the central bank of Iran, direct monetary policy tools include setting

minimum and maximum banks profit rates on any of the Islamic finance contracts, in addition to setting credit ceilings. This means that Islamic banks in Iran are ultimately forced to violate the rules of Shariʽah (CBIRI, 2017).

The central bank of Sudan issues Government Investment Certificates (GICs), which are long term *Ijarah Sukuk* involving payment of rentals by the government for durable assets it sells to a Special Purpose Vehicle (SPV) which then leases them back to the government, while issuing *sukuk*. The structure of the GICs raises serious Shariʽah issues. In addition, they are not designed as a monetary policy tool, but rather to absorb excess liquidity from Islamic banks (Khatat, 2016).

In some other Muslim countries, like Bahrain and Malaysia, the central bank takes a positive interest in facilitating Islamic finance. They have adopted ambitious targets for its growth and development. However, their national Shariʽah Boards behave in ways similar to individual Shariʽah Boards in Islamic banks, in allowing for products that mimic conventional finance. This has not yet caused any worries to the central banks.

Generally, central banks are careful about maintaining the financial stability of Islamic banks. Yet, they do not have explicit policy to keep Islamic finance Shariʽah-compliant, and they leave it entirely up to the Shariʽah Boards of the respective Islamic financial institutions.

4. Advantages of Islamic finance

In this section, we annotate the basic advantages of Islamic finance. This section draws upon Al-Jarhi (2004). The advantages highlighted include (i) efficiency, (ii) stability, (iii) dealing with information asymmetry risks, (iv) financing economic development, (v) systemic integrity, (vi) promoting equity, (vii) sustainability and (viii) providing a basis for international monetary and financial reform.

i. Efficiency

Samuelson (1958) and Friedman (1969) have shown that a positive interest rate leads to macroeconomic inefficiency. In a conventional economy, a zero-interest rate has been shown to be a necessary and sufficient condition for efficiency under a variety of assumptions (Chari et al., 1996; Cole & Kocherlakota, 1998; Wilson,1979).

Inefficiency stems from substitution of real resources for money in transactions, in order to allow money holders to increase their interest earnings. In Islamic finance, money is placed with banks, based on profit and loss sharing (PLS) or *modarabah*. Neither the principal nor the return on such investment accounts is guaranteed. Investment balances change only in response to changes in the fundamentals.

The rate of return on *modarabah* accounts itself is neither predetermined nor certain. While the rate of interest is administered by the central bank, return on *modarabah* is market determined. Expectations about such a stochastic variable would be subject to differences of opinions. Consequently, the incentive to substitute real resources for money in transactions in response to expectations would be unlikely. Since the rate of return on CDCs replaces the rate of interest as an anchor to monetary policy, even if expectations are unanimous regarding its rise, the central bank would automatically increase the money supply which would compensate for any tendency to substitute real resources for money (Al-Jarhi, 2017).

While money is created and allocated in a conventional economic system based on lending criteria, in Islamic finance (Al-Jarhi, 1981) money created by the monetary authority is placed in investment accounts held by the central bank with other banks. The classical loan contract is replaced by one or more of the many Islamic investment and finance contracts. While the single classical loan contract has its intrinsic risks related to information asymmetry, Islamic finance contracts can be mixed and matched to rid the financing process from such risks. Extra risks impose on the system lower efficiency due to extra risk-mitigating costs. The Islamic system has relatively more effective risk-mitigating means through mixing and matching of financial contracts to avoid extra risks and their costs. Such means of risk mitigation are not available to conventional finance.

Another factor influencing efficiency is how financial resources are allocated among different uses. In partnership finance, Islamic finance allocates financial resources based on feasibility. In the case of sale finance of both investment and consumption goods, competition among fund users will eventually equate the cost of finance—the markup on *Murabaha*, the profit margin on *Bai Bithaman Ajil*, the rental rate, the price differential in *Istisna'* and *Salam*—with the marginal value

in use (drawn from consumption or investment). This ensures that financial resources are allocated efficiently. On the other hand, being an administered price, role of the rate of interest in resource allocation would not lead to efficiency.

ii. Stability

By virtue of the fact that liability side of the balance sheets of all IBFIs are based on PLS, the risks associated with its assets are shared with investment account holders. This makes the possibility of a bank failure much more remote than in the case of conventional banks and financial institutions (CBFIs). Therefore, bank stability would improve with the application of Islamic finance.

Meanwhile, as explained above, the prohibition of riba in itself rules out debt and risk trading. Financial markets in an Islamic economic system would not include integrated debt markets or derivatives. No allocation, therefore, would be set aside for hot money to enter/exit at will in/out of the macro economy. An important source of macroeconomic instability and contagion is thus removed.

Some Islamic finance contracts lead to creation of debt. However, debt is not traded. This results in a fragmented debt market, where it is not possible to purchase debt instruments or speculate on their prices. This stands in contrast with conventional finance where debt, in the form of bonds, is traded in an integrated debt market with gates wide open to the entry and exit of hot money.

Another stability feature of Islamic finance is that every finance transaction involves a commodity in the real sector. The act of financing is not usually to provide cash to the fund user. Customarily, finance through partnership in profit provides for the injection of cash. Finance through partnership in product provides resources in kind, like fertilizers, seeds, trees and workmanship. Sale finance provides commodities in return for payments. Only *modarabah* and *wakala* involve the transfer of cash to fund users. We have proposed elsewhere certain procedures to avoid moral hazard in these cases (Al-Jarhi, 2014), in addition to using both of these contracts in conjunction with *musharakah*—joint partnership. The strong connection between finance operations and commodities prevents the movement of financial resources independently in order to leak into debt and risk trading. This provides an additional source of stability to the system.

iii. Dealing with information asymmetry risks

It is generally known that debt finance through the use of the classical loan contract suffers from information asymmetry. This subjects the financing process to intrinsic risks of adverse selection and moral hazard. In order to rid finance from such risks, it is necessary for lenders to monitor the borrowers. Monitoring is a costly process that requires continuous collection of information and evaluation. Conventional commercial banks have no alternative to monitoring. It can be done in cases of large-scale financing deals, where project finance is monitored through disbursement of the loan spread over stages, and not released unless consultants provide signed proof at every stage of completion.

Universal banks have a lower-cost alternative, i.e. providing joint equity and debt finance to the same customer. Equity finance affords a universal bank a share in management. This provides a free and a continuous flow of information about the progress of the fund user in using the funds provided to him. Additional debt finance may be provided without the need for extra monitoring. The experience of universal banking shows that equity finance, when properly used, provides sufficient monitoring to render the additional debt finance free from information asymmetry.

Islamic banks meanwhile have many finance contracts available to them. Some of these contracts are free from information asymmetry, and some are not. Of these, *modarabah*, *wakala* and *salam* contract are subject to information asymmetry. The rest of the available contracts—sale finance and partnerships in profits and output, to name a few—enjoy information symmetry. Islamic banks can mix and match the various contracts in order to insure symmetry of information between fund providers and users. This means that when Islamic banking is practiced by bankers and supervised by regulators who understand the consequences of information asymmetry, the risks of adverse selection and moral hazard may be significantly avoided.

There are, however, some obstacles in establishing the said practice. First, central banks have been accustomed to viewing *musharakah* or equity finance with apprehension. As a supervisory and regulatory authority, they assign heavy risk weights to equity finance. In addition, Islamic bankers, having had their initial education and experience in the commercial banking school, where universal banking is almost unheard

of within the banking environment, share with their regulators a similar apprehension about equity finance. Therefore, in order for Islamic finance to make use of this advantage, both regulators and bankers must reevaluate their mistaken apprehensions regarding partnership finance. In addition, both *musharakah* and *modarabah* require rehabilitation, in order to place additional safeguards in favor of fund providers (Al-Jarhi, 2016). This may go a long way in making such finance modes more popular.

iv. Financing economic development

Islamic finance is equipped to play an economic role in promoting economic growth and employment. The tools available in this regard range from partnership finance (in both profit and product) to the finance for acquiring assets. The financing of either supply alone or demand and supply simultaneously has its positive effects.

Finance through partnership in both product and profit is done on the basis of economic feasibility. The ability to pay plays a relatively lesser role than it does in conventional finance. All types of partnership finance directly influence supply. It provides more goods and services while increasing the incomes of the owners of factors of production. We can therefore argue that partner finance expands output, employment and growth.

Lease and sale finance is ideal facilitating the acquisition or the manufacture of investment goods (*Istisna'*). The assets involved can serve as collateral, which makes it easier to obtain credit by providing a self-mitigating mechanism for the financial risk. The ability to create new investment goods through *Istisna'* is a powerful tool in the same field. Therefore, we can agree that lease and sale finance reinforce the favorable effects of partnership finance on output, growth and employment. *Wakala* finance or investment agency, when properly carried out through feasibility studies and sufficient safeguards, can also prompt more output, growth and employment (Al-Jarhi, 2016). In view of these factors, a developing economy is expected to find Islamic finance working in its favor by promoting economic development in the most direct fashion.

In passing, it is worth mentioning that IBFIs will maintain minimal ethical standards in their investments. Therefore, due to the nature of the

Shariʿah rules, finance will stay away from investments in prohibited things and activities harmful for the environment.

v. Systemic integrity

In conventional finance, owners of funds leave financial risks banks, as they provide their funds in the form of loans with the banks guaranteeing the principal and interest. The banks, in turn, take risks only on collateral and shift the rest of the risk to the borrowers. Financial transactions themselves do not involve commodities most of the time. Financing is provided on the basis of the ability to pay, supported by suitable collateral.

A significant part of the financial operations conducted by CBFIs goes to finance transactions in the financial markets that have little to do with the real sector, e.g., financing trading in debt and derivatives. This means that the finance and real sectors are not strongly bonded together. Each sector has its own fundamentals. In particular, the finance sector can grow astronomically in a way that cannot be matched by the real sector.

An Islamic economic system would be effectively tied together through the internal risk sharing among all agents and sectors in the economy. People place their funds in banks on the basis of PLS. A good part of financial resources is allocated directly on risk-sharing implicit in partnership finance. The rest that is provided in the form of sale finance involving various degrees of risk sharing among fund users and the IBFIs. In addition, financial transactions involve and must pass through the real sector, wielding a strong tie between the financial and the real sector.

Institutional integrity is important. Financial transactions that fall into debt and risk trasfer leak out of the real sector. Adjustments in commodity markets in reaction to changes in the money supply place more pressure on demand and price adjustment. The speeds of adjustment in the real sector becomes lower than they would have been if all financial transactions were tied to the real sector. In other words, conventional finance has some negative effects on the market mechanism. In Islamic finance, systemic integrity leads to a better and stronger market mechanism. It inhibits the ability of the financial sector to dwarf the real sector. This has significant implications for stability and policy.

vi. Role in establishing equity

IBFIs have three roles to play in establishing equity and reducing poverty in an economy. The first starts with the bank itself. As Islamic banks have strict Shariʿah rules to follow, they may make mistakes that would render some financial operations Shariʿah non-compliant. The resulting profit from such operations are considered as unlawful income which must be given to charity. In addition, it is mandatory that IBFIs set aside zakah (obligatory charity) proceeds on theiry shareholders' funds. Investment-account holders can also pay zakah on their accounts to the respective bank if they wish to do so. The charity fund is usually used to provide financial assistance under the supervision of the respective Shariʿah board. Poverty eradication may, however, be most effective if Islamic banks use their zakah and charity funds to establish micro projects whose titles are transferred to the poor.

As for the second role, IBFIs can organize the collection of zakah payments by the public with the respective IBFIs being custodians of the zakah proceeds. The proceeds may be used to establish micro projects for the poor, as noted above. The community can supply the relevant IBFIs with a list of the deserving poor in their area.

The third role can be performed by IBFIs by consciously providing partnership finance with weight assigned to feasibility of carefully evaluated projects, with economic standing of the finance user not playing a dominant role in the provision of finance. This provides the poor a better chance to obtain finance. In providing sale finance, IBFIs may also use the assets acquired as collateral whenever possible and schedule repayments in ways that suit the cash flows of their customers, in order to enable the poor to acquire productive assets.

vii. Sustainability

Market economies have shown that they are prone to crises. In the latest international financial crisis (2007-2012) the United States and Europe faced an imminent possibility of total failure of their financial system. A disproportionate number of borrowers became unable to meet their payments. Some banks collapsed and many others approached a precipice. The main source of the crises was the systemic problems that manifested themselves in financial markets turning into gambling casinos, thanks to debt and risk trading. Some rules for relaxed in order

to protect the system from disintegration. The US and Europe dished out astronomical sums of money at the expense of taxpayers in order to bailout CBFIs and prevent a run on banks.

Had a similar crisis taken place in a hypothetical Islamic economic system, the financial market would not have been the source of trouble. Nonetheless, such an economy may face a crisis at the same scale, e.g., due to a natural disaster like an earthquake or a big failure of crops. But even in such cases, the response would be totally different. The first and foremost attention would be directed to debtors who cannot meet their obligation because of temporary insolvency. In such an economy, insolvent debtors would be provided free rescheduling. Those who become significantly poor would receive charity assistance to meet their basic needs. The government my shoulder only the cost of rescheduling. IBFIs will continue to receive payments albeit at a slower pace. In addition, the central bank may add to the money supply through augmenting its investment deposits with banks. In the end, banks will stay afloat; they will also continue the same level of their investment finance. People will continue their purchases, so that aggregate demand would not fall. The possibility of a recession will be remote. The crisis would pass more easily and quickly, because it is not caused by systemic deficiencies. We can, therefore, say that Islamic finance is sustainable, meaning it has no institutional features that cause it to be crises prone.

viii. A blueprint for international monetary & financial reform

Islamic finance presents a revolutionary formula for reforming market economies. Its agenda includes the following items:

1. Replacement of the classical loan contract by many an Islamic finance contracts;
2. Government-owned central bank having the exclusive monopoly of issuing money;
3. Placement of all issued money PLS investment accounts with banks;
4. Issuance of central investment certificates by the central bank that may be held by banks and the public, tradeable in open market as interbank and serve as monetary policy instruments;
5. Abolition of debt-trading as well as all risk-trading contracts in financial markets; and

6. Granting the debtors free rescheduling in case of temporary illiquidity, but penalizing them in case of delinquency.

The Islamic finance industry could have been an example for the whole world, provided the Islamic finance paradigm was applied to the letter. Now it is rather difficult to convince the world that Islamic finance works, when the Islamic finance industry itself has been converging to conventional finance.

5. Convergence to conventional finance

Until the 1990s, few researchers/scholars expressed serious concern about the possibility of Islamic finance converging to conventional finance. The onset of this century, however, witnessed widespread use of shady Islamic financial products that employ sale contracts artificially in order to provide formal validity to those products. Concern for the validity of purpose of such products gradually fizzled out, and little is usually done to ascertain compliance with the objectives of the Shariʿah.

Artificial sale contracts have been used in Islamic finance to shroud products like *ʻenah*, *tawarruq*, debt sale, international *murabaha* and some risk trading. The value of assets created by IBFIs in this manner has currently risen to very high proportions. Such practices lead us to believe that Islamic banks are becoming less distinguishable from conventional banks. The introduction of ruses in Islamic finance did not happen from the start. It evolved at different speeds in different countries. However, from the very beginning, Islamic finance eschewed risk and profits from partnership investment, and immersed itself into risk-free methods of leveraged finance (Garner, 2017). Later on, such debt-creating products came to involve camouflaging of interest.

Admittedly, Islamic finance uses contracting and documentation procedures that are more complicated than those in the case of the classical loan contract. The results are higher operating costs for IBFIs. Based on the fact that Islamic banks are private firms that seek profit maximization, their interest in Islamic finance is bounded by their desire to maximize profits. Mimicking conventional finance has, of course, been consistent with the bankers' desires to reach profitability. This has, however, led to two unintended but serious consequences.

The first and most obvious consequence is that mimicking conventional finance completely cancels out the benefits of Islamic

finance (*see below*). The entire economy suffers, as it misses the opportunity of cashing in on the said benefits. The second and less apparent result is conspicuous exploitation of the investment account holders. The latter provide financial resources under the rule of *modarabah*, which means that they will share in the profit and loss that may take place on the asset side. Meanwhile, the asset side of IBFIs mimicking conventional finance remains exposed to default risks similar to those faced by conventional institutions. In addition, the risks faced by these assets are significantly higher because of the use of the classical loan contract without resorting to either monitoring or governance. In this case, information asymmetry aggravates the risks of adverse selection and moral hazard. Therefore, the investment account holders bear higher risks, which they have to share, without enjoying higher returns associated with real investments. In the meantime, shareholders continue to maximize profits, while leaving investment account holders to shoulder a bigger share of the risk. This is an obvious redistribution of wealth in favor of the former group.

Pessimists believe that the Islamic finance industry is clinically dead, awaiting announcement of demise and burial. This would occur precisely when the public realizes that the industry has converted itself into some other industry that mostly deals with selling present for future money through contrived sale contracts. While the pessimistic view may be ignored as an exaggerated concern, the warning signals are plenty all around. All concerned need to listen and respond seriously. Apparently, saving the Islamic banking and finance industry is no longer a long-term objective. Some evidence is reported hereunder that adds to urgency for remedial action.

i. Islamic Finance through the public eyes

Interesting investigations by Majeed & Abida (2017) in Pakistan, Widigdo et al (2016) in Indonesia and Rod et al. (2015) in Malaysia reveal "how Islamic" is Islamic finance as perceived by employees and the public. As expected, Islamic bank employees are found to have a favorable perception, but the public have mixed opinions. Such studies, however, fail to measure Islamic finance against its true paradigm.

Latiff et al. (2015) classify public grievances towards Islamic finance in four categories. First, IBFIs prefer debt-based financing modes. Second, IBFIs' understanding of the Islamic finance products

is inadequate. Third, customers have doubts whether IBFIs comply with the Shariʿah. Fourth, customers complain about lack of product innovations and service quality at IBFIs. Findings of Latiff et al. point to the lack of adherence to the Islamic finance paradigm.

Azmata et al. (2015) compare conventional finance with a pure *murabaha*-based Islamic finance, and find that competition would eventually lead to convergence. The conventional structure crowds out the Islamic financial structure, which finally produces "Shariʿah-compliant" replicas. They also find significant empirical evidence for this crowding out. Their conclusion is that Islamic finance products have little structural difference when compared with conventional products. Ahmed et al. (2014) find there is no significant difference between the monthly average lending rates of Islamic banks and conventional banks, confirming strong similarity.

ii. Other empirical evidence

Olson & Zoubi (2008) compare financial ratios between Islamic and conventional banks, and find that such ratios can distinguish between Islamic and conventional banks. This can be interpreted as evidence against the existence of convergence. However, there is more substantial evidence to the contrary, as we see below.

Mirakhor (2007) and Askari et al. (2010) propose that financial globalization can be a factor in the convergence between Islamic and conventional finance. While globalization can have benefits, Mirakhor believes that such benefits depend on the degree of risk-sharing around the world. According to Mirakhor, the potential of financial integration to promote welfare has not reached its potential because of the lack of instruments as well as financial, legal and institutional requirements for greater risk sharing. Financial globalization has, however, been associated with innovations in trading debt and pure risk; little has transpired in the area of risk sharing. Askari et al. cite the rise of international capital flows, the growth of Islamic financial institutions in non-Muslim countries and the surplus capital gathering in oil-producing Islamic countries as factors that beefed up conventional finance as compared to more risk sharing finance. In our view, while globalization does provide Islamic finance an opportunity to offer risk-sharing a wider scope in the world, internal factors that motivate Islamic finance to mimic conventional finance are major inhibitors.

How can convergence that we asserted above be identified, despite the lack of transparency in Islamic banks' financial statements? Conventional finance products used by Islamic banks would be listed under Shariʿah-based sale contracts. *Tawarruq*, *'enah* and international *murabaha* (commonly known as reverse *tawarruq*) would be considered *murabaha*. Speculation in stock exchanges would be similarly listed. However, a simple test of convergence that calculates the percentage of such products of ill-repute to total assets is not possible.

Alternatively, indirect tests can be carried out. Hamza (2016) finds that capital ratios and interest rates positively influence return on *modarabah* accounts. This implies that returns come mainly from bank assets that are interest-based debts. There is no impact from the board of directors and Sharia board. Hamza used generalized moment test (GMM), to confirm the presence of the debt financing channel of monetary policy where interest rate variation affects Islamic bank financing. Furthermore, he found that the negative effects of interest rates on debt-financing growth were mitigated by growth enjoyed by investment accounts. In summary, such indirect evidence exposes the conventional nature of Islamic banking assets that is well camouflaged under *murabaha* terminology. In a later study, Hamza & Saadaoui (2017) confirm these results.

Empirically, Rajhi & Hassairi (2013) found that a higher share of loans in the asset structure contributed to increasing bank insolvency for large banks in MENA countries. In addition, Farooq & Zaheer (2015) found Islamic banks to enjoy a stable depository base it times of crises. Čihák & Hesse (2010) find small Islamic banks to be relatively more stable and large ones less stable than their conventional counterparts. Beck et al. (2010) found few significant differences in business orientation, efficiency, asset quality, or stability between Islamic and conventional banks. This implies that convergence of Islamic finance to conventional finance has blurred the differences between the two systems, thus supporting our basic claim of convergence and its consequences. To reiterate, our claims regarding stability hinge upon the proper adherence to the Islamic finance paradigm. Similarly, Chakroun & Gallali (2013), in terms of the impact of Islamic finance on macroeconomic stability, found mixed results that depended on bank size; in addition, their work also revealed negative results. Such results, when combined with the

work of Beck et al. (2010), give an indication of how the violation of the Islamic banking paradigm cancels out potential stability benefits.

6. Why is the promised dream fading away?

The question that needs to be addressed is: why are IBFIs increasingly becoming a distorted picture of CBFIs? Some important points in this regard are noted hereunder.

i. Role of bankers and finance officers

First, we must admit that procedures of conventional finance are less costly than those of Islamic finance. In addition, they are more in line with the mentality of bankers who have been practicing these procedures for decades. Like their counterparts, Islamic bankers and finance officers also want to maximize the profits of their firms. Unfortunately, the advantages of Islamic finance listed above do not bear directly on their financial statements. They are all external effects. In order to convince Islamic bankers and finance officers to abide by the rules of Islamic finance, such effects must first be internalized in order to discourage them from mimicking conventional finance. Since such internalization is not quite possible, the adherence of the rules of Islamic finance must be insured by regulation and supervision.

Islamic bankers and finance officers use their strong influence to pressurize the members of their Shariʿah boards to design products that short-circuit the principles of Islamic finance. Some economists accuse Islamic bankers and finance officers of Shariʿah arbitrage meaning that they appoint as members of Shariʿah boards those who are be expected to be most lenient in designing products (El-Gamal, 2005). This, perhaps, is an extreme perception, as bankers and finance officers in IBFIs have sufficient influence to demand the design of questionable products.

ii. Role of the Shariʿah boards

The first layer of regulation and supervision of IBFIs is entrusted to their Shariʿah boards. However, the Shariʿah boards until today perceive the Islamic finance industry as an infant industry, despite its being more than 40 years old. Such a perception has led the Shariʿah boards to provide the Islamic finance industry with products that reflect a lenient attitude rather than strict supervision of the industry. Licensing has become the major theme of such products rather than strict adherence. Even if

we accept the argument that it is an infant industry, licenses should be offered on a temporary basis with a timeframe attached to them so that questionable conditions can be tightened and eliminated in the future.

Another problem stems from the way in which members of the Shariʿah boards exercise their scholarship. As is commonly known, the methodology of Fiqh is based on the verification and interpretation of the Divine Texts. A substantial wealth of Fiqh writings has been inherited from past generations, which are rich in both documentation and logical deduction. Such wealth can be used to solve cases in a way similar to those settled by previous generations.

This opens the door for using excerpts from old Fiqh texts to prove validity. This is generally understandable, and should even be encouraged under three conditions. First, the contemporary Faqih (Islamic jurist) must adapt the old opinions for changing times and circumstances. Second, the contemporary Faqih should consider all direct and indirect consequences of using the excerpts. Third, such excerpts should not represent a minority or an exceptional opinion.

Fundamentally, the methodology of Fiqh for validating transactions is impeccable. Each transaction is considered as a contractual form. Every contract must be valid in both form and purpose. Conditions of the formal validity of contracts have been eloquently stated for many contracts by old Fuqaha (Islamic jurists), and have become a part of the Islamic Fiqh legacy. Conditions for the validity of purpose cannot be taken completely from Fiqh, as such conditions depend on times and circumstances and their 'discovery' requires special expertise.

The last factor is of special importance. An example would be the sale of antibiotics by a retailer. When done without prescription, the direct consequence may be the possible harm inflicted upon the buyer in exposing his/her body to life threatening allergies and the weakening of his/her natural immune system. The indirect effects could be manifested in the general increase of resistance of certain microbes or bacteria to antibiotics, which would render them ineffective in combating diseases. Therefore, the sale contract of antibiotics without prescription is formally valid, but its validity of purpose requires the expertise of a specialist in medical science.

Members of the Shariʿah boards usually consider the direct effects of transactions, which are easily understood by non-economists.

However, they have no tools from their training to foresee the indirect macroeconomic effects. Such effects get little or no attention, not because they are not important, but because of the nature of training of the Fuqaha.

Unlike the majority of academic Shariʿah scholars, members of the Shariʿah boards have been overly concerned with verifying formal validity. They have employed their knowledge and skills to find forms that lead to the ultimate conclusions usually reached by conventional finance while appearing to be Shariʿah compliant. This ingenuity brought to the IBFIs a series of products that placed an Islamic garb on exchanging present for future money. Such products run against economic logic, because they employ artificial sales contract as a façade to camouflage the conventional nature of transactions. It is, therefore, not surprising that the majority of the Shariʿah scholars in universities and Fiqh academies take a dim view of the opinions of Shariʿah board members.

Had members of the Shariʿah boards taken Maqassed al-Shariʿah seriously, they would not have found justification for using ruses to mimic conventional finance. They seem to consider Maqassed al-Shariʿah as loose rules, not as exact principles fit for application. In particular, no Shariʿah board member has ever blocked a transaction because it could lead to instability or inflation or unemployment, or even because it would redistribute income to the disadvantage of the poor.

iii. The Shariʿah board governance

There has been a conspicuous and long absence of qualified economists from the Shariʿah boards. This undoubtedly has caused the Shariʿah boards to be generally unaware of the macroeconomic consequences of the products they design. Without an economist in the Shariʿah boards, their members are more vulnerable to bankers' pressures.

Another conspicuous phenomenon of Shariʿah boards is that their members serve for life. The same group of people hovers around the various boards. Some members have even been able to bring their children into the boards right after their graduation. Some members serve in too many Shariʿah boards that it is obviously impossible for them to properly attend all the meetings.

The most serious problem with the Shariʿah board governance is that every Shariʿah board behaves like an authoritative Fiqh academy. None has so far abided by the rules of the OIC-International Fiqh Academy. Some even dare to state that they are not be bound by such resolutions.

The Shariʿah board members are supposed to be part of the wider community of the Shariʿah scholars. However, we notice an intellectual hiatus between the board members and academic scholars. For example, a product alike *tawarruq* is strongly condemned by the Shariʿah academics, while easily accepted by majority of the board members.

Furthermore, the Shariʿah board members are appointed without any specific standards of academic qualifications. Scholarship in any discipline is usually verified by obtaining a PhD degree from an accredited and preferably, a ranked university. In addition, a scholar must have the experience of teaching graduate students and should have published in refereed journals. Such criteria are generally not applied to the Shariʿah board members. It is, therefore, not uncommon to find board members without one or more of such qualifications.

7. Other challenges confronting Islamic finance

Having scrutinized in great depth the advantages of Islamic finance and some limitations in the practice of existing Islamic banking, we now turn to some external challenges that it faces.

i. Islamic finance as subsidiaries

An interesting phenomenon is establishment of Islamic banking subsidiaries by some conventional banking groups. Presumably, in a mixed system where Islamic and conventional banks exist, both types of banks should be competing. However, having both types of banks as subsidiaries of the same holding gives rise to conflict of interest. It also serves as an insurance against depositors moving their funds from conventional to Islamic banks. This is potentially an element conducive to encourages convergence of Islamic finance towards conventional finance.

ii. Asset-based and asset-backed sukuks

A challenging issue lies in the area of securitization. Sukuks still largely mimic asset-backed bonds. A completely ‘real sale’ in Islamic finance securitization ranges from being vague to being totally absent. The

special-purpose vehicle (SPV), in this regard, is invariably outside the authority of *sukuk*-holders. This makes it impossible for them to exercise their property rights over securitized assets. Sometimes, legal techniques are used to avoid the "real sale" of securitized assets, especially in the case of securitizing government-owned assets or 'leasehold' instead of 'freehold' real estates.

iii. Company classification

Another challenge lies in the Shariʿah boards working with financial markets. When companies are classified according to their Shariʿah compliance, a logical approach would be that all of their assets are Shariʿah-compliant assets. However, the Shariʿah boards use a questionable criterion of dominance, i.e. one-third, to ascertain the Shariʿah compliance. Such a criterion is borrowed from the percentage of bequest to be willed to non-heirs.

A rather critical point in company classification in the case of IBFIs is that IBFIs are automatically classified as Shariʿah compliant on the basis of having their own Shariʿah boards. This is rather unfortunate, for it allows such IBFIs to get the Shariʿah-compliance label no matter what type of asset composition they have. As an added measure, we propose that in order to be classified as Shariʿah-compliant Islamic banks and firms should be required to acquire the HALAL label. In this regard, the central bank must mandate that in order for an Islamic bank to keep its license, it must also be able to keep its HALAL label.

In order to make such proposals effective in preventing the convergence of Islamic to conventional finance, its requirements must be modified. This should also include the expansion of the HALAL trademark to reflect the extent that Islamic financial institutions base their operations on the Shariʿah, and not just compliance. In other words, offering the trademark must be associated with Islamic banks completely avoiding trading present for future money.

iv. The role of monetary authorities

The failure of Islamic finance to live up to its paradigm owes a great deal to the inactive role of the respective central banks. Monetary authorities from the very beginning have stayed aloof from the Shariʿah compliance. They limited their supervision of Islamic finance to the accounting side only. In most cases, we notice the absence of the Shariʿah boards at

the monetary authorities' level. Meanwhile, in cases where a monetary authority has its national Shariʿah board, the central bank seems to have no yardstick for vetting the board decisions.

The main reason is that in most cases the central banking law is devoid from any reference to principles of Islamic finance. In particular, the definitions of lawful Islamic finance products and the unlawful ones, e.g. *tawarruq*, are absent. This leaves the central bank to rely on the national Shariʿah board, if it exists, or leave this matter to the Shariʿah boards of individual IBFIs.

Can we then conclude that monetary authorities maintain Shariʿah neutrality? If so, then on what basis do they provide licenses to Islamic banks which are supposed to be Shariʿah- compliant? It should be only intuitive that monetary authorities, being charged with the protection of public interests, should make sure that IBFIs do not violate their licenses, which should be revoked under serious or repetitive violations.

Neutrality of monetary authorities towards Shariʿah has serious implications. Ideally, if monetary authorities are aware of the macroeconomic advantages emanating from an honest application of Islamic finance, they must not allow any violations. Otherwise, they should not be considered the lawful guardians of public interest. It would then be legitimate to ask whether monetary authorities are seriously and continuously concerned with macroeconomic objectives or are they totally immersed in their daily routines.

Another important aspect of the role of monetary authorities is to what extent they include the Islamic finance sector in their monetary policy considerations. According to the model of Al-Jarhi (1981), money created in an Islamic economic system should be placed by the central bank (as central deposits) in the form of investment accounts. The central bank issues central deposit certificates (CDCs) to be held by banks as well as the public, and whose proceeds would also be added to central deposits. Monetary policy would be conducted through open market operations via CDCs. The market-determined rate of return on CDCs would replace the policy-determined rate of interest.

Supposing the market share of the Islamic finance sector, measured by assets, is only 20 percent, how should the monetary policy be designed and conducted? On the assumption that the transmission mechanism

through which monetary policy influences income and employment would not be similar through Islamic and conventional finance, the action of excluding Islamic finance from monetary policy consideration would rely partly on its effects through conventional finance.

Under the assumption of the Islamic finance having 20 percent market share, we propose that the central bank deposit 20 percent of the money supply as central deposits with Islamic banks. Meanwhile, it issues the equivalent of 20 percent of domestic government debt in the form of CDCs. In other words, such CDCs would replace an equal amount of government debt; they can be swapped for an equal value of government debt with bond holders.

Let us assume the central bank wishes to add 5 million units of currency to the money supply. It should do so by buying 4 million units worth of government bonds from the public and augmenting its central deposits by one million. In this way, monetary policy would be carried out via two means, Islamic and conventional finance. Maintaining such proportionality would go a long way towards achieving an inclusive monetary policy.

8. Summary and conclusions

Islamic finance has now crossed the threshold of convergence to conventional finance. The system is losing its meaning and rationale. It is becoming increasingly devoid of any macroeconomic advantages which it can claim. The Shariʿah compliance is increasingly becoming a misnomer under which conventional finance is openly practiced. The Islamic finance industry is exposing itself to mockery, cynicism and disillusionment. Solutions must be designed to roll back the convergence between the two finance systems in order to secure the macroeconomic benefits that justify the switch from conventional to Islamic finance.

We have argued that, by nature and at the microeconomic level, Islamic finance has a higher cost than conventional finance, thanks to more documentation and roundabout procedures. This leads us to believe that the substantial macroeconomic advantages of Islamic finance cannot induce bankers and finance officers to apply the paradigm of Islamic finance according to the letter. It appears that only incentives provided through regulation and supervision would work.

We have placed the responsibility for implementing Islamic finance on all parties involved. Starting with bankers and finance officers,

members of the Shariʿah boards and the monetary authorities, each must take responsibility for what happens and act quickly and effectively in order to remedy the situation.

The seriousness of the current problems of the Islamic finance industry requires a society-wide dialogue in every country that has a stake in Islamic finance. A national committee should organize the dialogue and follow up on the implementation of its results. The participants should include legislators, monetary and financial authorities, bankers and finance executives, members of the Shariʿah boards and representatives from the OIC-International Fiqh Academy, Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic Financial Servies Board (IFSB), the Islamic Development Bank (IDB), the IMF and the World Bank. Such a dialogue may discuss the current state and the future of the IBFIs, and set an agenda of reforming the current state of Islamic finance in all respects.

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