

Reforming Islamic Finance: Why and How?

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ABSTRACT. After half a century of development, Islamic finance has grown into an industry that is very different from the ideals envisioned by its pioneers. There have been widespread calls for reform, but the direction of this reform has been a subject of great debate. This paper looks at the current state of the Islamic finance, defining where the main issues lie including a discussion on quantity versus quality. This paper will also propose an appropriate direction of reform that works to refine the current practice and expand the scope of Islamic finance to embody the ideals of its founding pioneers. The researcher utilizes both deductive and inductive methods referring to the wealth of Islamic finance literature as well as observation from her extensive practical experience in the industry as a methodology for this paper. The most important findings are that Islamic finance has thus far achieved great growth, but which lacks in quality. Various Sharī‘ah, authenticity, regulatory, and *maqāsid* realization issues still lurk. The ideal approach to reform looks at the current state of Islamic finance and attempts to refine the practices of Islamic financial institutions. Furthermore, it is proposed that the scope of Islamic finance be broadened to incorporate the underserved segments of the society including the third sector. The paper recommends that a platform be setup or an authority be commissioned to oversee this transition, and that a talent pool be created to lead the new initiatives and institutions that will result from this reform.

KEYWORDS: Islamic finance reform, Future of Islamic finance, Islamic financial inclusion.

JEL CLASSIFICATION: G20, P49, B59

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1. The Current State of Islamic Finance

Islamic finance (IF) is a system of financial principles, rules, ethics, contracts, and institutions that finds its basis in the Qur'ān, revealed by Allah, and which is intended to form a comprehensive code of conduct for people. IF finds its roots in the scripture of the Qur'ān, the traditions of Prophet Muhammad (may the peace and blessings of Allah be upon him), and the juristic (*fiqh*) literature of Muslim scholars. *Mu'āmalāt* was the term devised to describe the specific aspect of jurisprudence that adhered to the Qur'ānic and Prophetic teachings. *Mu'āmalāt* consists mainly of principles and contracts which form the basis of human contractual dealings, including, but not limited to, economic and financial dealings.

IF is a contemporary development whose origins can be dated back to 1960 when the first Islamic finance institution (Mit Ghamr) was established, to 1963 where Tabung Haji in Malaysia, an Islamic savings and investment platform, was instituted. In 1971, the Nasser Social Bank in Egypt was established as a social finance institution. In 1975, the first commercial Islamic financial institution (IFI) was established (now Dubai Islamic Bank) (Iqbal & Molyneux, 2005, p. 37; Orhan, 2018, p. 86; Lembaga Tabung Haji, n.d.). Since then, IF has only seen exponential growth pursuant to which clear divisions of institutions and services started to take form in the industry. Besides Dubai Islamic Bank, Kuwait Finance House, Faisal Islam Bank, and Bank Islam Malaysia were founded as commercial Islamic banks (IB).

Takāful (Islamic insurance) companies did not lag far behind seeing the first of such institutions, the Islamic Insurance Company, established in Sudan in 1979. Then, in Luxembourg, in 1983, Dar al-Maal al-Islami took up the *takāful* business, and in Malaysia, Takaful Malaysia was established in 1984 (Khan, 2013, p. 408). Soon thereafter, the capitalization needs of IBs and *takāful* funds, as well as other money managers, necessitated the institution of Islamic capital markets (Muhammad, Sairally, & Habib, 2015, p. 11).

IF is a contemporary development which has built its theoretical foundations on key principles. Among them, as elaborated by Çizakça (2011, p.

133), is the ban on *ribā* (usury), *gharar* (uncertainty), and immoral products; IF should embody profit-and-loss sharing (PLS), and the materiality of transactions must be linked with tangible underlying assets. Others do not limit IF to these principles but, for example, extend the modes of financing to add the principle of *bay'* (sale) besides PLS modes (Kahf & Khan, 1992, p. 28). These basic principles have a bearing on each of Islamic banking, Islamic capital markets (ICM) and *takāful*. Besides that, contracts common to the *mu'āmalāt* law such as *bay'*, *ijārah* (lease), *qard* (loan), *wakālah* (agency) and *mushārakah* (partnership) form the basis of all IF products and instruments. Finally, such principles and contracts are believed to lead to have the ultimate end of achieving economic well-being, justice, and development, besides other things which Muhammad Umer Chapra repeatedly emphasizes (Chapra, 2014, p. 1, 67).

In judging the achievements of the IF industry to this day, they are by no means trivial. As an industry and a system that rose to prominence in the face of the hegemony of capitalism, IF has made big strides and has extended its presence and product offerings to almost every domain of the financial sector. IBs today offer the full-range of depository and financing products, including term, trade, and revolving facilities financing. In fact, IB product offerings extend beyond that of conventional banks to include the investment account that, in some jurisdictions such as Malaysia, complies fully to the profit-sharing ideal of *muḍārabah*-based products including investment accounts and the recently-launched Investment Account Platform. The same argument can be made for ICMs where product differentiation exists as well from that of conventional capital markets, specifically due to an instrument that has enjoyed high acclaim, the *ṣukūk*. The *ṣukūk*, as asset-based or asset-backed securities, have been one of the IF's most successful experiments and have attained great sophistication and growth. The *takāful* industry, albeit smaller in asset size than IB and ICMs, has also developed greatly reporting year after year growth and, in some jurisdictions such as Malaysia, expanding its range of product offerings to match that of conventional insurance offerings. IF

assets stand at US\$ 2.591 trillion as of the end of 2018, a growth of 6.58% from the previous year with IBs possessing most of the global Islamic AuM (assets under management) (Azmi & Sheikh, 2019, p. 76).

Looking at the sophistication of legal and regulatory frameworks, Reuters' IF Development Report (Mohamed, Goni, & Hasan, 2018, p. 24) ranks Malaysia, followed by Bahrain, Indonesia, Qatar, Nigeria, Pakistan, Brunei, and Oman, respectively, as having developed regulatory frameworks. Of notable mention is the recent prudential regulatory developments by the Islamic Financial Services Board (IFSB). In 2015, the IFSB dedicated a taskforce to developing the prudential and structural Islamic financial indicators, besides the prudential standards that were developed prior to that, for IFIs to capture the strengths and vulnerabilities of the sector (al-Mamun, 2017, p. 4; IFSB, n.d.). The IFSB and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) have led IF in standard development issuing a variety of regulatory standards including prudential and market conduct regulation, corporate governance and Sharī'ah governance, accounting and auditing, Sharī'ah auditing, etc.

Coming to the IF legal developments, while they are wide-ranging in nature, they can be classified into extensive developments, moderate ones, and relatively negligible ones. Jurisdictions such as the UAE for example have incorporated *mu'āmalāt* contracts and principles into their civil code. Another type of extensive development is like what Pakistan has done which is to make amendments to its Banking Companies Ordinance to accommodate for non-interest banking very early on. Other countries however need to catch up having largely made moderate changes to accommodate for IF (Morocco, Lebanon, and Sudan) including amending tax laws for a more tax-neutral playing field; or minor amendments (the majority of IF jurisdictions) (Dewar & Hussain, 2018, pp. 95-96; State Bank of Pakistan, n.d., para. 3; Sujud & Hachem, 2018; Yesuf, 2017; Soudi & Cherkaoui, 2015; Ashraf & Giashi, 2011). Having said that, such sources cite that comprehensive legal frameworks which incorporate capital markets and *takāful* with the existing Islamic banking industry are generally lacking.

Sharī'ah governance is also an essential element of any IFI which has seen growing sophistication, especially in Malaysia, Bahrain, and Kuwait (Mohamed et al., 2018, p. 11). To demonstrate, Bank Negara Malaysia's (BNM) Sharī'ah governance framework comprises a wide array of 'Sharī'ah functions' including Sharī'ah review, Sharī'ah research, Sharī'ah risk, and Sharī'ah audit functions as well as the Sharī'ah committee (BNM, 2019). All such layers ensure rigorous checks and balances set in place to ensure product and operational Sharī'ah-compliance of IFIs. The work by IFSB and AAOIFI to standardize a global Sharī'ah governance system for Institutions offering Islamic financial services is another sign of the sophistication of the IF industry as a whole (IFSB, 2019; AAOIFI, 2015).

2. The Divergence between Theory and Practice

Having attained size and sophistication, the IF industry has not solved all of its problems. The question that begs answering is: where does the major problem lie in IF? Is it in IF theory or is it in the practice of the industry? Whatever the answer, there is a clear divergence between theory and practice, as will become clear, and thus, bridging the gap becomes priority number one. Alternatively, the problem may be even more deeply rooted in the IF industry itself in that it may be premised largely on its core profit-oriented institutions such as IBs and *takāful* operators (TO) which are imports of the conventional system.

To answer the first question, bridging the gap will mean identifying where the problem lies. This may at first sight appear to be a straight forward review of the theory and practice to judge whether it is the theory that is faulty, or the practice that has contravened theory. However, the fact that different opinions exist on IF's normative ideals and the varying references upon which different jurisdictions base their practice makes identifying the problem all the more difficult. To add to the complication, the majority of the Sharī'ah evidence (texts of the Qur'an and Sunnah) are not equivocal in their connotation which means they are subject to different interpretations by qualified scholars. The hegemony of the conventional financial system and the minuscule – albeit rapidly growing –

share of IF assets around the world raises a further question. Is it fair to judge the practice solely based on its conformity to its theoretical reference without considering conditions that are imposed on IFIs from their conventional competitors?

2.1 Issues in IF Theory

It would not be practical to review every issue that exists with the IF theory in great depth as other studies have executed well in that regard. However, as a demonstration of how intricate theorizing in IF can be, we review a classical issue that persists until today, the idealization of risk-sharing. Iqbal and Mirakhor (2011, p. 109, 371) and numerous other scholars before and after mention that the primary issue in IF practice is its divergence from the risk-sharing ideal which is heralded as the most equitable mode of Islamic financing. However, risk-sharing financing itself brings to light a further complication, i.e., risk-sharing contracts have not been the only theoretical proposition by IF since other scholars, such as Kahf and Khan (1992, pp. 27-28), identify the mark-up sale modes as another form of financing. In fact, sale-based finance is probably the only mode of finance directly explicated by the Qur'ān with no mention of risk-sharing contracts. Furthermore, risk-sharing is known to give rise to serious issues in practice such as adverse selection and agency issues (Farooq, 2007, pp. 72-75). Sale-based modes have their own issues in that if not executed properly, they may compromise equity and give rise to proliferation of debt in the economy.

Another issue that arguably ranks at par with risk-sharing is the issue of substance over form. The debate is not new to IF since it originated far before at the time of the classical jurists, but is just as relevant – if not more – to the complicated structures of IF products and instruments. It is well established that the *fuqahā'* have taken sides on both ends of the debate, some prefer contractual form, others prefer substance (al-Zuhaili, 2006, 1:404-405).

Another important theoretical issue is the amalgamation of contracts. The Prophet (may the peace and blessings of Allah be upon him) is known to have prohibited conjoining multiple sales in one contract or that a sale and loan be made conditional

on the simultaneous fulfillment of one another. However, to take inter-conditionality literally is problematic since some have argued that such prohibitions by the Prophet (may the peace and blessings of Allah be upon him) were only intended to prevent legal stratagems to incurring *ribā* (usury). The general position of the industry supports that interdependence or inter-conditionality of contracts is strictly prohibited (examples include: International Islamic Fiqh Academy, 1988, 2000; AAOIFI, 2017, p. 258, 662; BNM, 2010, p. 114). However, this issue does not end here. A variety of IF products and instruments do indeed incorporate a variety of contracts and supplementary conditions such as binding promises under a single agreement which have been approved of by the same bodies of IF experts that disallowed the inter-conditionality of contracts. Interestingly, this takes us back to the debate of substance over form.

Materiality is another important principle emphasized by Askari, Iqbal, Krichene, and Mirakhor (2014, p. 30) which ties transactions to real assets. This does, however, leave a question unanswered: are non-asset-backed transactions and securities considered fictitious? If that is the case, then a lot of today's IF practices and product structuring, especially in IBs and ICMs, meet the requirements of materiality only in form but not substance. Typical examples include *tawarruq*-based IB deposit and financing products, asset-based *ṣukūk*, Islamic structured products and Islamic derivatives. It then becomes essential that one understands the basis of materiality as a theory of IF and its influence on the validity of a transaction. Related to the materiality debate is the 'equity versus debt' debate since theoretically, the Sunnah explicitly permits credit transactions due to the need for them (Kahf & Khan, 1992, p. 28). The debate has largely been what is more ideal, asset-based financing or credit-based financing and, theoretically, should debt be allowed to proliferate?

The last issue that is of notable mention is the legitimacy of profits earned by IFIs, especially since they claim to adhere strictly to Sharī'ah principles and utilize *fiqh* contracts. The *fiqh* literature has upheld the notion that return is earned by a party only if that party dedicates either capital, labor (effort) or *ḍamān* (bearing risk) (al-Zuhaili,

1985, 4:816). The issue is that such elements have very broad interpretations such as the kind of labor that is intended, and how *damān* is handled by IFIs. Market, ownership, and capital loss risks have been proposed as the *damān* which the IFI must bear without transferring them to the customer. The labor elements are relevant to *muḍārabah* set-ups and compensating entrepreneurial resources. However, such interpretations are based on Prophetic reports which bear multiple interpretations and of which some are not historically authentic (having a weak transmission).

2.2 Issues in IF Practice

Besides the occasional allusions to the issues in IF practice that have preceded, there are a variety of issues in the practice that have been identified. Such issues may only appear as issues when framed in certain theoretical references, but may not appear to be so in other cases. For example, if IF theory strongly holds that replication and benchmarking of conventional products/indices goes against the distinct nature of Islamic law and of IFIs, then replication and benchmarking of conventional products and rates is a practical issue. However, if theory provides concessions for such practices as per the dictates of time and circumstance, and the requirements of gaining a competitive edge, then such practices should not be problematic. The same applies for the emphasis on debt-based financing for which IBs are notorious, along with money and capital market instruments which heavily rely on debt-based arrangements. Some concede that the credit-oriented status quo of conventional finance imposes itself on IFIs which deal in debt-like contracts. Some view this as by no means an ideal or the end of IF but merely a concession for a transitional step to risk-sharing equity arrangements (Usmani, 2002, p. 66).

Legal and regulatory consolidation, standardization, and development are other major issues which are not purely under the control of the IF industry per se. While some jurisdictions have advanced to a very sophisticated level of legislation and regulation, most other jurisdictions continue to disregard IF's potential as preceded. Even with sophistication of the legal and regulatory frameworks, standardization still remains an issue. It is

very clear from the preceding discussion in the introduction that the various developed jurisdictions have not taken the necessary steps for harmonization and consolidation, perhaps due to the lack of collective will on the part of IFIs to pressure their regulators and governments.

Sharī'ah standardization is another major issue which is closely related to IF law and regulation development since international Sharī'ah standard-setting bodies like IFSB and AAOIFI do not wield any legal authority over any one IF jurisdiction. The variety of Sharī'ah governance structures presents another issue such as in UAE where no central Sharī'ah board exists to standardize the *fatwā* (Sharī'ah legal verdict) for the individual banks. Malaysia is a good example of standardization and centralization of *fatwā* and regulation including Sharī'ah governance due to the setup of a Sharī'ah Advisory Council (SAC) at its central bank. One will notice divergences between the SAC's Sharī'ah Resolutions in Islamic finance (2010) and AAOIFI's Sharī'ah Standards (2017). The lack of standardization presents an impediment to the harmonization of markets as well. A number of IF products and instruments such as *takāful* products and capital market instruments could easily be bought and sold across different jurisdictions if proper legal and regulatory standardization could be achieved.

Closely related to the preceding discussion is corporate governance. While Sharī'ah governance has advanced far in some countries such as Bahrain and Malaysia, corporate governance as a whole at IFIs remains faulty. An important element of corporate governance of IFIs is to ensure stakeholder interests are met among other things (Hassan, 2014, p. 83). Although Islam has given utmost regard to proper corporate governance and the preservation of stakeholder interests, till today, the interests of key stakeholders at IFIs are not properly looked after. This and other governance issues give rise to yet another issue in the practice which is the lack of transparency as reported by the Islamic finance development report (Mohamed et al., 2018, p. 5). Chief examples that come to mind are the rights of depositors and investment account holders relative to those of shareholders at IBs; the rights of *shukūk* certificate holder in a variety of

liquidation events relative to those of the issuer; and the rights of *takāful* participants (policy holders) relative to those of the shareholders of the *takāful* operators.

The final issue of significance is that the IFIs have largely marginalized social finance and the third sector. Composed of mainly *zakāh* (mandatory alms) institutions, *waqf* (Islamic endowment) and Islamic microfinance institutions (IMFIs), Islamic social finance lags far behind its commercial counterpart in development. One of the main reasons that is cited by Azmi Omar (in 2014) is that Islamic social finance “failed to catch the fancy of the (Islamic finance) professionals and practitioners” (Junaidi & Aziz, 2018, para. 4) It is argued that IFIs currently look for safe and lucrative finance investments to inject their funds into, something which the Islamic social finance and the third sector currently does not offer, and may never be able to offer for that matter.

This interestingly leads us to the second major question that was posed in the beginning of this section. Has the IF system in theory and practice premised itself on ideas imported from the conventional system? This is a much deeper problem as it goes beyond the question of replication. Were large sophisticated commercial institutions ever meant to be the focus and end of IF? Considering the general lack of care for social responsibility, is an IFI free of societal obligations? And is it permitted to discriminate against one category of people or is there an Islamic moral obligation that society as a major stakeholder should elicit as much, if not more, concern than IFI’s shareholders and their profit motives? If one is to answer such tough questions, it would require reviewing the Islamic worldview for a moral reference and ensuring that IFIs and their purpose, responsibilities, and operations fit well within this worldview.

While capitalism advocates for free market and private ownership and communism gives all members of society equal share in economic product and almost no control over the markets, the Islamic worldview puts IFIs in the middle of such contrasting extremes – while individuals are entitled to private ownership and accumulation of wealth, it is not done at the neglect of social well-being. While IFIs do not wield absolute control over the market, they wield a critical amount of influence, enough

to balance the circulation of capital so those who need it most and those who need uplifting get an opportunity to do so. Is this the case today? This does not seem to be fully realized today and the question of when and if ever it is going to be realized remains unanswered.

3. Quantity versus Quality in Islamic Finance

Considering the rate at which IF has grown, it behooves us to ask whether or not this growth has fulfilled the expectations of IF’s pioneers and visionaries. Before that, it is important to look at the reason for the rapid growth – albeit capturing only a small share of the global financial markets. The first and foremost point of relevance is IF’s emphasis on values built on the Islamic legal system which is based on divine revelation. It provides a moral and ethical compass for human beings in different walks of life. The Sharī‘ah upholds justice, it is humanitarian in nature, and thus uplifts marginalized segments of the society. It upholds cleanliness, and thus does not allow financing impure and harmful activities, and upholds moderation, such as in the consideration of stakeholder interests. Furthermore, well-being is the ultimate goal of development. Hence, financial growth is not the end itself but a means to the well-being of society (al-Qaradawi, 1995, p. 65).

The value propositions offered by IF products in each of IF’s three sectors are arguably another important reason for its rapid growth. To Muslims, they provide an alternative and Sharī‘ah compliant access to finance, while to non-Muslims they provide an alternative avenue to financial products and instruments, be it for the sake of affordability, profitability, or even diversity.

The stability of the Islamic financial system (IFS) is another attention-getter, especially after the subprime crisis caused by irresponsible banks and regulators in the United States. The IMF’s survey ‘The effects of the global crisis on Islamic and conventional banks: a comparative study’ (Hassan & Dridi, 2010), proves evidently that IBs, which are at the heart of IF and compose its largest share, are more stable than their conventional counterparts due to the materiality of their financing and investments. IBs were only adversely affected after the effects of subprime crisis made it to

the real economy. However, they fared much better during the initial credit crunch which saw the value of fictitious assets such as MBS (mortgage-backed securities) and CDS (credit default swaps), and profits of conventional banks wiped out very quickly. Even the negative effects on IBs were in part due to the lack of economies of scale, lack of diversity of investment avenues, etc., unlike their conventional counterparts (Hasan and Dridi, 2010, p. 24-25, 33).

The spread of IF to almost every continent, to a variety of non-Muslim jurisdictions (IFSB, 2019, p. 12; Domat, 2018), and its growing awareness (Mohamed et al., 2018, p. 12) in a short timeframe is nothing short of impressive. It is high time however to look at such achievements and compare them against the ideals and expectations of IF's pioneers and visionaries. The Islamic moral economy (IME) represents a holistic framework of values and norms for IF (Asutay, 2012, p. 99). It goes beyond commercially-oriented IFIs and centers its focus on the Sharī'ah tenants and principles, the real economy, and has a society orientation. Besides the prohibition of *ribā*, *gharar* and certain goods/activities, the IME emphasizes risk-sharing and discourages credit products. It emphasizes the real economy and is society-oriented finance. Asutay (2012, p. 97) further identifies Mit Ghamr, which preceded the first commercial IFI (Dubai Islamic Bank established in 1975), as having upheld the premises of the IME. His conclusion is that the financialization trends observed in Islamic banking and finance (IBF) today do not conform to the norms of the IME and ultimately, the vision of its pioneers. Of special mention is the neglect of society which will be the focus of a later section. The substance and attainment of *maqāṣid al-Sharī'ah* (Sharī'ah objectives, referred to as '*maqāṣid*' for short) are another good measure of quality achievement in IF which shall be revisited in the next section.

While some aspects of the IME could be debated, such as the idealization of risk-sharing and discouragement of debt, the emphasis on social objectives of IF and the IME are hard to disregard. While it can be submitted that Islam does not discourage profit-making and commercial enterprises, it definitely cannot be the only objective of IF. The

simple reason behind that is that concern for different stakeholders, segments of the society, and environmental sustainability are all considerations that have to be made if a moderate approach, which is so important in Islam, is to be taken. IF's qualitative success must then take a comprehensive approach and not merely meeting commercial interests of relevant stakeholders.

Developed legal, regulatory, and governance frameworks are also important indicators of the quality of IF development. While a variety of IF markets previously mentioned have attained legal and regulatory sophistication, corporate governance remains a major issue due to the sheer number of affected stakeholders as explained earlier. A subset of corporate governance is Sharī'ah governance which represents another important measure of the quality of IF. Finally, the quality of IF practice would not be up to standard without a comprehensive litigation and dispute resolution framework and institutions to reduce friction in cases of conflict. This measure is yet to be tested thoroughly in most IF jurisdictions.

While the qualitative elements are numerous, the goal here is to bring to the surface the most important ones. The quantitative achievements of IF have to be supported by qualitative success to ensure the sustained growth of IF. The two aspects work to benefit one another since, if quality in IF is maintained and improved, the numbers should be expected to grow healthily.

4. Issues and Concerns that Still Exist

IF derives its uniqueness in that it is based on the Sharī'ah and its value system which is why the primary issues that must be set straight are Sharī'ah issues. Building on that, one must also look to the authenticity of products which must balance out with innovation, for if anyone were to outweigh the other, either authenticity would be compromised or innovation impeded. Another issue of focus is regulation which represents a check and balance to facilitate conformity to the law, or to the Sharī'ah in the case where IF law does not exist in the respective jurisdiction. Furthermore, since IF is not value-neutral and in fact differs from other finance philosophies in its system of divinely-ordained values, it is important to reassess

whether the Sharī'ah values embodied in its objectives (*maqāṣid*) are upheld in IF practice.

Whether Sharī'ah issues exist in IF practice is a matter of frame of reference and depends on who you ask. Hardliners and idealists will label the entire IFS as non-compliant with the Sharī'ah. Practicality and industry advocates may admit to the impracticality of attaining ideals while at the same time reiterating the general Sharī'ah compliant nature of IF practice.

The attempt of IBs to recreate conventional products, but structure them in a manner which fulfills the contractual requirements of *mu'āmalāt* law has attracted a lot of criticism. For example, the *hibah* on deposit products, the correlation of investment account (IA) returns with those of prevalent conventional deposit rates, the Sharī'ah status of investment account holders (IAH), the legal stratagems used in financing products such as *tawarruq*, the ownership issues in financing products such as *murābahah*, *ijārah*, and *mushārakah* finance, the benchmarking of conventional interest rates in financing products, the emphasis on fixed return non-participatory modes of financing, and the list goes on.

In ICMs, a similar set of criticisms of Sharī'ah non-compliance is directed at the practice; most notably, the proliferation of debt-based *ṣukūk* and ownership issues that exist therein, debt trading in *ṣukūk* and other Islamic money market (IMM) instruments, the status of *ṣukūk* holders, and the distinction of ordinary and preference shareholders. The overall structure of Islamic derivatives and structured products draws lots of criticism due to the use of undertaking to recreate a contract with the fictitious and prearranged nature of transactions to replicate returns of other assets and indices. The concessions in Sharī'ah screening methodologies such as those used by AAOIFI and the Securities Commission of Malaysia as to the percentage of allowable conventional activities, and financing and income from impermissible activities also draw some criticism.

There are also various Sharī'ah issue cited in *takāful* practice. These include the basis for surplus redistribution and *tabarru'* (contribution), the status of participants and the TO, the imposition of

the *qardḥan* to cover deficits of the *tabarru'* fund (risk fund), the basis for certain family *takāful* products, etc.

These issues barely scratch the surface of the plethora of Sharī'ah issues which have existed and persist, and which present a large obstacle for IF as the idealists would have it. The role of Sharī'ah scholars and advisors is important as they are looked to as the ultimate reference on compliance or non-compliance of products and operations, both at the central supervisory body and at individual IFIs. Sharī'ah scholars and advisors should use their influence for concerted action to lead reform of IF practice to resolve the issues where possible, or to find a common ground. Respective bodies which aggregate such scholars like the Association of Sharī'ah Advisors in Islamic Finance in Malaysia or the variety of international *fiqh* councils could push for such reform.

The discussion on authenticity and product innovation in IF will follow a similar pattern as the one above, since IF experts remain in a tug of war over idealism and practicality. The industry itself is in a constant struggle between maintaining Sharī'ah authenticity and innovating alternatives to compete for market share. While both authenticity and innovation are legitimate considerations, the balance of the two rests in the ability of IF experts and stakeholders, including practitioners, scholars, regulators, policy makers, and other stakeholders to maintain open dialogue, commit to understanding, and abide by revelation while not neglecting reason. Hence, criticisms of Sharī'ah non-compliance must be accompanied by practical alternative propositions which are more Sharī'ah compliant, while the concessions granted by Sharī'ah advisors and other so-called realists must be accompanied by a roadmap and a competent action plan as to the expected reform towards quality, comprehensiveness, and authenticity.

As of the beginning of 2018, IF regulation has come a long way with 45 countries having Islamic banking regulation (Mohamed et al., 2018, p. 5). However, it still has some way to go in attaining sophistication across different IF jurisdictions, such as in instilling a strong sense of governance. Mohamed et al. (2018, p. 24) report a lack of

Sharī'ah governance regulation in many countries with only 25 countries having such regulations, slightly lead by accounting regulations for IFIs which is present in 26 countries.

Overall, the major reasons for weakness in the governance of IFIs is the lack of transparency and corporate social responsibility. Other reasons identified are the conflicts of interest that persist between key stakeholders of IBs, *ṣukūk* and *takāful*, even in the most advanced jurisdictions such as Malaysia. With better transparency and greater consideration for corporate social responsibility, such conflicts stand a better chance of being resolved.

There is further weakness in Sharī'ah governance regulation which is attributed to the lack of variety of Sharī'ah scholar backgrounds. While this is true for some countries such as Bangladesh (Mohamed et al., 2018, p. 25), other jurisdictions such as Malaysia and Bahrain have a much more well-equipped pool of scholars due to the two countries' advancement in IF education and training programs as well as sophisticated standard-setters. An allusion must be made to supervisory as the technical provisions made for IFIs, especially IBs, are different than those of their conventional counterparts (el-Qorchi, 2005). This is primarily due to the unique nature of IFIs and the contracts underlying deposit, financing, and investment products.

Capital adequacy and risk management are issues that have persisted in regulatory and supervisory frameworks developed to cater to IFIs. It may be the case that different jurisdictions adopt different approaches to regulating and supervising IFIs; or it is the case that a limited number of countries have applied already existing regulatory and supervisory standards developed by standard-setting bodies such as AAOIFI (Kammer et al., 2015, p. 17).

A last issue that elicits serious thought and which has been pointed out before, is the attainment of *maqāṣid* in IF practice. To ensure their fulfillment, a methodology and perhaps a set of parameters or an index, is required. Numerous claims exist that IF practice has not been coherent with *maqāṣid*. However, such judgements that are not accompanied by a methodology or parameters based on which such claims are made, is not a

healthy approach as criticism alone does not help in solving the problem. Criticism must be constructive. It must be well articulated with regards to the methodology used in gauging the fulfillment of *maqāṣid* or the lack thereof, and it must be accompanied by alternatives.

Also of relevance is the observance of the basic principles and contractual conditions of *mu'āmalāt* which render transactions valid and which are undisputable. Thus far, a good solution has been the practice of *talfīq* which refers to a form of cherry-picking appropriate verdicts from a certain *fiqh* school which suits the IF product under consideration.

5. Overcoming the Issues

Overcoming the numerous issues discussed will require a two-pronged approach which includes enhancing the current state of the IF industry and further expanding into other sectors and activities. First, on the side of existing commercial IFIs, there needs to be a focus on ethics and a refinement in some aspects such as disclosure for greater transparency and social responsibility. Furthermore, IF practice has to broaden its scope to be more inclusive of other sectors and activities such as the third sector.

As for the first prong of the approach, a variety of Sharī'ah, prudential, supervisory, corporate governance, ethical, and *maqāṣid* issues have been pointed out. If the IF industry is expected to grow sustainably, it must be ready to tackle these issues. It is not intended here to present the appropriate response to these issues, suffice it to say that elaborate propositions have been made by researchers and experts. Furthermore, policy action, awareness, and dialogue are all important factors for taking on these issues.

The second prong entails the serious consideration for expanding IFI activity and products for a more comprehensive approach to financing. The focus on shareholders as the primary stakeholders of the IFI will need to be relaxed and a serious consideration must be given to other stakeholders such as unbankables and other less privileged segments in the society. This includes the proper fulfillment of solidarity duties of the IFIs such as *qard*, *waqf* and *zakāh*. This further entails the financing of marginalized groups which form a significant portion of the society. Such expansion to

other activities and products should learn from the experiment of the existing commercial institutions. The principles of IF do not change such as the basic prohibitions of *ribā*, *gharar*, *maysir*, and immoral activities, and the requirements for validation of contracts. The nature of products, prudential and market conduct regulation, supervision, and governance, etc., will naturally differ due to the alternative ethical considerations that are required for expanding into other sectors and catering to other segments of the society.

The IFSB refers to social solidarity instruments which have their unique set of concepts and contractual obligations (IFSB, 2018, p. 11). While *muḍārabah* financing is equity-based in nature and does not have the strict features of credit financing, *tawarruq* does, and is commercial in nature as it requires the fulfillment of the terms of the underlying sale contract including meeting the payment schedule.

Prudential regulation would relax some technical requirements for IFIs offering social or micro-finance due the differing nature of risks. This would not mean however the exemption of IFIs offering social finance from proper prudential requirements as they are part of the financial system and may or may not affect systemic risk. The conduct of IFIs offering social finance is also important and has a bearing on ethics in dealing with a unique segment of the society, its financial literacy, disclosure requirements, and so forth. The supervisor will need to be considerate as to their approach to IFIs which conduct social finance activities including regarding the financial reporting requirements as is duly noted by IFSB's Technical Note 3 (TN-3) (IFSB, 2018, p. 73). The TN-3 is a commendable initiative on behalf of the IFSB which focusses on providing a benchmark of regulatory and supervisory policies to support financial inclusion. It factors in proportionality of regulation, recent developments in financial inclusion propositions, modalities for Islamic social finance, and highlights challenges and proposes solutions for hindrances to microfinance expansion and financial inclusion.

A best practice model can be followed for the expansion of IF into new sectors and activities. IFSB's TN-3 provides a variety of considerations for key ingredients of this model. This can bridge

the gap between current theories and propositions such as IFSB's TN-3, and between practice. It is argued that theoretical propositions and models have failed to materialize. This failure is attributed to the collectivity of stakeholders, although individual persons or institutions may be given due credit for extensive effort in advocating for a more comprehensive and inclusive IF. It is merely paying lip service to commend the progress of inclusiveness of IF while there is prevalent reluctance to lead the transformation from stakeholders including IFI directorship and ownership, Shari'ah scholars and advisors, regulatory and supervisory bodies, and governments.

To lead the initiative of a comprehensive and inclusive IF, a taskforce needs to be commissioned which must have a minimal level of authoritative-ness. An existing institution that has extensive experience in inclusive financing, such as the Islamic Development Bank (IDB), may take up the initiative. The taskforce could consider a platform which will facilitate serious dialogue and push for action for inclusion of the third sector and other underserved segments by IF. Prerequisite ingredients for the success of this transition and effectiveness of the taskforce and platform that is set up is effective education of both IF students and practitioners. Educational curricula will need to do justice to all aspects of IF to ensure comprehensive understanding by newly graduating talent. This can be complimented by the transfer of talent from existing IF practice and institutions to new or existing IF institutions and activities that focus on inclusion of other non-commercial sectors. The ultimate success of the transition will lie in the creation of an effective talent pool which is technically equipped and morally conscious of its duty to uphold an inclusive IFS.

6. The Way Forward

A careful systematic process of reform is required for IF. Neglect of any single important element of a systematic process could either hinder or completely ruin any reform progress that is made. The IFS is not exempted from the complexity and multi-faceted nature of a financial system. The inception and growth of the IFS for 50 years is a good example of the transition of reform from theoretical propositions to practice. A limited number of institutions

were initially developed with limited capital, talent, products, customers, legislation, regulation, etc. As awareness spread, so too did market interest, the sophistication of education and qualification, product

diversity and intricacy; legislative, regulatory, and policy action all had to follow. It is imagined that a similar transition process will be made to a new comprehensive and inclusive IFS.

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إصلاح التمويل الإسلامي: لماذا وكيف؟

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المستخلص. بعد نصف قرن من التطور، أصبحت المالية الإسلامية صناعة مختلفة كثيرًا عن المثاليات التي كان ينشدها رواد الصناعة. هناك نداءات واسعة الانتشار إلى التجديد، ولكن اتجاه التجديد لا يزال محل جدل. نَظَرَ هذا البحث في الوضع الراهن للمالية الإسلامية، وذلك بتحديد الإشكالات الرئيسة القائمة بما في ذلك قضية الجودة والكمية. ومن ثم اقترح هذا البحث اتجاهًا مناسبًا للتجديد، والذي يدعو إلى صقل الممارسة الحالية وكذلك توسيع نشاطات المؤسسات المالية الإسلامية لتحقيق المثاليات التي كان ينشدها رواد الصناعة. تم توظيف المنهجين: الاستقرائي والاستنباطي لتحليل الدراسات الجمة حول المالية الإسلامية، كما اعتمدت الباحثة على منهج الملاحظة المتمثلة في خبرتها العملية الواسعة في صناعة المالية الإسلامية لإجراء هذا البحث. توصلت الدراسة إلى نتائج أهمها: أن صناعة المالية الإسلامية أنجزت نموًا عظيمًا إلى حد الآن، ولكن لم يصاحب هذا النمو الجودة المنشودة. كما أوضحت نتائج الدراسة أن ثمة إشكالات عدة لا تزال قائمة، أهمها: الإشكالات الشرعية والتنظيمية، والأصالة، وتحقيق مقاصد الشريعة. المنهج المثالي للتجديد يتمثل في تقييم الوضع الراهن للمالية الإسلامية ومحاولة صقل ممارسات المؤسسات المالية الإسلامية. ويقترح البحث توسيع نطاق المالية الإسلامية ليضم القطاعات المهمشة في المجتمع بما في ذلك القطاع الثالث. أخيرًا، يوصي البحث بإنشاء منصة أو مفوضًا خاصًا للإشراف على هذا الانتقال، وأن يتم تكوين مجمع مواهب ومؤسسات مخصصة لقيادة المبادرات الجديدة لكي تحقق الصناعة نتائج إيجابية من هذا التجديد..

الكلمات الدالة: إصلاح التمويل الإسلامي، مستقبل التمويل الإسلامي، الشمول المالي للتمويل الإسلامي.

تصنيف JEL : G20, P49, B59

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