Intellectual Discourse

Volume 26 Special Issue 2018

Special Issue

Rethinking Islamic Economics and Finance: Paving the Way Forward for Inclusive and Sustainable Development

International Islamic University Malaysia
http://journals.iium.edu.my/intdiscourse/index.php/islam

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Volume 26 Special Issue 2018

Intellectual Discourse is a highly respected, academic refereed journal of the International Islamic University Malaysia (IIUM). It is published twice a year by the IIUM Press, IIUM, and contains reflections, articles, research notes and review articles representing the disciplines, methods and viewpoints of the Muslim world.

Intellectual Discourse is abstracted in *SCOPUS, ProQuest, International Political Science Abstracts, Peace Research Abstracts Journal, Muslim World Book Review, Bibliography of Asian Studies, Index Islamicus, Religious and Theological Abstracts, ATLA Religion Database, MyCite, ISC* and *EBSCO*.

ISSN 0128-4878 (Print); ISSN 2289-5639 (Online)

http://journals.iium.edu.my/intdiscourse/index.php/islam
Email: intdiscourse@iium.edu.my; intdiscourse@yahoo.com

Published by:
IIUM Press, International Islamic University Malaysia
P.O. Box 10, 50728 Kuala Lumpur, Malaysia
Phone (+603) 6196-5014, Fax: (+603) 6196-6298
Website:http://iiumpress.iium.edu.my/bookshop

Intellectual Discourse, 26:2 (2018) 463–484

ISSN 0128-4878 (Print); ISSN 2289-5639 (Online)

Islamic finance crossing the 40-years milestone – the way forward

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Abstract: Islamic finance has experienced considerable growth worldwide in terms of deposits and assets of Islamic banks over the last 40 years, but shows little signs of achieving maturity. Almost all Islamic finance products currently is use are mere replicas of their conventional counterparts. This study follows the archival research strategy of Bryman (1989), and analyses the literature on Islamic finance theory and products and practices in order to ascertain the reforms needed for the maturity goal. The paper proposes adoption of a new law regarding money, different policy approaches, new structures of finance for shifting to risk-based financing, new models, procedures and some fresh thought in order to relate banking and finance to the real economy. It recommends a leading role for Islamic economists for effective reforms in the monetary and credit system in order to ensure that all financing is based on goods, services, stocks or securities representing real assets in line with the Shariʿah principles. The suggested policy measures are expected to lead to social inclusion and harmony in the interests of all stakeholders in business and finance transactions.

Abstrak: Kewangan Islam telah mengalami perkembangan yang pesat ke seluruh dunia dari segi deposit dan aset perbankan Islam pada 40 tahun yang terdekat ini, namun sedikit sahaja menunjukkan tanda-tanda kematangan. Hampir kesemua produk kewangan Islam yang digunakan kini adalah semata-mata tiruan daripada kewangan konvensional. Kajian ini menuruti strategi penyelidikan arkib oleh Bryman (1989), dan menganalisis literatur dalam teori kewangan Islam, dan juga produk dan pengamalan supaya dapat memastikan perubahan yang diperlukan untuk mencapai kematangan.

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Kertas kerja ini mengusulkan penggunaan undang-undang baru mengenai wang, pendekatan dasar yang berbeza, struktur baru kewangan untuk beralih kepada kewangan berasaskan risiko, model baharu, prosedur dan buah fikir segar untuk mengkaitkan perbankan dan kewangan kepada ekonomi sebenar. Ia menggalakkan peranan utama oleh ahli ekonomi Islam untuk perubahan berkesan dalam sistem monetari dan kredit demi memastikan kesemua pembiayaan adalah berasaskan kepada barangan, khidmat, stok atau sekuriti yang mewakili aset sebenar selaras dengan prinsip Shari'ah. Penetapan dasar yang dicadangkan dijangka akan membawa kepada keterangkuman sosial dan harmoni kepada kepentingan semua pemegang taruh dalam transaksi perniagaan dan kewangan.

Kata Kunci: kewangan Islam, kewangan global, Rancangan Chicago, *Maqāsid al-Sharī'ah*, Patuh Sharī'ah, lembaga Sharī'ah.

Key words: Islamic finance, IFIs, AAOIFI, sukuks, Shariʿah Boards, Maqasid al-Shariʿah, fiqh, the Chicago Plan

1. Introduction

With momentous growth over the last four decades, since 1975, Islamic finance has become a global reality. Total Islamic finance assets had grown globally to USD 1.88 trillion by 2015 (COMCEC, 2016). The growth has, however, been concentrated in a few countries. According to EY (2016), Qatar, Indonesia, Saudi Arabia, Malaysia, UAE and Turkey together held approximately 80% of the global Islamic banking assets in 2014. With Bahrain, Kuwait and Pakistan also added to the list, the said ratio stood at 93% of global Islamic banking industry assets. EY (2016) also projected these countries to remain the key drivers of Islamic banking during the next 5 years. However, during the same period the market share of Islamic banking industry has experienced a decline in its growth in Malaysia, Pakistan, UAE and Turkey (EY, 2016, p. 13). This might be explained by referring to Islamic banking not moving into growth areas—such as, agriculture, micro business, the SMEs, infrastructure development and venture capital—but focusing on financialization, i.e. making more money with money using somewhat differentiated financial products, in already saturated markets. Notwithstanding this, more serious questions beg answer: why has Islamic banking not gained general acceptance in Muslim-majority countries?

This paper, based on the analysis of the available literature regarding Islamic finance, is an attempt to suggest changes in Islamic finance infrastructure in order to ensure that Islamic finance is effectively linked to the real production and business sectors for ultimate benefit to mankind. Following Bryman (1989), it uses an archival research strategy to analyse the literature regarding Islamic finance theory, products and practices for ascertaining the required reforms. Section 2 discusses major problems of Islamic finance, the credibility issue and the reasons behind this. Section 3 conducts a SWOT analysis and tries to explore the conflict between the economic objectives of the IFIs and the need for the Shariʿah compliance. Section 4 suggests measures and steps for facing the challenges, and explores the potential for risk- based ethical finance for effectively supporting the real sectors in an economy. Section 5, the final section, comprises recommendations for improving the global Islamic financial architecture and their implications.

2. The major challenge - credibility issue

Islamic finance is, by default, subject to observing certain principles different from those of conventional finance. The practices of Islamic financial institutions (IFIs) suggest that the objectives for introducing Islamic finance have been ignored altogether, or their relevance has been changed to avoiding *riba* merely by way of *ḥiyal* (ruses) for maximising earnings. Profit maximization alone cannot be a sufficient goal for any business of IFIs; it must be accompanied by efforts directed at ensuring transparency/disclosure, justice and fair play at all levels of interaction. According to Wajdi (2009), innovative products like sukuks (Islamic bonds) and other tools/structures that aim at achieving the same economic outcome as that of conventional instruments, distort the vision of Islamic economics based on justice and equity. In this context, scholars and finance experts need to look into how the concept of Maqasid al-Shariʿah (the ultimate objectives of the Shariʿah) for businesses might be actualized in modern times.

A crucial factor in any perception about Islamic banking in vogue is that all Muslims believe in prohibition of *riba*, and a vast majority of them also believe in prohibition of commercial interest, considering it the most serious sin after polytheism. They are not satisfied with what IFIs are offering as alternative to doing business while avoiding *riba*. Thus, they either avoid banking altogether or continue to do business with conventional banks despite the presence of Islamic banks. According to 02 November 2015 issue of *The Banker,* more than 75.12% of the world's Muslim population remained vastly under-banked. This adds to the challenges facing Islamic finance. Accs explained by Ayub & Paldi (2015), among other things, the main issues that ultimately lead to the credibility-related problems for Islamic finance are:

i. Prioritization of economic objectives by IFIs over the ultimate objectives of Islamic finance, and replication of the conventional financial products;
ii. Lack of a single unified basis for *fatawa* (*s. fatwa* – juridical edicts) related to and approval of banking and finance products, and resultant lack of integrity;
iii. Variety of conflicts of interest in the supervisory framework, and ineffective role of the scholars/boards in ensuring the Shariʿah compliance in letter and spirit; and
iv. Lack of proper education and commitment of the personnel of the IFIs, particularly those at the helm of the institutions.

All of the above matters may boil down to one point: standardization of financial products across all financial institutions around the world according to the Shariʿah standards (SS) developed by the Bahrain-based Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) and the principles for mainstream Islamic finance accepted by forums like Makkah- and Jeddah-based Islamic Fiqh Academies as well as the Islamic scholars around the world. Most of the Muslim countries are, however, going for slow adaptation, not for adoption, of the AAOIFI's standards. The main motivation behind this approach is that the IFIs require flexibility, keeping in view the market requirements and varying tolerance levels of different markets. As discussed in the next section, such flexibility is not available in adopting the AAOIFI standards, which of course are based on a generally recognized and reliable approach.

3. SWOT Analysis of Islamic Banking and Finance

While carrying out this SWOT analysis of Islamic finance as evolved thus far, we discuss the unique principles of the Divine system of finance that give it its *Strengths*—provided, of course, that the system is applied in its true sense and spirit. *Weaknesses* are taken to imply the problems emanating from the way Islamic banking and finance products and the system have been applied that have led to failure in terms of realization of the Maqasid. *Opportunities* imply the potential of Islamic finance for promotion and development as a means for socioeconomic development and business proposition, particularly, in the OIC-member states. *Threats* are seen as the challenges facing the evolving system that might lead to its failure. These four matters are discussed one by one in the following subsections.

3.1 Principles of Islamic finance

The principles that are unique to Islamic finance and form the basis of Islamic banking and finance, can be listed as below.

i. Seeking rent on money capital is not allowed due to the prohibition of riba/interest.
ii. Goods with their own intrinsic values are to be treated differently in sale and exchange as compared to money, monetary units (cash and receivables) and fungible goods (that may serve as money) for which there are separate transaction rules;
iii. Risk must not be separated from real transactions: owners of assets must bear the risk while having any claims to reward;
iv. While taking business risk is a precondition for a valid eturn, generating and exchanging speculative risk (*gharar*) is to be avoided;
v. All contracts must be enforceable to ensure transfer of risk and reward to the parties as per the terms of the relevant contracts;
vi. No short selling except under conditions for *salam* (forward) sale; and
vii. The Shariʿah compliance is a must for broad-based legitimacy.

Some of the resultant strengths of Islamic finance system that stem from the above principles, are these. Prohibition of interest but permissibility of profits through trading and business is likely to lead to equitable and sustainable growth of economies without booms and bursts. Permissibility of forward sale with the conditions prescribed for *salam* would result in money and credit creation according to potential of an economy in the near future. Incurring debt is allowed but not mere financialization. This, in turn, would minimize the chances of advancing money and credit without any link to the real economy. The system will have built-in discipline due to the rules of avoiding riba, gambling, short selling – which are all means of earning without value addition and taking business risk. Importance of emphasis on transparency and disclosure hardly needs any comment. Last but not least, one can look forward to having a balanced approach to the goals of efficiency and profitability, social responsibility, risk management and the Shariʻah compliance.

3.2 Objectives of Islamic Finance

Islamic finance is *Maqasid*-based rather than a purely financial engineering model. The foregoing principles provide basis for defining objectives of a system of Islamic finance. Primary objective of Islamic finance is value creation by channelling a community's funds towards production and exchange of goods and services, and closing doors on uses of finance that inflate the financing relative to real production and exchange activities. The monetary policy in a growing economy should be able to create sufficient employment opportunities and have inflation under control. For this to occur, the government and the central bank need to be jointly able to control money supply. It is noteworthy that notwithstanding commendable work done on Islamic banking and finance, contemporary jurists have accomplished little on the issue of money and credit creation in the light of above principles. Only a few economists and finance experts have discussed this recently, and expressed their view on this subject. According to Riazuddin (2011), "the 'principal' created through a book-keeping entry by the State Bank of Pakistan (SBP) seems to be clearly a kind of excess over nothing and, therefore, seems to be a grave injustice and resembles riba in its essence" (p. 30).

The basic function of Islamic financial institutions has to be very different from the conventional financial institutions. Providing finance by replicating conventional instruments and tools may only add to problems and miseries for the poor and developing economies. As per Islamic principles, money is not entitled to returns on it without incurring business risk., This is possible only if the IFIs ensure that all financing is based on real assets in line with the principles of credit and forward trading as provided in the in respect of *shirkah* (partnerships), *mu'ajjal* (deferred payment) and *salam* (forward sale) contracts. Through such means the monetary authorities would be able to help generate money and credit sufficient enough for exploiting the potential of the economy without inflation and preventing recessions. The amount of money created under this system ought to be by way of sharing risk and reward as per the related business activity. It would require application of 100% reserves banking, as was suggested in the Chicago Plan of the 1930s, instead of the fractional reserves banking that is the basic cause of anomalies and recurring financial crises. In this perspective, Islamic banks need to become models for global finance.

The ultimate objectives of Islamic finance, in the light of the foregoing discussion, are three: (a) ssocioeconomic justice, equality of opportunities for all by avoiding *riba*, *gharar* and short-selling; (b) linking banking transaction to real business and socioeconomic activity—agriculture, industry, energy, infrastructure, education and health, etc.—in an exploitation-free and cooperative framework; and (c) value addition for growth of commodities- and services-related sectors for true benefit of the people.

Islamic finance with its value based features can become the basis for financial discipline on a solid underlying foundation, i.e. by risk sharing. A visible move by the IFIs towards the values-based procedures and practices may be useful in attracting global cooperation needed for the purpose of developing finance for the service of human beings as a whole.

3.3 Weaknesses of contemporary Islamic finance

Generally, lack of instruments for liquidity management and education, training and public awareness about Islamic banking and finance are regarded as main causes of weaknesses of the system that is at present working side-by-side with the conventional interest-based system. But, non-availability of investment instruments or otherwise are secondary matters. The real problem lies in the paradigm that is largely the same as that of conventional finance, which treats money as an exchange commodity, and other contributing factors are mind-set and approach of the practitioners and the compliance level of the instruments used by the IFIs. The AAOIFI has done a commendable job of issuing accounting, auditing, governance and the Shariʿah standards for a large number of possible contracts used for financing and investment operations. These standards, however, have not been applied in most of the jurisdictions. There is no common basis for deciding the matters at the national level, even in those Muslim countries that claim to be the regional or global hub for Islamic finance. At the international level, there are no guidelines for national boards for adoption of these standards (COMCEC, 2016, p. 3). The Shariʿah advisors and the various Shariʿah boards are free to decide and take position on the basis of *Istiḥan* (juristic preference) and thereby adopting any *Shādh* (irregular) or *Nadir* (limited or rare) opinions from the fiqh literature or any contemporary practice under contagion or path dependency effect. This has led to the general impression that Islamic banking mimics debt-based banking and largely consists of replacing English terms with Arabic ones: Muslim investors feel that they are being offered conventional products with Islamic labels.[1]

3.1.1 What went wrong?

Current state of Islamic banking and finance can be summed up in the following fourteen points:

1. General lack of clarity on the objective of introducing Islamic finance, especially among the Shariʿah scholars and jurists who have the final say in approving the products
2. Still unresolved controversies over the nature of some of the products that constitute a large part of the portfolios of IFIs
3. Lack of a common code of business and ethics
4. Operating in dual financial setup within the capitalistic paradigm
5. Focus on short term monetary gains without any weight assigned to the long term socioeconomic objective of balance and sustainable growth
6. Decreasing role of Islamic economists and increasing role of finance experts in developing products with no allowance for their impact on the economy and society
7. Poor knowledge of the scholars on innovative financing tools and their implications;
8. Absence of any common basis for issuance of *fatawa* (s. *fatwa* – juridical pronouncement)
9. Limited role of Islamic infrastructure institutions like the AAOIFI, the Islamic Financial Services Board (IFSB) and the Islamic Development Bank (IDB)
10. Forex business on the basis of currency salam
11. Financial engineering aimed at debt securitization in pursuit of commercial objectives

12. Use of multiple *wa'ad* (promise), as alternative for contract, in financial engineering
13. Use of financial *tawarruq* both on deposits and assets sides, and
14. 'Islamic' financial derivatives, particularly profit rate and currency swaps

The practitioners, albeit bankers, sitting at the helm expect the experts to approve "Shariʿah-compliant" alternatives to all existing and future conventional products with some cosmetic changes. This is, however, practically not possible due to certain limitations rooted in the basic principles of Islamic finance noted in Section 3.1. Generally, the bankers want flexibility in practical matters comparable to that enjoyed by conventional institutions, with the objective of earning profits. Accordingly, practices in the various markets with respect to, among others, *bai' al-dayn* (sale of debt), *bai' al-'inah* (buy-back), *murabaha* (cost-plus sale)/*bai' al-muajjal* (sale with deferred payment)/ commodity *murabaha* (financial *tawarruq*), *salam* (advance sale), *ijarah* (leasing), diminishing musharaka and even *shirkah al-'aqd* (contractual partnership), have some features that are unique to them and all of which differ from the AAOIFI's approach in varying degrees. In the case of hedging by way of investment in derivatives, the *tahawwut* master agreement (TMA) was prepared jointly by the Bahrain-based International Islamic Financial Market (IIFM) and the New York-based International Swaps and Derivatives Association (ISDA) in 2010. It closely resembles conventional standardised documentation for derivatives used widely in western markets drafted by the latter in 1992 (Wigglesworth, 2010). The TMA is used as a vehicle for all kinds of Islamic swaps, including single-sale, double-sale, cross-currency swaps and forex swaps. The main issues with forward and futures and other derivatives are deferment in price and asset to a future date in transactions that involve forex and netting-off to avoid delivery of the exchange item for risk aversion. Further, the principal in the profit rate swaps is notional; it is never exchanged but always netted off.

Sale of debts, buy-back (or, sell-back) practices and currency *salam* are clearly against the AAOIFI standards. Adaptations have been made in many markets in case of the said modes as well as those allowed by AAOFI in such a way that the spirit of the actual products have been compromised. Organised or financial *tawarruq* is the main grey area product being used extensively to circumvent the prohibition of interest (Khan, 2010; Siddiqi, 2007). Along with *wa'ad*, it has become a major part of the Islamic financial derivatives like credit-default and Islamic profit-rate swaps (*see below*). *Tawarruq* was prohibited by the International Islamic Fiqh Academy, Jeddah in 2009. AAOIFI allowed it under certain specific conditions, but a number of studies carried out later underlined that fulfilment of the conditions of AAIOFI for valid *tawarruq* was simply impossible, and this was the reason why the International Islamic Fiqh Academy prohibited it by withdrawing its permission (Khan, 2010). There is no moral argument supporting the proposition that *tawarruq* is better than a conventional overdraft; rather, such practices result in wide scepticism and damage to the reputation of the Islamic finance industry (Wilson, 2011).

Certain segments in the market are increasingly investing in derivatives on the basis of *wa'ad* and organised *tawarruq* without fulfilling the condition of transfer of the asset being traded and its risk. For instance, Islamic profit-rate swaps, analogous to conventional interest-rate swap, have emerged as instruments for hedging against volatility in the rate of return, but they rest on a string of notional principal amounts that are never exchanged. The respective players are interested in standard documentation as a formality for derivatives requiring a title transfer arrangement (Battiwala, 2017). This is despite the fact that the academia and senior researchers have been cautioning the practitioners of Islamic finance regarding abuse of conventional derivative products. For example, Suwailem (2016, p. 110) observes, "Conventional finance thus has shifted since the 1990s to more "exciting" activities, involving exotic derivatives such as collateralized debt obligations (CDOs) and credit default swaps (CDSs). Unfortunately, these activities are mainly gambling and high-risk betting that add no value to the economy. Instead, they create toxic assets that set on the balance sheets of banks and financial institutions as time-bombs. The bombs set off the Global Financial Crisis (GFC) in 2007."

There are other doubtful products that aim at generating fixed returns comparable to those in the conventional market. These are used mainly for liquidity management, trade financing, corporate financing, etc. A few such products are discussed hereunder to give an idea on how Islamic banking tools are creating qualms about Islamic finance. The examples taken are mostly from the Islamic banking and finance scene in Pakistan.

The SBP advised the IFIs in 2008, as per IBD Circular 2/2008, to obtain prior approval for use of *tawarruq*. The situation has changed in the past few years, and now the SBP is implicitly allowing *tawarruq* by way of '*sukuk murabaha'* and secured lending to conventional banks through *tawarruq*-based liquidity investment, secured by interest based Treasury Bills.

Salam in currencies has been used as an alternative for 'Bills Discounting' although AAOIFI standards do not allow it and the Shariʿah Board of the SBP also has not approved it. The latter even issued a regulation saying that *currency salam* is not a desirable product, but several Islamic banks, led by the Meezan Bank, the premier Islamic bank of Pakistan, are using it extensively with the approval of their respective Shariʿah Boards. This creates problems for other IBIs whose boards might not be inclined to accept *currency salam* as Shariʿah-compliant.

Running Musharaka (RM), an alternative to Over-Draft (OD) facility offered by conventional banks, though not formally approved by the Shariʿah Board of SBP, is being increasingly used by IBIs in Pakistan as substitute for *murabaha*, *ijarah*, *salam* and *istisna* (sale on order). By dint of flexibility comparable with the conventional OD, RM turned out to be No. 1 mode of financing by Meezan Bank in 2015, being 25% of its financing portfolio (from just 2% in 2012), while *murabaha* went sown to on 10% of its total portfolio. Because of the distortion created in the market, all IBIs in Pakistan follow the lead of Meezan Bank with their Shariʿah Boards permitting RM under the pressure of it having been allowed by the Meezan Bank's Shariʿah Board.

RM is *musharaka* only in name. Practically, it is debt-based financing by which the bank gets KIBOR-related fixed rate (the target rate) and the corporate client 99.9999 % of the additional profit. In addition, neither the bank has any identified objects or assets as *musharaka* capital nor it faces any commodity and market risks. Removing *jahalah* (ignorance) with regard to the nature of investment of joint capital is next to impossible when two or even three banks provide running finance on the same inventory. *Hiba* (gift) then becomes a norm to the effect that one party (bank) gets a fixed return by a formal understanding as integral part of the contract agreed to at the very beginning. It is not *musharaka* by the AAOIFI Standards. This is also against the philosophy of Islamic banking and that of *Shirkah* (Usmani, 2000, pp. 20, 238-246). Practically, increasing adoption of RM by all IBIs in the dual-banking system, with little perceptible difference from the OD facility, is a step backward for credibility of Islamic banking in Pakistan. Interested readers may refer to the Editorial of *Journal of Islamic Banking and Management*, 6(1), June 2016 for further details on the points raised here.

Bai al-Muajjal (sale on deferred payment) of Government of Pakistan's Ijarah Sukuk near their maturity is a product approved by the Shariʿah Board of the SBP, and followed by the Shariʿah Boards of all IBIs in Pakistan. This enables the IBIs to get return for the credit period despite the fact that lease of the asset stands terminated a few days after the sale agreement and the asset is sold back to the obligor (the Government of Pakistan). This is not allowed according to the AAOIFI Standards.

3.3.2 The Missing Key Element

The Shariʿah Boards and Advisors, respectively, are mostly autonomous and free to approve any products submitted by financial engineers/banks as business propositions, without adhering to the AAOIFI standards or some strict rules. This has created the key missing element in current Islamic finance: the lack of any one sound Shariʿah basis for products approval. This gap exists both at the level of the central Shariʿah boards in the various countries/jurisdictions as well as at the level of Shariʿah Boards of IFIs in a jurisdiction. The following examples support this conclusion.

i. Short-selling, financial *tawarruq* (commodity *murabaha*), *bai al-ʿinah*, and *bai al-dayn* approved only by the Shariʿah Boards of the Bank Negara Malaysia and the Securities Commission of Malaysia;
ii. Permissibility of sale on deferred payment of *GoP Ijarah Sukuk* near maturity of the sukuk by the SBP;
iii. Currency *salam* used by some Islamic banks in Pakistan, although not approved by the Shariʿah Board of the SBP;
iv. Commodity *murabaha* or financial *tawarruq*-based deposit products by many Islamic banks in some Muslim countries; and

v. *Bai al-'inah-* or *tawarruq*-based personal financing products and credit-card facilities in some countries.

Accordingly, as Islamic banks increasingly replicate the conventional products, their credibility decreases. Not only the layman, but also the scholars not associated with the IFIs, academicians and other opinion-makers in the society are of the view that interest-based banking is being promoted in the garb of Islam. It has resulted in chaos with regard to issuance of *fatawa* for permitting products and various categories of sukuks that are practically debt instruments. The following quote from Foster (2010) is quite revealing on 'Fatwa shopping', still in practice in one way or another, and its implications:

> The potential wealth locked up in oil-rich Gulf states encouraged the conventional banks to enter Islamic finance. HSBC established the Amanah Islamic Finance brand in 1998 and Deutsche Bank, Citi, UBS and Barclays quickly joined the fray, all offering interest-free products for wealthy Arabs. However, this new generation of Islamic bankers had cut their teeth in the City and Wall Street, and were used to creating sophisticated financial products. They often bumped heads with the Sharia scholars who authorised their products as Sharia compliant. However, these bankers had a way of dealing with this, as one investment banker based in Dubai, working for a major Western financial organisation explains: "We create the same type of products that we do for the conventional markets. We then phone up a Sharia scholar for a Fatwa [seal of approval, confirming the product is Shari'ah compliant]. If he doesn't give it to us, we phone up another scholar, offer him a sum of money for his services and ask him for a Fatwa. We do this until we get Sharia compliance. Then we are free to distribute the product as Islamic.
>
> This "Fatwa shopping", which was carried out by some institutions, brings us back to the Sharia scholars. Even these scholars do not agree all the time, which means that in some cases a product is deemed Sharia compliant in one market and not in another. This is especially the case with Malaysian products, which are often deemed not Sharia complaint in the more austere Gulf.

3.3.3 Conflict between Economic Objectives and Shariʿah Compliance

The weaknesses noted above arise due to the conflict between Shariʿah-compliance, on one hand, and economic objectives of the IFIs, on the other. Working in the same market as conventional banks, with the same mind-set and operative objectives, Islamic banks are inclined to use the conventional products with minimum changes to maximize their returns. El-Gamal (2008) has explained how the jurists certified "Islamic" alternatives synthesized from simple traditional contracts in order to allow *futures* and *options* trading that is banned by the majority of Islamic jurists. This strengthens the general impression that has emerged about Islamic finance that in practice it is the same as conventional finance. Hussain et al. (2015, p. 12) are quite forthright: Islamic banks are not different from conventional banks, apart from few differences in business orientation, asset quality, efficiency or stability.

The IFIs resorted to financial engineering on a massive scale in the 1990s (Vogel & Hayes, 1998, p. 236). Even the sukuks, many of which have been validated by the AAOIFI, practically evolved in such a manner that they have been dubbed as "*Shariʿah-compliant government bonds*", which is a wrong signal sent to the market that they are debt instruments. Sukuks increased in popularity but hit compliance issues. Juristically, sukuks have to be equity based as far as investors are concerned. The AAOIFI's Standard No.17 makes it clear that income from sukuks must be derived from the underlying activities for which the funds have been used. Hence, the debt-based sukuks would not be valid as per Islamic principles. But, there have been many lapses in observing these principles on account of which Sheikh M. Taqi Usmani, as chairman of the AAOIFI's Shariʿah Board, issued a statement in 2007 that 85 % of the sukuks were not compliant in reality.

4. The way forward

The current state of affairs, as discussed above, implies that some major improvements be made to the current set-up, and fundamentally different steps be taken. Otherwise, the products and the processes of Islamic banking and finance will not serve their purpose. Policymakers, regulators, product developers and, in particular, the Shariʿah scholars in the IFIs must rethink of changing their objectives, approach and the procedures in order to not only exploit the huge potential of Islamic finance but also transform the financial system into an enabling instrument for equitable socioeconomic development at national and global levels. We identify hereunder some milestones for the future track that may enable economists, the Shariʿah scholars and personnel at the helm to contribute to the promotion of a system of finance useful for societies and economies at a broader level. These are: adoption of a new money and credit creation law, commitment to Islamic banking at the national level and facing challenges regarding external finance, as explained below.

4.1 Adoption of a new money and credit creation law

Avoidance of interest, short-selling, gambling and pursuing risk-free returns, among other things, has paramount importance for salvation of Islamic banking and finance. This, in turn, is possible only when each and every transaction is backed by real sector/production/distribution/business transaction. It is, therefore, time for Islamic economists and Islamic finance practitioners to get out of the currently in vogue "Financing through Money Creation" model, and to work with other economists working for monetary reforms. The much needed reforms ought to be based on the well-established Islamic principles of exchange and trading.

The present approach of creating, investing/lending and exchanging debt-based money by IFIs, effectively working as money making machines, is simply a recipe for failure. The need of the hour is strict adherence to the Islamic principle of money earning returns only by way of taking business risk and adding value for all parties concerned. This, in turn, implies that money must not be created except for the goods available in an economy or the economy's potential, based on the principles of valid forward trade (*salam*). Any amount of money created beyond that limit, if needed, must belong to the nation as a whole, and not to the banks/other private financial sector entities. It has to be an international agenda to solve the problems facing global and national economies. It would require a 100 % reserve system to replace the current fractional reserve system and for sovereign money to be issued and managed by the autonomous central banks and monetary authorities in respective countries according to available resources, goods, services or their well-defined potential.

In the aftermath of the Great Depression of the 1930s, the Chicago Plan was proposed in order to reform the monetary system, but not implemented. Interest in reviewing the global financial system is again on the rise after the 2007 financial crisis in the West. All of these attempts revolve around reform of money and credit creation. Time is ripe for Islamic economists and experts of Islamic finance to develop the Islamic financial architecture to a sympathetic audience.

4.2 Islamic Banking at National Levels

As far as Islamic (OIC-Members) countries are concerned, we suggest that their entire banking system be transformed to that based on Islamic principles of business and finance. Islamic system suits their economies because the debt-based system has proved to be unsustainable even from an economic point of view for them. The riba versus interest debate is more or less settled, and consensus exists on the need for further necessary action. The work by internationally-reputed fiqh councils and organizations and the AAOIFI provides a basis in this regard. Of course, with regard irto the application of the alternative system, financial institutions have to change the structure and business procedures. A phasing approach for coverage of different sectors and subsectors.

In order to resolve the issue of public debt-related treasury operations, the 'holding company model' of banking may be adopted to finance all business sectors and sub-sectors in the economy by the fully owned subsidiaries of the banks that will be conducting different activities like trade related banking, investment banking, and commercial banking, etc. (Ayub, 2002, pp. 136-158). Treasury functions may be undertaken by every parent company for investments of its equity.

Inefficient tax system, lavish government spending, corruption and resultant unsustainable fiscal deficits lead to the debt trap. Transformation of the public debt system requires serious deliberations and re-organisation aimed at balanced budgeting by the governments and the public sector expenditure plans and exploring interest-free alternatives for public sector financing. As banks do not generally pay any returns on current accounts' balances, they can be asked to remit a certain part, for instance, 50 % of the same to the state with or without service charge (to recover the actual expenses). Private banks, doing business with the funds provided by the society, are socially bound to serve the society, and remitting a part of the current account deposits in the form of repayable loan to the state is a kind of social service.

4.3 Challenges related to external finance

Transforming external finance to interest-free bases is a bigger challenge than domestic debt. The recurring balance of payments crises sometimes leave little option but resort to IMF or other external donors to bail the affected countries out of debt default situations. Debt-based international financing from such sources, known as structural adjustment programs in the case of IMF bailouts, comes with conditions that generally do not enable a country to emerge out of poverty or achieve stability. Instead, they often lead to long-term dependence and compromises on national interests. A new approach to the global finance system, therefore, needs to be advocated whereby a new economy- and finance-related protocol is agreed upon to accommodate risk-based returns and to close doors on incomes based on short-selling, gambling, speculation, and unethical activities and behaviour injurious to mankind and nature. The principles of Islamic finance provide good basis for further necessary action, especially after global spread of the message of Islamic finance through emergence of Islamic banks worldwide and a growing number of counties and international development agencies entering sukuk markets to raise capital.

5. Further Recommendations

The foregoing deliberations comprising some fresh thoughts about the absolute necessity to relate banking and finance with the real economy, different policy approaches, new business structures in banking and finance, new models and procedures guide us to the way forward for success. The top priority of investors/deposit holders in Islamic finance should be Shariʿah compliance; only then the returns come. IFIs cannot be, and need not be, competitors of the conventional institutions in terms of earnings. Instead, they need to facilitate business and production units and corporate entities to provide a better and stable link between the real and the financial economies.

The IFIs, in order to provide a true alternative to the present toxic system, have to take the lead to be innovative for proper linkage between the real and the finance sectors of the economy and discipline the latter to abide by the principles of justice, moral values and business ethics. Implementing the natural law for creating harmony among various groups in society would lead to the achievement of the much sought after objective of providing funds to the *'financially excluded'*. Even the industry players doing business with replicated tools and products are of the view that Islamic finance products have to be materially differentiated from the conventional products. Rafe Haneef, the CEO and Managing Director of Global Markets for Asia Pacific of HSBC Amanah Malaysia noted the following in an article published in the ISRA & Thomson Reuters Islamic Commercial Law Report, 2016, pp.122-124:

> "It is timely for the Islamic banking industry to take a different path. Whilst their products may be a replication or adaptation of conventional banking products and solutions in a Shariʿah-compliant format, the approach and manner of offering these products and services have to be materially differentiated from the conventional banking system".

The first step towards this end is regulators making the AAOIFI standards obligatory through an effective implementation framework and intervention by the IDB, AAOIFI and the IFSB, in 10 countries, namely Saudi Arabia, Kuwait, UAE, Pakistan, Malaysia, Indonesia, Bangladesh, Brunei, Oman and Jordan, where Islamic finance has become important for financial systems, accounting for over 15 per cent of total financial assets there. This step may also be taken in those non-Muslim jurisdictions that claim to be the regional hubs for Islamic finance.[2]

Attempts are needed to promote uniformity in the implementation of the AAOIFI standards by appointing a Higher Supervisory Board (HSB) in the IDB, comprising scholars from the International Islamic Fiqh Academy, Jeddah, the AAOIFI, the Islamic Research and Training Institute of the IDB and other related research institutions, to review and decide about the position of major structured products in terms of compliance. Decisions of the HSB must be made binding for all IFIs operating in the member countries of the IDB. By doing this, the IDB will be carrying out the same function as the Bank for International Settlements (BIS) for banking institutions operating at the global level. Considering that the International Islamic Fiqh Academy, Jeddah and the AAOIFI have done much valuable work for developing common standards, it is only right that these standards be implemented at national and transnational levels. The long-term solution is for the structured products that are being used currently to be revisited by the HSB, based on whose findings general guidelines should be implemented.

The Bahrain-based General Council for Islamic Banks and Financial Institutions (CIBAFI) can also play a role in the adoption of common standards and procedures. Having done that, the HSB may notify, from time to time, the list of banks and financial institutions operating in various jurisdictions based on established Islamic principles. In order to aid this purpose, researchers well-versed in Islamic economics and finance may develop compliance indices to be approved by the HSB. The notifications by the HSB may also include the institutions falling below the minimum compliance level, i.e. not properly implementing the HSB recommendations, as and when such evidence is received.

An SOP for developing finance and investment products may be introduced by infrastructure institutions, like the AAOIFI and the IFSB, in the light of which the products could be structured, approved and amended, if and when the need arises, keeping in view the implementation results. The SOP may also include detailed guidance and advice for practitioners on the procedures and documentation of the products for bringing reforms to the approach and the system in vogue.

The following policy measures may be vital for enabling economists, scholars and personnel at the helm to ensure that the future is different from the experience of the mankind is different from that during the last four centuries under conventional finance:

i. At the current stage when Islamic finance has been introduced to the global economy, IFIs should consciously act as standard-bears of Islamic finance through their approach, role and activities. Compliance with the Shariʿah in both letter and spirit, without resorting to debt or short sale-related *ḥiyal*, must be the mission and objective of all stakeholders of Islamic finance, in particular the Shariʿah scholars.
ii. The ‘Fit and Proper’ criteria for the appointment of scholars for Shariʿah certification and for advising the IFIs must include among other qualifications a sound knowledge of contemporary finance and engineered products and their impact on various categories of stakeholders and the economy.

Islamic finance with its value-based features can provide the basis for financial discipline at the macro level. Ethical and responsible finance is need of the global economy, especially to put a check on excessive risk-taking by financial institutions. However, the Islamic financial industry has to put its house in order, as also be truly innovative if it wants to stay on its current trajectory of growth and productivity (Suwailem, 2016).

The commercial banks, investment banks, mutual funds and all off-balance sheet vehicles of banking need to be brought under such regulatory perimeters that lead to linkage between the surplus and the deficit units in an economy based on really productive activities or future potential at national and international levels. Such an inclusive business strategy is expected to be helpful in promoting the objective of Islamic finance relating to growth and development coupled with social harmony.

Endnotes:

1 Stanton (2008) offers an interesting reading in this regard.

2 So far only a few regulators like monetary authorities in Bahrain, Qatar, Sudan, and Syria have made AAOIFI's standards mandatory for the IFIs (Hussain et al., 2015).

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ISSN 0128-4878 (Print)

ISSN 2289-5639 (Online)

ISSN 0128-4878
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