Dichotomy between Sharīʻah Compliance and the Economic Goals of Islamic Finance Institutions

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Abstract

Islamic banking has crossed the milestone of forty years since the Dubai Islamic Bank and the Islamic Development Bank were established in 1975. Islamic banking windows, standalone Islamic banking systems and even full-fledged Islamic banks, are operating as a part of global finance industry in the scenario wherein interest based institutions capture the overwhelming part of the business. Islamic banking institutions (IBIs) use Islamic equivalents of almost all conventional finance products for financing and liquidity and risk management, from 'over draft' to the most toxic derivatives like swaps to compete with the conventional banks in profitability. As a commercial necessity and the need to compete for profitability, many Islamic finance professionals, academics and some Sharīʻah scholars advocate for the use of such products and devices treating it '*ḥājjah*' for risk hedging on the basis of '*maṣlaḥah'* or '*umūm balwa'*. The path dependency syndrome may lead to credibility loss to Islamic finance resulting in persistent financial exclusion of the faith based clients / investors. This paper discusses the severity of the dichotomy between economic goals and the Sharīʻah compliance focusing on the negative impact of financial derivatives and suggests some policy initiatives and steps to reduce it and make Islamic banking and finance an increasingly sustainable global discipline based on sound principles. It recommends that the jurists and Islamic finance professionals should explore the Sharīʻah rules and real business potentials to find answers to the current Islamic banking conundrum and lead the industry on the right path of developing Sharīʻah based ethical products and using really Sharīʻah based devices to hedge risk.

Keywords: Islamic Finance, Sharīʻah Compliance, Financial derivatives, *Maqāṣid al-*Sharīʻah, Islamic Swaps, Financial Stability, Structured products, *Maṣlaḥah.*

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1. Introduction

The now forty years old Islamic finance industry that is growing at a long term rate of around 15% per year is also facing the challenge with regard to integrity. According to a survey by consultancy PWC, published in October 2014, 52 percent of Islamic banking customers in the Gulf region believed that their bank lived up to their religious values. Bernardo Vizcaino (2015) of Reuters / Zawya in a blog that despite success there are doubts over whether Islamic finance is living up to all of its principles as, *"it was launched not merely to make money, but to promote Muslim values such as equity, risk-sharing and social inclusion*". Based on the prohibition of *ribā*, *gharar*, with transparency and disclosure on the terms of the contracts, Islamic finance has to promote real economic activity, instead of monetary speculation. The prime values of Islamic finance are lost when the financial engineers tend to replicate the synthetic products including, *inter alia*, financial derivatives and structured products based on sale of debts, receivables and the Forex exchange. The rationale for this lax approach is said to be the demand of the market, the corporate clients dealing in speculative markets and the need to operate with profitability in competitive environment. Here lies the dichotomy between Sharī'ah Compliance, the *raison d'etre* of Islamic finance, and the economic goals of the IBIs.

This paper aims to explore the trade-off between Sharī'ah compliance and economic goals in the development of Islamic finance products, analyze the dichotomy and suggest possible policy initiatives and steps to reduce it making Islamic finance an increasingly sustainable global discipline based on the sound principles. It examines the dilemma surrounding usage of derivatives in conventional finance, outbreak of Islamic alternatives to derivatives along with some other structured and maneuvered products, and the importance of risk management, asset-liability management and liquidity as ingredients of economic goals of any bank –conventional or Islamic.

With the purpose of bringing an agreement between the Islamic finance scholars and the practitioners regarding the structured products, the paper analyses the business instruments used by the Islamic financial institutions (IFIs) in the light of the principles of Sharī'ah and the available literature on Islamic finance. The section **1** after the introduction, explores the colossal growth of conventional finance over the last three decades that coincided with the exponential growth of Islamic finance during last two decades, particularly in terms of structured products aimed at earning profits from money placements in the costume of trade

practices. Section **2** discusses the principles of conventional and Islamic finance and the economic goals of IFIs that they have set in the competitive environment of proliferated global finance. Section **3** discusses some major structured contracts that IFIs have introduced replicating the conventional products and tools. Section **4** suggests some policy options and steps helpful in developing solid *Sharīʻah* based products and tools to finance the real economy, do business to earn *ḥalāl* profits and to hedge against the business risks. The last Section **5** concludes the paper with some recommendations to achieve sustainable growth of Islamic finance broad based enough to support the real economy at national and global levels.

Section 1 Coincidence of Growth of Islamic and Innovative Conventional Finance

1.1 Explosive Growth of Innovative Finance

The last two decades of the 20th Century were marked with explosive growth of finance at global level. The increasingly innovative financial products were the main driving force of this growth as a result of which the tools of earning money by way of creating and lending interest based money transformed into the new tool of earning even without actual investments, i.e. through '*notionals*'. This was through creating and selling risk, short selling and multi-layer securitization. Traditionally, banks and financial institutions' income and returns come from fund-based and non-fund-based activities. In the fund-based category, a major part of the income emerges from the money created out of thin air by dint of fractional reserve system, lent in the form of 'overdrafts' for general purposes, and project financing for specific purposes[1]. This in itself had been a problem due to being source of interest income on money created out of thin air. But with the advent of financial derivatives[2] in 1990s, practically a new non-fund-based category on account of notional assets and netting-off in the 'short contracts' led to speculative income that candidly be termed as 'gamble takings'. The new category particularly pertains to the so-called hedge funds that are not supervised as heavily as banks, although all hedge funds are owned by the big banks which led

[1] Banks create and lend money through the deposits and other placement earnings from customers, banks and other financial institutions (Ford et al, 2003).

[2] Although the world of derivatives comprises a wide variety of financial instruments, the most common derivatives fall into four categories: Swaps, Options, Futures and Forwards. For types and evolution of derivatives, see: Goldman Sachs Asset Management; *A Pocket Guide to Derivatives*; Dusuki, 2009 and Al Swailum, 2006.

many banks to fail. Under this category, swaps have been the smartest of the structured derivatives excessively used by financial institutions over the last two decades. They provide the highest degree of leverage than any other categories of derivatives and can lead to insolvency of any big financial institution and even distort the whole system. Practically, these are being used less for 'hedging' and more as a tool of speculation for extraordinary benefits to innovators of the increasingly complicated synthetic products and the related market players.

Alfred Steinherr cautioned about the dangers associated with the derivatives by declaring them as dynamite for financial crises and the fuse-wire of the international transmission; what happened practically is sufficient to prove that its ignition trigger was not under control. [3] It was due to high speculative benefits that swap deals increased exponentially; starting from 1981, the swap transactions reached approximately US $4.6 trillion by the end of 1992 and to more than US $ 415.2 trillion by the end of 2006[4]. As the derivatives market is dominated by the insured banks, the big banks moved aggressively for ever increasing risk free profits. According to ISDA Market survey, total Interest Rate, Currency and Credit Default Swap outstandings amounted to US $ 457,177.71 billion as at the end of 2009. As reported by *'The Economist'*, over-the-counter (OTC) derivatives were approximately $700 trillion as of June 2011, while the size of the derivatives traded on exchanges totaled an additional $83 trillion.[5] The extraordinary huge amounts of money flowing through derivatives channel could be gauged from the fact that the total budgeted expenditure of the US government during 2012 was $3.5 trillion; the total value of the U.S. stock market was estimated at $23 trillion, while annual GDP of the world was about $ 65 trillion. As against this, the notional value of the CDS alone amounted to $25.5 trillion in early 2012, down from $55 trillion in 2008.

As derivatives developed quickly over the last three decades, they accentuated the problems like the one that initiated from sub-prime mortgages during 2007-08 to take the form of global financial crisis. Replacing the Glass Steagall Act of 1933 with the Financial Services Modernization Act in 1999 in USA opened the floodgates of engineered

[3] Steinherr, Alfred; 2000; P. 194.

[4] Based on the statistical reports issued by the Office of the Comptroller of the Currency (OCC), 97.3% of the total derivatives are used by dealers, i.e., speculators; Al-Suwailem (2006); P. 43.

[5] "Clear and Present Danger; Centrally cleared derivatives. (clearing houses)".The Economist (Economist Newspaper Ltd). April 12, 2012.

financial products for American banks carrying huge returns without actual funding even. Use of derivatives, generally dubbed as the toxic products, particularly interest rate, currency and credit default swaps and the short selling based speculative and unethical activities of brokers and institutional investors exposed vulnerability of the system. A famous example of short selling is that of George Soros who caused huge loss to the Bank of England in 1992, where he shorted $10 billion worth of Pounds for one day gain of over $1 billion. It established that *"the horse of financial innovation was much ahead of the mule of supervision"*. The exotic financial derivatives that crippled the economy in 2008 started roaring back in US big banks that dragged 7.5 billion Dollars from derivatives trading during the first quarter of 2013. However, the critics worry that there are still too few rules to protect taxpayers from a market dominated by a handful of banks (Douglas 2013).

The main cause of anti-capitalist rhetoric in recent years has been the high speculative finance and too much secondary market dealing in financial assets by creating and selling the risk. The dilemmas of capitalism and disasters of financial markets became increasingly intolerable on account of financialization creating a structure that supported speculative trading without any value addition to the system. John Plender, formerly working for '*The Economist*', and presently a columnist with the *Financial Times* writes in his book, 'Money, Morals and Markets', **"***bankers have undoubtedly done their best to give capitalism a bad name. The extraordinary scale on which big banks have been rigging interest rates and foreign-exchange markets and ripping off their customers is almost beyond comprehension*." (Plender, 2015) An obvious outcome is the extreme nature of concentration of wealth in fewer hands in all developing as also developed economies. While individuals earned billions without any value addition to the economies, corporations grew bigger and bigger-some bigger than some economies even (Ethica 2014-b).

1.2 Simultaneous Growth of Islamic Finance Industry

It is pertinent to note that Islamic finance industry also emerged at global level in the last decade of the 20th century and developed fast with the dawn of 21st century when financial engineers were able to develop "debt-based" *ṣukūk*[6], organized *tawarruq* and *wa'ad* based liquidity management

[6] As per AAOIFI's Standard No. 17, *ṣukūk* are based on *muḍārabah* principles; it is the use of the funds so mobilized on the basis of which *ṣukūk* are termed as *ijārah ṣukūk*, *salam ṣukūk*, *istiṣnā' ṣukūk*, *murābaḥah ṣukūk*, etc. Hence, *ṣukūk* represent common

and hedging instruments. They replicated the conventional instruments with addition of Islamic terms for structuring money market / hedging instruments including Islamic cross-currency swaps, profit rate swaps, credit default swaps, Islamic repos, and fund index-linked derivatives. Organized *tawarruq* became popular in mid-1990s with the formal tool of '*commodity murābaḥah* [7]. IFIs, although had not ventured into the derivatives by that time, were not immune to the economic downturn / global crisis in 2008 and "suffered from controversy over the very nature of some *ṣukūk* structures and observations that some *ṣukūk* in issue were not Sharī'ah-compliant" (Norman, 2009). Financial engineers continued innovation till the requirement of a tangible asset underlying any *ṣukūk* issue was removed even in case of *ṣukūk* labelled as '*mushārakah ṣukūk*. In February 2008, AAOIFI suggested six core principles for structuring *ṣukūk*, that according to AAOIFI were often being ignored in the larger or volume-based *ṣukūk* structures. The engineers again circumvented this pronouncement by moving to *wakālah*-based *ṣukūk* –an asset lite structure. The latest approval by the Sharī'ah Board of the State Bank of Pakistan (DMMD Circular No. 17 Oct. 15, 2014) allowing the GoP *ijārah ṣukūk* holders to sell the near-to-maturity *ṣukūk* on deferred payment basis by adding the T-bills related return for the credit period even after maturity of the *ṣukūk* has practically eliminated any difference between *ṣukūk* and the debt instruments.

Deutsche Bank (DB) that had been structuring 'Islamic' swaps since 2005, published a white paper on the use of reciprocal *wa'ad* in January, 2007 for structuring Islamic swaps. The Sharī'ah Advisory Council (SAC) of the Securities Commission of Malaysia in its meetings during the period August, 1996 to July, 2005 passed certain resolutions on validity of *bai' al-dayn*, regulated short selling (RSS), Securities' Borrowing and Lending (SBL), Composite Index Futures Contracts, financial hedging, use of *tawarruq* for deposits mobilization and money market investments, etc. on the basis of *maṣlaḥah* and *isteḥsān* (public interest at individual and general levels, *tā'wīl* (allegorical or esoteric interpretation of the Sharī'ah

undivided shares in the ownership of underlying assets by the *ṣukūk* holders (See: Taqi Usmani, 2007; Ayub, 2007:396).

[7] In *tawarruq*, the monetizer (*mustawriq*) buys any commodity at a deferred price in order to sell it in cash at a lower price to the third party. According to the jurists, this kind of transaction is permissible provided laws and rules of a valid legal sale are fulfilled. However, if the buyer sells the item back to the seller for immediate payment of a lower price, it becomes *bai' al-'īnah*, prohibited as per the mainstream approach in Islamic law.

tenets), *'umūm balwa* (unavoidable wide spread practice / situation), *fasād al-zamān, 'urf* (custom), and combination of some such principles[8]. Financial derivatives that were considered as prohibited in the beginning, came into the grey area particularly after the above pronouncements. M. Hashim Kamali also discussed the possibility of options and futures in Islamic Commercial Law in 1997 on the basis of *maṣlaḥah*, *ibāḥah* and the need for *ijtihād* [9].

As a first step, hedging and short-selling mechanisms were approved using the concept of promise (*wa'ad*). To give the concept practical shape, the financial engineers trained in the conventional set-up, first tried to develop 'Islamic' derivatives during 2000-2005 on different using *tawarruq* / commodity *murābaḥah*.[10] As the detailed principles applicable to *wa'ad* were laid down in recent years around 1990s, they took liberty to transform the accessory nature of *wa'ad* to the full-fledged contractual structures along with excessive use of *wakālah* on the basis of which 'Islamic' derivatives started emerging. In November 2006, Bank Islam Berhad and Bank Mumalat Malaysia Berhad agreed on a derivative Master Agreement for documentation of Islamic derivatives. The BNM, the central bank of Malaysia, issued the Islamic Derivative Master Agreement (IDMA) in 2007. It was followed by the *Ta'hawwut* (Islamic hedging and risk management) master agreement (TMA) jointly developed by IIFM and ISDA that was drafted by the *'Clifford Chance'* law firm. [It is important to observe that IIFM Sharī'ah Advisory committee gave Sharī'ah approval on the agreement structure only leaving the assurance of Sharī'ah compliance on the parties to any such arrangement.] Since then, they have developed a number of standards to facilitate hedging by the IFIs. Quite recent of such standards has been the 'ISDA/IIFM Islamic Cross Currency Swap Standard' that utilizes commodity *murābaḥah* and

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[8] SAC, S. C., Resolutions (passed in 69th meeting held on 18th April 2006). It is important to note here that the RSS, first introduced in Malaysia in 1995 was suspended in 1997 following the economic crisis which threatened the stability of the share market activities in the KL Stock Exchange.

[9] Kamali, Mohammad Hashim; Islamic Commercial Law: An Analysis of Futures and Options; Islamic Texts Society, UK; 2000.

[10] Edwards, Waren, 2007: [*all banking products are built from four pillars: deposits, exchange, forwards and options. ..... as almost anything is permitted in conventional banking, Islamic banking is no different, merely a special case. Just as conventional products can be built from the four pillars so too can Islamic products be built using Islamic equivalents. ... 'Instead of using back-to-back loans, Islamic products can be created using Islamic equivalents of back-to-back murābaḥah, back-to-back ijārah, or back-to-back ṣukūk*].

reverse *murābaḥah*, linked with multiple but unilateral *wa'ad* committed separately by each of the counterparties. As regards usage of the TMA, any definitive data is not readily available because derivatives transactions are bilateral and privately negotiated.

A.A. Jobst of the IMF (2008) accepts with regard to the practice of derivatives by saying that derivatives almost never involve delivery by the parties as they reverse the transaction and cash settle the price difference only. It transforms derivative contracts into paper transactions without any genuine sale. Notwithstanding the reality as confessed by him, he suggests in a paper written subsequently (2012) five axioms of 'Sharī'ah-compliant Financial Derivatives' as given below:

The derivatives may be compatible with Sharī'ah law if they:

a) address genuine hedging demand associated with effective and intended ownership *(qabḍ)* in an identifiable asset or venture,

b) guarantee certainty of payment obligations arising from contingent claims on assets with clearly defined object characteristics,

c) disavow / reject deferment of contractual obligations *(nasī'ah)* from the actual and direct transfer of a physical asset as the object of an unconditional transaction, except for cases when the doctrine of extreme necessity applies,

d) contain collateralized payment for the use of risk protection but rule out provisions aimed at generating unilateral gains from interim price changes of the underlying asset beyond the original scope of risk sharing among counterparties parties, which favors win-win situations from changes in the value of the reference asset, and

e) Eschew all prohibited sinful activities *(ḥarām)*, in particular those deemed similar to gambling *(maīsir)* and speculation due to uncertainty *(gharar)* by means of clearly stated object characteristics and/or delivery results, which mitigate the risk of exploitation from ignorance *(jahl)*.

Jobst adds that Sharī'ah compliant derivatives must also be employed in keeping with the precept of maintaining an equitable system of distributive justice as a public good *(maṣlaḥah)*.

However, the contention point is that derivatives never involve delivery by the as Jobest himself accepted; then how Islamic financial institutions could be expected to abide by the above rules when they tend to use them to get competitive returns as their conventional counterparts

do. The case is similar to that of organized *tawarruq* that was not practiced with the conditions as required by Islamic law, and hence the permission withdrawn by the Jeddah and the Makkah based Islamic *Fiqh* Councils. Other areas of concern with regard to Sharīʻah compliance of derivatives according to Jobst (2008) are: i) the selection of reference assets that are nonexistent at the time of contract; ii) the requirement of taking possession of the item prior to resale; iii) mutual deferment of both sides of the bargain, which turns a derivative contract into a sale of one debt for another; and iv) excessive uncertainty or speculation that verges on gambling, resulting in zero-sum payoffs of both sides of the bargain. According to Al-Suwailem (2006:40) such speculative activity leads to a form of eating wealth for nothing (*akl al- māl bil bāṭil*) that is prohibited expressly by the Holy Qur'ān (4:29).

Overall, the tools used to replicate the conventional liquidity management / investment products pertained to securitization, credit enhancements, guarantees, re-purchase undertakings and agreements by using the basic concepts of *wakālah* / brokerage, multiple promises, *muqāṣṣah* (netting-off), back-to-back *murābaḥah*, sale of debt / receivables, *salam* in currencies and hedging through Forex trade in general based on *wa'ad*. Another notable development has been that permissions granted by Islamic finance scholars on case-by-case situations are sometimes used by the industry practitioners as a rule rather than exception or any specific permission. From here the term '*fatwá shopping*' evolved referring to using any specially granted permission in specific case as a vanilla liquidity management product whereby the institutions who invest for taking fatwa for any product sell it to others on charge (Omar Osani and Farooq, 2013). If this trend is not controlled with joint efforts of the Sharīʻah scholars and the policy makers at apex levels, this might ultimately expose Islamic finance to the colossal risk of Sharīʻah noncompliance and extreme loss of credibility.

Section 2 Principles, Sharīʻah Compliance and Economic Goals

While the value neutral conventional finance separates all business activities from religion and ethics and concentrates on mere earnings management and profit maximization, Islamic finance is based on divine principles and values. Banking and finance companies working in capitalistic environment focus on short term results to get more and more profits rather than long-term policies aimed at sustainable development (Tim Montgomarie, 2015). As regards the socio-economic justice or social welfare, it is not included in their objectives, although it could be a

separate agenda item of some individuals, any State departments and the NGOs. Reference to justice is made in conventional economic and finance as well, but the principles of justice in conventional system have their roots in self-interest; so the objective that prevails is 'profit maximization' *per se*.

The first step to achieving that objective of Islamic finance is to ensure Sharīʻah compliance which is the basic cause of coming into being of Islamic finance. Sharīʻah compliance, along with risk management, prudential and profitability related measures, implies avoiding *ribā*, *gharar maisir* and all other unjust and unethical practices. These prohibitions are based on rationale (*ḥikmah*) of social justice, avoiding exploitation, equality of opportunities to all irrespective of race, colour and creed, and the property rights determining rights and liabilities of all stakeholders minutely. The *'illah* (effective cause of prohibition) that is a tool for application / implementing the prohibition of *ribā* being excess claimed over and above the principal is based on the *ḥikmah* and would be decided keeping in view certain parameters on case to case basis. But the crux of the matter is that all Divine tenets are based on *ḥikmah*. This requires specific principles and a code of ethics to be introduced and implemented by the banking and financial companies, regulators and other institutions to ensure that all stakeholders behave as per Sharīʻah commandments and everyone gets its share from the Almighty's bounties. Accordingly, AAOIFI and IFSB have suggested comprehensive structures of code of ethics for the IFIs and their employees (Lahsasna 2013). Other principles are indicated below:

a) Through the prohibitions, Sharīʻah tends to ensure that no party should be allowed to get undue return or made to suffer any undue burden or loss to other party of a transaction. Sharīʻah accepts risk and uncertainty as an inalienable feature of life and as a genuine part of the businesses. The requirement of the Sharīʻah that risk must not be separated from the real transactions is crucial, natural and conforms to economic reality (Al-Suwailem, 2006: 59; Ayub: 2007; Pp: 53, 81, 82). It is based on *ḥadīth* of the Holy prophet (pbuh), *"do not sell what you do not possess"* and the famous principle of Islamic law of contract that one cannot sell what does not own and has its risk (*daman*). The rationale behind this is that the seller should take risk and reward of his trade activity.[11] The classical legal maxim, "*al-kharāj bi-ḍamān*" links valid gains and incomes to such risk taking

[11] Tirmidhi, 1988, No. 1308-1033, p. 25

which is exposure to loss of value as per the agreement of trade or business.

b) Claiming or seeking any return from any investment / project without being liable to taking risk of possible loss in that investment is not allowed due to being *ribā*[12]. However, risk taking or *ḍamān* in a business has to be distinguished from *gharar* that means risk creation and dealing in risk[13].

c) Creating or taking abstract risk leading to any ambiguity with regard to rights and liabilities of the contracting parties is prohibited due to being *gharar,* which is very wide term applicable to lack of clarity in commercial transactions in commodities or financial markets, and contrived non-delivery of the exchange items, or non-fulfillment of the contract just to avoid loss. It implies that the contracts in which price has not been finalized or future performance has been kept vague for availing of, or avoiding the result of any movement in the market price involve *gharar* rendering the transaction void from Islamic perspective (Nabel A. Saleh; 1986: 49-56). It further implies that 'short selling' is not allowed that creates absolute uncertainty with regard to enforceability of the contract – delivery of the subject matter and payment of the exchange value[14]. All contracts relating to commodities and stocks must be able to be delivered to ensure transfer of risk and reward to the parties;

d) Money/monetary units, cash, and receivables cannot be traded except at par (in case of same currency on both sides) and that too 'hand to hand'; an additional condition with regard to loans and debts is that they could be sold (at face value) with recourse to the original debtor, making it effectively assignment (*ḥawālah)* of the debt. Shares of joint

[12] It must be clear, however, that prohibition of *ribā* /interest never meant to be a prohibition of rewarding financing in general and debt-creating financing in specific. The nature of reward must be risk based.

[13] The classical legal maxim, "*al-kharāj bi-ḍamān*" links valid gains and incomes to such risk taking. In financial perspective, risk is an exposure to loss of value in cash as per the agreement of trade or business. In business, risk is the probability of loss that is considered in Islamic law of contracts as *ḍamān* vis-à-vis profit, meaning that accepting liability of business loss justifies the profit taking.

[14] Exemption to forward sale / purchase of certain types of fungible goods, (not including money or monetary units), is allowed, rather approved by the Holy Prophet (pbuh) himself, subject to observing the conditions of '*salam'* – the quality, quantity, price and the time of delivery must be settled, price fully paid in advance at the time of contract, and delivery to be effected necessarily.

stock companies or other instruments that represent joint ownership (*mushā'*) like that of *muḍārabah* / *mushārakah* / *ijārah ṣukūk*, can be traded at a market price based on the rule of majority - the majority of a company's assets are real / tangible assets and not receivables and cash; [for example: IDB's mixed *ṣukūk* (Ayub,2007)].

e) Last, but not the least, complete clarity, disclosure and transparency is needed with regard to the subject matter in the contracts and rights and obligations of the contracting parties; any such ambiguity would invoke prohibition due to possible injustice and *gharar*.

2.2 Objectives of Islamic Finance in line with the above principles

a) Facilitation of the real sector through supply of sufficient purchasing power to properly explore the potential of growth in an economy without involvement of interest, *gharar* and other unethical and unjust elements; it implies that while avoidance from *ribā* is the basic objective, taking profits or maximise earnings is not the objective *per se*.

b) Channeling of funds from the resource surplus units in an economy to the production sectors instead of enticing financial and human resources from the productive sectors to speculation (Kahf: 2011). It also means creating value for the society and parties to the business contracts.

c) Providing requisite finance to small businesses and medium size enterprises, generally grouped as SMEs, and the agriculturists / the farming community that are the basic producing units in any economy. Providing them finance on any of the non-exploitative bases is the basic objective of Islamic banking and finance (CII, 1980).

d) Serving for the cause of the society and welfare of the human beings as Corporate Social Responsibility (CSR) which is being increasingly focused in the corporate sector at global level pertains more to the IFIs than to the conventional finance institutions because of the commandments of the Sharī'ah with regard to *ḥalāl* and *ḥarām*, business ethics and social and moral values.

2.3 The Economic Goals of Islamic financial institutions

Various prohibitions like that of *ribā, gharar* and gambling and the tenets for ethical, honest and straightforward behavior, transparency and disclosure are the means to healthy and stable growth of economies and the human societies and not to prohibit profit taking (Qur'ān, 2:275). To

be specific, prohibition of *ribā* /interest never meant prohibition of rewarding finance in general and debt-creating financing in specific (Kahf 2006). Islam likes efficiency, profitability and efforts to enhance value of the business in competitive environment and as per requirement of the parties it provides principles for both cash and credit businesses and the markets.

The modes of business and the contracts for intermediation could be partnership based[15] as also debt creating as a result of trading and leasing activities (Chapra, 1998). Islamic finance, while encourages for this intermediation, a greater reliance on the former category – profit and loss sharing through equity based modes, it allows the latter category - debt creating modes like credit and forward trading (*mu'ajjal muḍārabah, salam* and *istiṣnā'*) *ijārah* and service based modes. Collectively, these modes fulfill all types of financial needs of the production and services sectors in an economy. The latter types of modes are rather crux of business concerns and activities that are undertaken in sole proprietorship or partnership structures. Trading that pertains to purchasing and selling the wares for profit has been considered a respectable profession by Islam. Professor Constant Mews of the Monash University confessed with regard to this feature of Islamic economics and finance by saying, "*The interesting thing about Islam is that it was a much more commercial culture from the outset than Christianity.*" It was by dint of this culture that from around the middle of the eighth century to the middle of the 13th, the Islamic world enjoyed a golden age, while European Christians were struggling through the Dark Ages (cf: Mike Seccombe, 2012).

It implies that profits can be earned in a business as much as possible remaining within the limits imposed in the Islamic law of contracts. When comes to banks, however, it needs utmost care so that it might not transform to prohibited activities involving *ribā* and appetite for leveraging. Hence, while doing any profitable business, debt can be created through credit or forward sales subject to fulfillment of the relevant conditions. That way, the quantum of debt will remain in a limit and not lead to instability and financial and economic crises. The economic goals as accepted by Islam subject to observance of the relevant principles and rules include earning valid profits in genuine businesses and, in case of corporate business, increasing the shareholders' value remaining within the Sharī'ah constraints.

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[15] It includes all forms of business organization where two or more persons pool together their financial resources, entrepreneurship, skills and goodwill to do business.

For efficiency and sustainability, the banking, finance or other Islamic business institutions would also resort to:

a) Controlling the risks, minimising the operational costs and avoiding the losses;
b) Enhancing quality of products and services;
c) Offering competitive financial products and services;
d) Facilitating and encouraging the customers to do business and undertake productive activities in socially responsible and ethical manner; and
e) Enhancing the outreach through balanced and just policies for all sectors of the economy focusing on agriculture, SMEs, micro business and the infrastructure development sub-sectors.

2.3.1 The Economic Goals as being pursued by the IFIs

On the basis of objectives and economic goals as indicated above, it was expected that Islamic finance industry could contribute to financial stability both at national and global levels. Its success or failure would be assessed on the basis of the extent to which the modes and contracts are designed to realize the objectives for prohibition of *ribā* and other unearned returns. Professor Michael Skully of Monash University, while accepting that the '*financials'* were the main culprit behind the global crisis observed that Islamic finance can do better if not being exposed to *financials* and highly levered companies" (Sadiq, K. and Ann Black, 2012). But what emerged practically, we discuss briefly in the following sub-section.

Islamic finance that commenced working on mixed equity and debt model in 1980s, started replicating the conventional products in mid-1990s to compete in the profitability, and with that objective resorted to almost same tools and instruments with all complex deals as in the conventional financial markets. The IFIs neglected the requirement of clearly differentiating the permissible and prohibited instruments in capital markets in a value-neutral scenario, although by getting clearance from the Sharī'ah scholars who might not fully understand such products and their impacts.

In that perspective, there has been a proliferation of 'Sharī'ah compliant' products, which mimic conventional tools with an objective to earn risk-free return as far as possible. No effort was initiated to bring about the structural changes in the modus operandi for effective intermediation between the real and the financial sectors of the economies.

It limited the scope for truly Sharīʻah based banking as they had to manage risks and continue liquidity management function to remain competitive and profitable.

Section 3 Major categories of Structured Islamic Finance Products

3.1 Use of Multiple promises

Using multiple *waʻads* to construct practically a full-fledged contract creating a right and a liability of the parties to the contract was the first step that served as foundation of all synthetic / structured products. Besides, netting-out (*muqāṣṣah*) has been an integral part of such products, alongwith organized *tawarruq*. It is the *muqāṣṣah* that leads to a full-fledged contract through acting upon any of the reciprocal promises. Although unilateral promise is considered as a necessary and valid risk mitigation technique in *murābaḥah*, *ijārah* and diminishing *mushārakah,* binding bilateral promises (*muwāʻadah*) or the multiple promises (given reciprocally by both parties with the effect that each one is the promisor as well as promisee) are not valid as per the Sharīʻah principles. The rationale of prohibition is that such multiple promises in a sale lead to the sale transaction itself, in which case the requisite condition is that the seller must be the owner of the commodity being sold so that the prohibition by the Holy Prophet (pbuh) for the people selling what they do not possess is not circumvented[16]. To AAOIFI, accordingly, bilateral promises are not permissible, unless the option to annul is granted to one or both parties[17].

3.2 Financial / Organized *Tawarruq*

Organized *tawarruq* is the major vanilla tool used in a number of structures of Islamic finance in vogue also including financial derivatives. According to the '*Ethica*', one of the main reasons due to which customers question the credibility of Islamic finance is the use of *tawarruq*. "A product that began as the industry's somewhat embarrassing black sheep over a decade ago has now grown into the *'Eight Hundred Pound'* darling of many Islamic banks". Despite permissibility of juristic *tawarruq* or its use in unavoidable cases of cash crunch, a question was generally raised: if it becomes a regular product, is it still Islamic finance? Jeddah based

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[16] Council of the Islamic Fiqh Academy, *'Resolutions and Recommendations'* (1985-2000), IRTI, IDB, Jeddah, 2000; Pp: 86, 87 (Resolution 40 & 41 (2/5, 3/5).

[17] For further details on *waʻad*, see Ayub, 2012.

Islamic Fiqh Academy whose resolutions and decisions are the basis of the AAOIFI's Sharīʻah standards discussed the issue and took back its permissibility in 2009 (19/5: Resolution 179). AAOIFI still allows *tawarruq* with some strict conditions, fulfillment of which, of course, is almost impossible as indicated by Salman H. Khan (2010). Hence, although industry is still using this grey area product, but Sharīʻah compliance of its practice is questionable.

Malaysia based IFSB also issued guideline for *Commodity Murābaḥah Transactions* (CMT) as a tool for liquidity management and noted with concern that the IFIs expanded its use to other areas despite serious difference of opinions [Guidance Note on CMT, 2010]. The use of CMT may expose them to substantial counterparty credit risk and have a significant influence on liquidity and prices in the specific segments of the commodities market in which they are investing. The IFSB also noted, "some central banks/supervisory authorities have served as facilitators of CMT for specific purposes, such as by providing a platform (i.e. liquidity management infrastructure) --------- and by using CMT in central bank operations with IIFS, such as those undertaken as a Sharīʻah-compliant lender of last resort (SLOLR)".

The reality is that fulfilling the conditions advised by AAOIFI renders the *tawarruq* economically unviable. As such, the IFIs seemingly enter into a number of separate transactions, but typically operate a netting facility by using and reusing the same stock many times in a day in numerous consecutive sales–the transactions in a day are carried out without demarcation and even the minimal transfer of constructive ownership does not take place. "*Daily net positions dictate the overall net stock balances, i.e. how much is encumbered and how much is free to be used for new tawarruq transactions*"[18].

Malaysian scholar Aznan Hasan has explained how the Sharīʻah auditors managed to uncover non-Sharīʻah compliant *tawarruq* practices by brokers on the LME. Hasan discovered the frequent overlapping ownership of underlying assets and exposed what he termed "Fictitious *Murābaḥah*" activities undertaken by some LME brokers. After a Sharīʻah audit he illustrated how commodity broker (A) when selling a commodity, involved multiple and simultaneous ownership, meaning one particular commodity was sold to more than one buyer" (Khnifer, 2009). IFSB in its

[18] Salman H. Khan; Organised *Tawarruq* in Practice: A Sharīʻah Non- compliant and Unjustified Transaction; NewHorizon, October-December, 2010.

Guiding Note as indicated above recognized that the IFIs might "structure CMT very simply or in a highly complicated way, often resulting in complex structures that may pose additional prudential risks and raise capital requirements issues".

3.3 Islamic Financial Derivatives

The permissions granted by some scholars for the tools as indicated above enabled the financial engineers to replicate, the most importantly, exotic derivatives like credit default, interest rate and currency swaps. Some writers on Islamic finance favoured such innovative move, eminent among them included, Hashim Kamali and Obiyathulla. We analyze briefly the stance of the both the learned authors. Their gut instinct was to propose the use of derivatives to mitigate risks. However, they missed the point that derivatives have been used overwhelmingly for speculative purpose. In fact, Warren Buffet took a stronger stance against derivatives than some Islamic academics and considered derivatives as "financial weapons of mass destruction". Similarly, Alan Greenspan recognized that the derivatives were highly leveraged by construction and that this leverage made the financial system highly vulnerable. (cf: Al-Suwailem 2006: 50).

The tension between Sharīʻah compliance and the use of derivative products in Islamic finance is well illustrated by Kamali's argument for the use of financial derivatives, which can be easily picked-up and utilized by Islamic finance practitioners for the use of otherwise forbidden products. Defining the hedging by way of illustration of holding the bushels of wheat, Kamali (2000) contends that by way of hedging, the holder of wheat eliminates the risk of price fluctuation. But, Paul H. Cootner, from whom Kamali takes the illustration, exposes the erroneous version of hedging that emphasizes two supposed properties of the hedge: a) price movements of the warehouse inventory and the futures contract will be exactly offsetting (the expected value of the hedged position is zero), and b) the hedge "eliminates the risk of price fluctuation " (that there is no variance around this expected value). To Cootner, both the ideas are incorrect. In normal hedging practice, price changes are not expected to be offsetting; and while risks might be reduced, they will not be eliminated.

Kamali (2000:39) argues that the arrangements such as clearing houses reduce the uncertainty element of futures contracts and that the regulation of the trading activity combined with standardized contracts, the margin deposit and marked-to-market or daily settlement procedure somehow allow the 'futures' the ability to evade the necessity of Sharīʻah

compliance in respect of possession and short selling – the objections, among other, that in futures, no goods are delivered and hence no price is paid. He purports that "hedging allows the risk of price changes to be shifted or shared; hence the costs of production, marketing and processing are reduced and this is ultimately beneficial to the public." He reiterates that hedgers provide actual goods and services to the economy and futures and options enable them to provide these goods and services more efficiently. Besides the point that risk shifting to others without shifting ownership is invalid, it is, conversely, questionable that hedgers provide real goods and services to the economy using options and futures as this involves the sale of unbundled risks, which separates the transaction from the real economy.

Although Kamali addresses pertinent issues in Islamic law of contracts, but he doesn't give adequate weightage to the the rules found in Sharī'ah and fails to acknowledge the adverse effects of hedging and speculation and the long term cost to the society. He argues that the option's premium transforms the unbundled risk into a bundled risk as he says the premium price constitutes property (*māl*), but Al-Suwailem (2006) contradicts by saying that derivatives involve separating risk from economic activity, thereby opening the door for pure speculation and potentially leading to the destabilization of the entire global financial system. Furthermore, the cost of doing business may actually go up as the business's core activity may shift to speculation for profit, exposing real capital to major risks totally unrelated to their normal business. Kamali also admits that there is no real distinction between hedging and speculation.

According to Al-Suwailem (2006:53), derivatives may provide value through management and distribution of risk, but they are also perfect tools for gambling, and consequently would distort incentives in a manner that defeat their legitimate purpose. He explains that derivatives unbundle risk from real economic activity and make it trade separately, thereby transforming the risk into a commodity. He says that commoditizing the risk is likely to make risk multiply and proliferate, making the economy more risky and less stable. He elaborates that derivatives result in the creation of a pure speculative market due to artificial risk structures and artificial arbitrage opportunities.

Obiyathulla (2004:73) took a stance similar to that of Kamali and argued that disallowing derivatives' use in Islamic finance would have adverse implications for the industry including value loss and inability to compete. He contends that in a system where conventional banks hedge

and Islamic banks do not hedge, the wealth would be transferred from the un-hedged to the hedged. He further asserts that un-hedged equity risk "stunts capital market growth, denies businesses easy access to capital in order to grow …." Practically, however, derivatives are instruments of loss and not gain as 70% of derivatives trading ends up in loss (Al-Suwailem 2006:53) and therefore may be more detrimental to wealth creation than using other risk mitigation techniques. The learned author should have given weightage to the fact that derivatives are not 'real' transactions since no transfer of ownership takes place and that they result in the selling of unbundled risk, which leads to the distortion of asset prices, leading to negative impacts on real investment opportunities. The speculative activity may expose the real capital of the business to major risks totally unrelated to the normal business and increase the costs of the business as a result (Al-Suwailem 2006:53). Therefore, in actuality, derivatives will render businesses less competitive in the long-run.

While Obiyathulla's passion to facilitate the IFIs is appreciated, he should have taken into consideration the very objective of Islamic finance, i.e. Sharī'ah compliant / *ḥalāl* return, instead of mere returns, and that genuine risk mitigation solutions for real sectors' financing by the IFIs could be found within the Sharī'ah itself. He does not acknowledge or admit in his analysis that the sale of something one does not own, unbundled risk, and debt-for-debt as well as getting return without transferring ownership and taking possession are expressly prohibited by the Sharī'ah due to being a sorce of injustice.

In the above perspective, when some cases of *ṣukūk* default occurred due mainly to their debt based structure, the call for Islamic Credit Default Swaps (CDS) was made only months after the conventional CDS industry had brought down the international financial system. Mahmoud El-Gamal commented on this call by saying that the recent crisis has not taught the practitioners of *"Islamic finance"… .. they do Islam a great disservice by using it as a brand name to market their grossly inferior and poorly construed products for a profit).*" [19] Although there might be some legal possibility to use CDS for genuine hedging, as long as there is direct link between the amount of the underlying assets held on creditors' books and the notional amount of the CDS; yet they certainly are open to manipulation as practically happens in the derivatives markets. Similarly, to replicate the conventional profit rate swap, the parties only settle their

[19] http://elgamal.blogspot.com/2010/01/have-we-learned-nothing-here-come.html; the Blogspot of Dr. Mahmoud El-Gamal (January 03, 2010).

respective obligations by offsetting net value - neither party pays the real value[20]. In the so-called Islamic Total Return Swap (TRS), a client invests in Sharī'ah-compliant assets, but the exposure is swapped for that of another asset that may be non-Sharī'ah compliant. "*Because the client's money is directly invested in* Sharī'ah-*compliant assets, and the TRS is based on accepted Islamic principles, the investor is able to gain exposure to assets that, if invested in directly, would be forbidden*". This way, the TRS opened the market to a whole array of underlyings that would otherwise be prohibited[21].

The main issues of concern in so-called Islamic derivatives pertain to separation of risk from ownership, trading in excessive risk, short selling and netting-off to avoid impacts and implication of transfer of possession (*qabḍ)* that resulted in collapse of big corporate in recent years. The financial engineers did not concede the reality and claimed, "One of the main innovations in the market has been the ability to *benefit from conventional yields, like index products, whereby the underlying index need not necessarily be* Sharī'ah-*compliant*. It can be a hedge fund, for example, and the investment will still be Sharī'ah-compliant if so approved by a scholar".[22]

As per the specific mechanism outlined in the Deutsche Bank's White Paper, the *wa'ad* based Islamic swap is an agreement between the bank and the investor to swap the returns from two baskets of performing assets (one haram and the other Sharī'ah-compliant). The transactions do not actually take place and are *deemed to take place* as per promise to sell or purchase, as indicated in the Paper, "Following receipt of the relevant notice to perform the obligations of either Promise 1 or Promise 2 ... Islamic Account and DB *shall be deemed to enter into an agreement on the terms of the form …*" (P.3).

It is also important to observe here that all permissions for 'Islamic' swaps have reportedly been given for the purpose of genuine hedging by observing relevant rules of Islamic business and trade. Five, rather six axioms suggested by Jobst A. A. (2012), as listed above also qualify Islamic derivative with such conditions observance of which will not yield the profits that IFIS tend to earn while competing with the conventional hedge funds. Hence, expectation that the axioms will be taken into account reflects wishful approach as practically no genuine trading takes place. The truth is that limiting the practitioners to the permitted and Sharī'ah

[20] Dusuki and Shabnam, ISRA Paper No. 14 / 2010; pp. 37-39.
[21] For further details, see Ayub, M; 2012; *Use of Wa'ad and Tawarruq --- Finance*;
[22] Luma Saqqaf: http://www.risk.net/risk-magazine/feature/1506267/structuring-sharia

conforming purpose is next to impossible because of the *tawarruq* and *wa'ad* based complicated but money-spinning structures. It is more likely that with limited permission, IFIs' major activities might concentrate on synthesized products leading ultimately to derivative-driven system and debt contracts instead of the real sector business.

Section 4 Alternative Policy Options and Steps

4.1 Proper Risk Management: A Necessity

Risk management (RM) serves several important functions, including implementation of strategy, development of competitive advantage; measure of capital adequacy; aid to decision making, aid to pricing decisions, reporting and control of risks, and management of portfolio of transactions. According to the IFSB's guidelines on risk management (2005), the main risk categories facing IFIs include credit risk, market risk, liquidity risk, operational risk, Sharī'ah compliance risk, equity investment risk, rate of return risk and displaced commercial risk. IFSB subdivided the risk management practices into 'Risk Policy and Environment', 'Risk Measurement' and 'Risk Mitigation'. Basel II, and subsequently Basel III tended to establish more market discipline along with risk weighted capital requirements on banks to reduce the probability and severity of future crises. Basel III combines micro and macro prudential reforms to address both institutional and system level risks. It focuses on the most problematic risks like trading book exposures, counterparty credit risk, derivatives and other securitization activities implying that its spirit seems to be moving away from the complex hybrid products.

While Sharī'ah encourages proper measures for safeguarding the resources and wealth of the societies as also of individuals, it draws a clear line between *ḥalāl* and *ḥarām* and recommends avoiding doubtful things and activities[23]. Qur'ān also warns that the 'LIMITS' (Hudood) set by Allah Almighty must not be breached (2:187). Risk-free returns stemming from *ribā* and *gharar* that add no value to the wealth of the society tend to breach the 'LIMITS' set by the Almighty. It breeds unethical practices by the managers, CEOs and the shareholders to get higher pays, hefty bonuses and ever-increasing profits, (The Economist, March 19 2008)

[23] "What is lawful (*ḥalāl*) is evident and what is unlawful (*ḥarām*) is evident, and in between them are the things doubtful which many people do not know. So he who guards against doubtful things keeps his religion and honour blameless, and he who indulges in doubtful things indulges in fact in unlawful things, …. Beware, every king has a preserve, and the things Allah has declared unlawful are His preserves…" (Bukhārī, Vol 3, No 267).

which ultimately leads to the crises. The express permission of forward sale (*bai' al-salam*) with specific conditions as imposed by the Holy Prophet (pbuh), implies that "ambiguity" and "uncertainty" has to be differentiated from normal business risk for earning valid profits and avoidance from invalid gains.

Risk structure of financial institutions has close relevance with capital adequacy structure as required by the Basel for ensuring solvency and stability of global finance. To be considered adequately capitalized, Basel requires international banks to hold a minimum total capital equal to 8 percent of risk-adjusted assets. Investments in exotic instruments could further heighten vulnerability of the IFIs. This is why, the IFSB indicated in its amended capital adequacy standard that as Islamic finance is closely linked to real assets, it is less prone to credit bubbles, and Islamic banks do not engage in highly speculative trading. However, as commodity prices could change, Islamic banks need to build up countercyclical capital buffers in good times as per the provisions of Basel III. It is incomprehensible, however, that the IFSB also indicated how to calculate the exposure to derivatives like profit rate swaps, the replica of interest rate swaps in conventional finance.

4.2 Available Risk Management Tools

Having conceded the point that proper risk management is a pre-requisite for a successful business, and Islam encourages both cooperative and managerial styles of risk management to avoid losses to life, limbs and property, the approach, the strategy and the processes of risk management need to be changed to make the financial sector a facilitator for real sector in the national and global economies. During last three decades, emphasis in global finance has shifted from balance sheet risk management to off B/S risk management, relying heavily on financial derivatives. For IFIs, balance sheet risk management is still vital due to prohibition of exotic financial derivatives.

The main rationale for using the derivatives is said to be risk management and hedging from the potential losses. But distinction has to be made between the real business risk and the external risks created and traded without any accompanying real activities or projects. The internal risks that Sharī'ah allows to be managed by observing some general rules may be the credit risk, market risk, liquidity risks and the operational risks. Such risks can be measured by applying various tools and techniques and managed keeping in view the nature of the transactions and the risks involved. It may involve proper reviewing, monitoring,

communication, and regular feedback at all steps which are all Sharīʻah neutral measures and hence allowed to be used.

The seminal sources of injustice, exploitation and instability are the the complex derivatives, hedging products, and creation of purchasing power, money and credit irrespective of the availability and potential of goods and services. Creating private money by the banks by dint of fractional reserve system, or the central banks' money issued to finance fiscal deficits without any increase in the goods and services in an economy could be the destabilizing factors for Islamic finance as in the case of conventional finance.

Any system that claims to be shunning interest and *gharar* must choose an alternative money creation and currency system that structurally eliminates interest and other exploitative returns as Islam, Catholic Church and other divine religions so require[24]. As Islamic financial institutions have to avoid all such returns that accrue without taking due risk and making value addition, they must abstain from such financing / investments that are not backed by the useful assets or real economic activity.

Accordingly, the practitioners need to focus on choosing the truly compliant and the most adequate risk management tools that broadly include *rahan* (collateral), personal guarantee, pledge, *hamish jiddīyah*, promise, agency, *khiyārāt* (option to rescind any contract), parallel forward transactions like in *salam*, *takāful*, *sharṭ al-jazā' ī* in *istiṣnāʻ* etc. The non-systematic risks can be mitigated by ensuring cost effectiveness, by providing requisite training to the practitioners, by resorting to suitable *takāful* policies, by choosing good clients, by adopting suitable capital budgeting and by prudent and Sharīʻah compliant liquidity management policies.

In addition to the permission for managerial types of risk management techniques, encouragement for the cooperative risk management measures is evident from the Holy Prophet's approving the historical systems of *al-nahd* (النهد) (partnership in the provisions on mutual cooperation basis) and liking his *'ashʻarī* Companions who put forward a mutual help concept and practiced it in their life as explained by Imam Nawavi in *Sharah Ṣaḥiḥ Muslim*: 62/16) (cf: JIBM, June 2013). Accordingly, IFIs in various areas and jurisdictions may establish risk study and awareness centres and

[24] As from 1971, money is created by making loans depending upon banks' own reserve ratios and the discount rate, and through the purchase and sale of government securities by the central banks.

cooperative risk management pools to be funded by their contributions for payment of claims of defined losses.

4.3 Effective Regulation, Implementation, Clarity & Surveillance Needed

EY World Competitiveness Report 2013 indicated the weak risk culture a hindrance to sustainable growth of Islamic banking. Furthermore, effective regulation of the Islamic banking industry requires change in approach of the structural institutions and the regulators. Islamic banks need to adopt better management skills and operational systems to mitigate the risk of losses in their business. In addition to risk and capital structure management, providing for strong internal and external controls may create a more stable risk mitigation system.

4.4 Developing Secondary Market for Islamic Finance Instruments

The dichotomy that exists between the objective of Sharī'ah compliance and the need to compete in a conventional system can also be relieved through creation of an active secondary market for Islamic finance instruments. IFIs may exchange funds among themselves on the basis of *muḍārabah* instead of strengthening the interest based system by way of *tawarruq* and other ruses and this cannot be accomplished except with efforts of the regulators and global structural institutions like IDB, AAOIFI, IFSB and Sharī'ah advisory and consultancy firms operating at broader levels. Such means of obtaining liquidity could be through *Tradable Inventory Certificates* (Kahf and Maha, 2015), securitization of both short and long term Islamic financial contracts and by developing Sharī'ah approved liquid secondary market for securitized instruments (Vogel and Hayes 2006). The increased liquidity potential provided by such a market would relieve pressure on banks in fulfilling their liquidity function and lessen the pressure for risk mitigation while at the same time lowering the levels of required capital.

5. Conclusion

Islamic finance is fast on growth and innovations but slow on establishing its credibility. The practitioners and some regulators generally think that by using synthetic products they attract customers, but in reality they lose them in the long term (Ethica 2014). The emphasis on form over substance has led to abuse of Sharī'ah principles to justify the contracts which undermine the objectives of the Sharī'ah (Wajdi 2009). It has hindered journey of financial system to real sector economy to help resolve serious problems facing the world. It seems that the tendency of a few Islamic scholars to lean towards conventional products has perhaps misled Islamic

banking professionals in the wrong direction. A recent IMF Working Paper draws conclusion that although theoretically Islamic finance is resilient to shocks, but practically it may not be so; "While these banks face similar risks as conventional banks do, they are also exposed to idiosyncratic risks, necessitating a tailoring of current risk management practices (Hussain M; WP/15/120).

The Muslim investors are becoming distrustful of Sharī'ah compliant investment products: "*They feel they are being given conventional products with Islamic labels*". "*Islamic financing is also subject to high judicial risk, as clients may turn to Sharī'ah courts that rule on a case-by-case basis, as well as seek redress in regular courts*" the W/P cautions. A clear lesson is that the IFIs have to avoid speculative exposures and all risk free earnings. It is possible only if they abide by the principles of Islamic finance that ensure sustainable growth and *ḥalāl* returns, though lesser than the short term excessive and cyclical returns as experienced by the global finance industry during the last two decades. They can use such conventional technical tools that do not conflict with the Sharī'ah principles that may, *inter alia*, include internal rating systems, risk reports, internal control systems, external audits, maturity matching, and GAP analysis (Hussain; WP/15/120).

Sharī'ah compliance is the basic cause of coming into being of Islamic finance institutions; if it is not taken care of, there would be no need for any separate system within the conventional finance. Implementation of Islamic finance principles determines the level of Sharī'ah compliance, in letter, in spirit, in both letter and spirit, or sometimes none of them. Financial derivative do not involve genuine sale/purchase and sometimes even the subject matter, making Sharī'ah compliance doubtful even in legal sense. The ban on selling before possession implies that consequent upon a sale agreement, delivery has to be given and possession taken, implying that settling only the differences in prices is against the rules for valid transactions. Al-Bashir (2008) concludes his book *'Risk Management in Islamic Finance: An Analysis of Derivatives Instruments in Commodity Markets'* by contending that the forwards, futures and options contracts in currencies, interest rate and stock indices are not permissible in Islamic law due to the clear involvement of *ribā* or excessive risk which is a form of *gharar*. He accepts the possibility of shares and commodities based derivatives and this is the area in which Islamic finance experts may explore on the basis of cushion provided by the Sharī'ah by way of *salam* principles. He contends that development of a viable Islamic future market is possible if we adapt the conventional

commodity forward contracts on the basis of *salam* principles. In this context he validly refers to the resolution of the Jeddah based Islamic *Fiqh* Academy [No. 107 (1/12) 23–28 September 2000] which maintained the following in its rejection of the forward contracts in commodities:

> "If the subject matter in the forward contract is a commodity that needs manufacturing, transaction must fulfill the conditions of *istiṣnāʿ*. If manufacturing not needed, price must be paid on spot and the transaction must fulfill the conditions of *salam*. However, if the price is not paid at the spot, the transaction will be illegal because it is a kind of *bai' al-kālī bil kālī*. On the other hand, if the transaction is just a promise and not binding upon either parties or at least one of them, it will be permissible".

Proper risk management involves and requires a clear policy and process of decision making, transparency, properly availing the opportunities for profit and overseeing the performance of the personnel involved. For the IFIs, the risk of Sharīʿah non-compliance is also important and needs to be taken care of in addition to the common risks. It is imperative that the Sharīʿah scholars and practitioners abandon the practice of justifying non-Sharīʿah compliance on the basis of ruses or for commercial reasons. The dichotomy between developing Sharīʿah based products and competing in the conventional market can be resolved by strengthening the regulatory regime(s), introducing ethical aspects, creating secondary market for Islamic instruments, implementing Sharīʿah based risk mitigation techniques, strengthening internal and external controls and Sharīʿah certification SOPs and procedures. Banks may also diversify financing and investments for the purpose of risk mitigation.

Better risk management also requires better monetary management by the monetary authorities to ensure that the human and material resources are diverted from speculative / unethical activities to the real economy. The money or the purchasing power created at national and global levels must represent the existing or the potential real assets in the spot and forward markets to ensure that all economic agents get return based on genuine risk-reward structures. Finally, the management and personnel of the IFIs should not become a part of the self-centered conventional business model, which "*made it easier to operate in one's own narrow interests, without the usual feelings of empathy that alerts us to the pain of others and define us as humans*." (Abdullah and Mirakhor, 2013). They must stick to the moral and rational principles to become flag bearers for prevention of harm to the human beings. Only then, we can persuade the global community to work for universal values for application of the 'golden rule' and equitable fair dealing.

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