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Gaps in Theory and Practice of Islamic Finance

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In this paper the author attempts to identify what he calls gaps in the theory and practice of Islamic economics. He records ten such gaps; namely:

1. Division of Labor between Economists and Sharīʻah Scholars.
2. Absence of an Islamic Economic System in Real Life.
3. Absence of a General Equilibrium Model for an Islamic Economy.
4. The Role of Sharīʻah Boards.
5. The Absence of a Unified and Well-Defined Sharīʻah Methodology.
6. Central Banks' Treatment of Islamic Finance.
7. Central Banks' Application of Capital Requirements to Islamic Banks.
8. Faulty *ṣukūk*.
9. The Split between Monetary Policy and Islamic Finance.
10. Shyness in Using Moral Values.

In the following paragraphs, we will make some observations on his views about each of the above gaps.

1. Division of Labor between Economists and Sharīʻah Scholars

Designing new financial products is the first step in making the practice of Islamic finance a reality. It is important to ensure that any new product fulfills Sharīʻah requirements. Therefore, the role of Sharīʻah scholars becomes important. However, I agree with the author that in addition to being Sharīʻah-compliant the basic purpose to design a new financial product is to meet the needs of investors in the framework of modern financial markets. The complexity of modern financial markets and the needs of investors are beyond comprehension of ordinary Sharīʻah scholars. Therefore, I agree with him that Sharīʻah scholars may engage themselves in ascertaining the legal validity of contracts while the validity of purpose is left to economists.

However, I find two ‘gaps’ in his argument. Firstly, just as considering the time and effort involved in studying economics, one cannot imagine that Sharīʻah scholars would instantly turn economists, once they supervised Islamic financial transactions; it is not appropriate to assume that “the popular Islamic finance and investment contracts can be quickly learnt by an economist”. The challenge for Islamic finance is to design a stream of ‘new’ Sharīʻah-compliant financial products and not only to understand the existing ones. When it comes to designing new products, that are Sharīʻah-compliant, economists also need a fairly good background in Sharīʻah rules in general and those relating to finance in particular. Therefore, in my view instead of ‘division of work’ between Sharīʻah scholars and economists, perhaps ‘sharing of work’ between them would be more productive.

Secondly, in my view the proclamation that “economists would have a comparative advantage over Shariʻah scholars in defining *maqasid al-Shariʻah* in the field of economics, which is something to which Sharīʻah scholars pay little attention”, is over-simplification. Is it not true that until recently, Islamic economists endorsed the *maqāṣid al-Sharīʻah* arrived at by Imam al-Ghazali (died: 1111)? If Sharīʻah scholars did not pay any attention to investigating *maqāṣid al-Sharīʻah,* ‘in the field of economics’, they can be forgiven. Blame would fall on Islamic economists for not doing so because, as claimed by the author, they were better equipped to do that.

2. Absence of an Islamic Economic System in Real Life

The author finds the absence of a model of Islamic economics that is applied in the real world as a big disadvantage for Islamic economists as compared to economists studying other systems, e.g., socialism and capitalism. Once again there is a ‘gap’ in his argument. One has to realize that normally ‘theory’ precedes application. Practice then refines theory. The capitalist system was modeled on the theoretical contributions of many scholars. The crown of being the 'Father of Capitalism' goes to Adam Smith but the theoretical contributions of John Maynard Keynes, Milton Friedman, Bohm-Bewark, Friedrich Hayek and many others were important in the development of capitalistic model (s), be it the so called mainstream or the heterodox. Similarly, many consider Karl Marx to be the 'Father of Socialism', but recognize the theoretical contributions of Friedrich Engels, Jean-Jacques Rousseau and others being important in the development of Socialism as an economic system. As compared to that most Islamic economist admit lack of an Islamic economic theory or paradigm. Once again, Islamic economists must take the lead to develop such a theory rather than hiding behind the excuse of absence of an applied real world model.

3. Absence of a General Equilibrium Model for an Islamic Economy

The author complains that the paradigm of Islamic finance took a wrong diversion from the very start by concentrating on the prohibition of *riba* or interest and how to provide finance in an interest-free environment. He calls for building a more detailed general equilibrium model in which there is a market for trading each commodity, either spot, against deferred payment or with deferred delivery. He has a justification in saying that the paradigm of Islamic finance requires refocusing on the absence of spot-against-future money market but his prescription that this entails finance being redefined to include investment and trading activities is largely semantics. It may be true that universal banking as a 'model' is closer to Islamic finance as compared to Anglo Saxon commercial banking, but in recent years, in practice, the two models have come closer to each other. Application of 'pure' universal banking or 'pure' Anglo Saxon commercial banking is fast fading out. Financial intermediation enhances efficiency, be it universal banking or Anglo Saxon commercial banking. In this perspective what is needed is to highlight the unique features of Islamic finance (not necessarily to be restricted to Islamic 'banking') as compared to other models of financial intermediation.

4. The Role of Sharī'ah Boards

Author's fourth gap emanates from the absolute requirement of Sharī'ah Boards in Islamic financial institutions. The function of Sharī'ah Boards, he states, is to "structure Islamic financial products". Here the author goes completely off the mark. The 'function' of Sharī'ah Boards has never been to ‘structure’ Islamic financial products. It is finance-cum- Sharīʻah experts who structure a product. The role of the Sharīʻah Boards has been to check that structure for Sharīʻah-compliance: they are a vetting body not a financial engineering body. However, I agree that putting standard definitions into law would reduce the reliance on Sharīʻah Boards for their ‘vetting’ role. Starting development of Sharīʻah Standards by bodies such as Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) is a step in the right direction. However, since AAOIFI standards are not mandatory, further efforts are needed to get universal acceptance of Sharīʻah Standards on all Islamic financial products. That would perhaps weed out what the author rightly calls the ‘products of ill repute’ and which, as he points out; unfortunately dominate the Islamic finance market. In the present practical situation, Islamic finance can hardly be called ‘*Islamic*’.

5. The Absence of a Unified and Well-Defined Sharīʻah Methodology

Hardly anyone would disagree with the author that what needs to be seen are the ultimate consequences of contracts. One would also agree that the methodology for designing new products for the Islamic financial industry needs to be perfected. However, that does not need unifying Sharīʻah methodology alone. The whole process of development and designing new products has to be reviewed. In this respect *fiqh al-muʻāmalāt* is only one part. *Fiqh* is a crucial source, but not the only one. In realizing *maqāṣid al-Sharīʻah*, the contributions of Islamic scholars in previous centuries in general and not **only** *fuqaha’*, evolution in human knowledge in general and economics, finance and law in particular, developments in skills, technology and communications are all important. If a revolution in *fiqh al-muʻāmalāt* is needed as advocated by the author, revolution in other fields should at least be taken note of.

6. Central Banks’ Treatment of Islamic Finance

That Islamic banks and financial institutions do not get a fair treatment by Central banks is a genuine complaint. Special nature of their activities requires special treatment. Once that is done, central banks must regulate and properly supervise Islamic banks’ activities. However, to demand that they should review investment procedures, feasibility studies and investment worthiness of Islamic banks’ use of funds is going too far. These are not the functions of any Central bank *and in my view should not be*.

Checking Sharīʻah-compliance of Islamic banks' activities is very important. However, how that can be done best needs careful consideration. Assigning that responsibility to Central banks may or may not be appropriate. What is needed is Sharīʻah-auditing. Specialized Sharīʻah-auditing firms who can hire and train auditors in this field may perhaps do that job better. If conventional financial auditing can work outside the framework of Central banks, why the Sharīʻah auditing cannot? Central banks are supervisory bodies. They can make rules for such auditing and in case of violation can take necessary action including revocation of license.

7. Central Banks' Application of Capital Requirements to Islamic Banks

The author points out that since Islamic banks' liabilities comprise of share holders' funds and investment deposits both of which are not guaranteed, the capital requirements for Islamic banks should be lower than conventional banks. On the assets' side Islamic banks use equity finance which is relatively free from information asymmetry and consequently protects banks from risks of adverse selection and moral hazard. That argument is correct at least in theory(1). However, I do not understand the logic behind author's recommendation that central banks should instruct Islamic banks to use *murābaḥah* finance solely with *mushārakah*. In my view any restriction on the way Islamic banks use their funds would limit their liquidity and risk management abilities as a whole and affect their profitability. Therefore, such restrictions should be avoided.

8. Faulty *Ṣukūk*

If structured properly, *ṣukūk* can be a useful product to mobilize resources for the corporate and public sectors(2). Unfortunately, the way these are being structured in practice have raised serious doubts about their Sharīʻah-compliance. In fact the Islamic financial industry received a big jolt when in 2007, the Chairman of the Sharīʻah Board of AAOIFI. Justice Taqi Usmani issued a statement that 85% of *ṣukūk* were non Sharīʻah-compliant. Damage control policies were immediately undertaken by the stakeholders and the industry has seen a revival. Once again, *ṣukūk* are among the top of the list of products of ill repute.

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(1) In practice, Islamic banks' assets side is dominated by fixed return modes. The share of profit sharing modes is very small. See, **Iqbal Munawar** and **Philip Molyneux** (2005).

(2) **Iqbal, Munawar** and **Tariqullah Khan** (2004).

Therefore, the concern of the author is genuine. As a matter of fact, in my view the situation is more serious, because the bad reputation of *ṣukūk*, or for that matter other similar products, is being largely ignored by the market. That is one reason why a common man does not see any difference between Islamic and conventional banks. Conventional banks and institutions *may* even hold majority of the *ṣukūk* and *tawarruq* markets. A major correction is indeed needed. However, I do not concur with author's suggestion that the International Islamic Fiqh Academy should consider issuing its *ṣukūk* standard. Even if the Academy issues such a standard, I do not think the market will 'listen'. To change market dynamics, the battle ground lies elsewhere, most importantly in an awareness campaign to be spearheaded by Islamic scholars in Sharī'ah and economics.

9. The Split between Monetary Policy and Islamic Finance

The ninth gap relates to the absence of any measurable link between monetary policy and Islamic finance. It is true that the process of issuing money and the control of money supply in a conventional economy is debt-based. What role could Islamic finance play in this? The first of the two suggestions of the author, i.e., the central bank must attune monetary growth to economic growth, and not to the requirements of financing government budget deficit has nothing to do with Islamic finance. The second suggestion that all money issued must be invested through banks as investment deposits and profits would ultimately help in financing government budget has many caveats. At present, the share of investment deposits of Islamic banks in total deposits of the financial sector is a very small proportion. The placement of those deposits in 'profitable' ventures is also a big question mark. Hence, the new money creation cannot be absorbed in that sector. Moreover, why should the responsibility of financing government budget or a major part of it be placed on the shoulders of Islamic banks? What are needed instead are fiscal reforms in Muslim countries.

10. Shyness in Using Moral Values

Not many scholars disagree that Islamic economics should be value-based. Prominent economists have opined that even the conventional economics is value-based(3). Positivism has lost much of its luster even in

(3) Anas al-Zarqa, (1980).

conventional economics. Many conventional economist have shown flaws in this paradigm(4). However, why is this gap in the theory and practice of Islamic finance? True, Islamic finance is part of Islamic economics, but the problem should be discussed at a wider level. That is being done. Perhaps this paper was supposed to address issues specific to Islamic finance.

In his prescription for filling these gaps, once again the author has chosen the wider spectrum of Islamic economics. One can understand his selection. However, issues relating to the broad spectrum have been discussed in other papers(5) in the same Workshop at which this paper was presented, which has given rise to some repetition. However, due to the high stature that the author enjoys in the comity of first generation Islamic economist, adding his voice to others is a tolerable, even desirable repetition.

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(4) For example see, Quine (1951).
(5) For example see, Volker Nienhaus’ paper, in this issue.