Reforming Islamic Finance

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Ankara Sosyal Bilimler Üniversitesi

July 2020

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Abstract:

Pessimists would rather declare the Islamic finance industry as clinically dead. Such dim expectation would be a reality when the industry will completely switch to selling present for future money through contrived sale contracts. The writings are plenty on the wall. We need to listen and respond seriously. Calling for the reform of the industry could be the last attempt to save it. Hassan's paper (2020) provides a good perspective of the current problem, albeit dispassionate.

This comment provides a brief explanation of the theoretical rationale and the macroeconomic benefits of Islamic finance. It diagnoses the problem of Islamic finance as that of convergence. Moreover, it makes few modest proposals are presented to mitigate the problem.

Keywords

Islamic economics, Islamic finance, interest rate, monetary theory, real and nominal transactions, Islamic finance regulation.

المستخلص:

يفضل المتشائمون أن يعلنوا أن التمويل الإسلامي قد توفي سريريا. والحقيقة أن هذه النظرة المتشائمة يمكن أن تتحقق إذا ما تحول التمويل الإسلامي تماما إلى بيع النقود الحالة بالنقود المستقبلة، مستخدما في ذلك عقود بيوع مصطنعة. والكتابات ظاهرة على الجدران، مما يجدر بنا أن ننصت ونتفاعل معها بجد. فالدعوة لإصلاح الصناعة المالية الإسلامية هي النداء الأخير لإنقاذها. وتقدم ورقة حسن (2020) تصورا معقولا لهذه القضية المعاصرة، وإن كان على قدر من التساهل.

ويلخص هذا التعليق المبررات النظرية والمنافع الاقتصادية الكلية للتمويل الإسلامي. وتشخص مشكلة التمويل الإسلامي، بتورطه في التقارب المتزايد مع التمويل التقليدي. ويقدم التعليق بعض المقترحات المتواضعة لمواجهة هذه المشكلة.

الكلمات الدالة: الاقتصاد الإسلامي، التمويل الإسلامي، النظرية النقدية، المعاملات الحقيقية والإسمية، الرقابة على التمويل الإسلامي.

Theoretical rationale of Islamic finance

A rather basic but difficult question is whether there is justification for the conventional system, which is interest-based. Böhm-Bawerk (1890) justified interest by the presence of time preference as well as the time involved in the production. While Böhm-Bawerk's theory has been used by Irving Fisher (1908) to construct a theory of intertemporal choice, and later by Keynes (1936) as well as the neoclassics in their theories of interest, we take a strong exception in its basic premise. To justify a premium between the present and future consumption of a commodity, based on both factors, cannot be automatically used to justify a premium between the present and future money. Intuitively, each individual has a different rate of time preference for each commodity. Besides, the contribution of a commodity in production would differ from one individual and one commodity to another.

Market prices hardly reflect the rates of time preference for commodities. We can find highly expensive commodities with low rates of time preference and vice versa. Moreover, the size of productive contribution per unit of a commodity would differ from one individual to another. It even differs for the same individual, from one use to another. Therefore, aggregating a set of heterogeneous commodities, using their prices or even their contribution to production as weights would not yield a meaningful aggregate to compare over time. In other words, there is no way we can discover a single rate of time preference to be used for the intertemporal allocation of such a group of commodities for a single individual. The same is true for a group of individuals.

To hypothesize a rate of time preference aggregated both over individuals as well as commodities and attach it to a quantity of money, as representing commodities is therefore faulty. Even if we were to consider money as an asset, we cannot claim that the relationship between present and future money measures the same between the present and future goods. This is exactly what the neoclassical theory of the rate of interest, based on loanable funds and Keynes liquidity preference has done. The common mistake is to assume a well-defined mapping from a set of commodities, each with a unique rate of time preference ununiformly used by a set of individuals to a monetary aggregate. To do so, the heroic assumption regarding commodity homogeneity and individuals preference similarity must be swallowed.

We conclude that there is no market rate of interest, no matter which theory of interest you believe in. The rate of interest found in an economy is merely an administrative price, which is set by the central bank, or a club of banks (as in Libor) and imposed on the economy as a part of the conventional banking and finance system.

Samuelson (1958) and then Friedman (1969) argued that a positive rate of interest places a cost on using money in transactions, leading people to economize on the use of money, by substituting real resources for money in transactions, thereby, reducing total output and efficiency.

Friedman proposes reducing the nominal interest rate to zero, by deflating the economy at a rate equal to the real rate of interest. Ignoring the practical difficulties in implementing Friedman's rule, in many ways, it exonerates the concept of avoiding the use of the rate of interest in finance as espoused by Islamic finance. Islamic finance removes the Samuelson-Friedman inefficiency by introducing a creative institutional arrangement to flush out interest from the system. Indeed, to establish an Islamic finance industry without being integrated into an Islamic monetary and financial system, along the lines proposed by Al-Jarhi (1981) would take it out of context.

The application of the Islamic finance paradigm must be associated with allowing only real and semi-real transactions and strictly prohibiting nominal transactions (Al-Jarhi, 2002), which include money (spot or deferred) against commodities (deferred or spot) as well as spot transactions in foreign exchange, respectively. Meanwhile, nominal transactions or spot money against deferred money or a result of a gamble as well as all futures transactions would be prohibited. Contemporary Islamic banking indulges in debt and pure risk trading which are all nominal transactions. While real and semi-real transactions improve the market mechanism and have positive effects on real income, the effects of nominal transactions could be detrimental (Al-Jarhi, 2002).

There are other gains from Islamic finance, in addition to its being free of the Samuelson-Friedman inefficiency, including more efficient resource allocation, based on investment profitability in cases of partnership finance and directly tying the cost of finance to the value in use in cases of sale finance (Al-Jarhi 2017). Further benefits include stability at both the firm and the macroeconomic level, the advantage of working as universal banks, including mitigating the risks associated with asymmetric information, the higher capability of fund mobilization, the greater resilience in the face of external shocks, more systemic integrity, the higher potential of reaching equitable redistribution, and the greater debt sustainability. Indeed, an Islamic economic system represents a reform agenda for the world economic order.

The convergence of Islamic finance to conventional finance

According to Majeed and Abida (2017), Widigdo et al (2016) and Red et al (2015), Islamic bank employees have a favorable perception of their industry, but the public has mixed opinions about the Islamic finance industry. Latiff et al (2015) identify inadequacies of the industry as inclination to debt-based financing modes, misunderstanding of the nature of its products, customers' doubts about its Shari'ah compliance, lack of product innovations, and low service quality.

Azmata et al (2015) find empirical evidence that conventional structures are crowding out the Islamic financial structures, leading to little structural differences between conventional and Islamic products. Ahmed et al (2014) find no significant difference between finance pricing of Islamic banks and conventional banks, confirming strong similarity.

There are indications that Islamic banks have been indulging in nominal transactions at an increasing rate, i.e., mimicking conventional finance while striving to camouflage the conventional nature of their products. Such convergence to conventional finance is surprising, considering that Islamic finance has a solid theoretical rationale as well as significant macroeconomic advantages. The question is why. This presents an irony to explain. The reason is twofold. First, the advantages of Islamic finance could be diminished, because its institutions are not supported by an Islamic economic system. Second, the advantages of Islamic finance are mostly of a macroeconomic type that cannot be internalized by Islamic banks.

Why Shari'ah governance is ineffective

Shari'ah governance of Islamic finance varies widely in degrees of sophistication. Some countries have rudimentary arrangements while others, like Malaysia in particular have a very sophisticated system of Shari'ah governance. However, we find that the convergence of Islamic to conventional finance is present in both types of countries. This must be explained.

The first and most important aspect of this dilemma lies in the qualifications of the members of Shari'ah boards. It cannot be denied that bank operations require specialization in financial and monetary economics. yet, we can hardly find one economist as a member of Shari'ah boards. This charges Shari'ah scholars who are members with a function they cannot possibly perform, due to their specialization. It would be more conceivable to have Shari'ah boards with a majority of members that are qualified in monetary and financial economics, while one member would be specialized in Shari'ah. Needless to say, some of the Shari'ah board members may not have sufficient qualifications in Shari'ah. Worse yet, some members hold seats in numerous boards, indicating a conflict of interest as well as insufficient time to focus on business.

Any Shari'ah scholar would agree that transactions require both formal validities as well as the validity of purpose, which reflects their compliance with Maqassed. Because of their education and training, Shari'ah scholars focus on formal validity, ignoring the other component, which can only be ascertained by properly trained economists. Recomposing Shari'ah boards to be dominated by economists would hopefully remedy this problem.

Second, the most important stakeholders in Islamic banking, namely investment account holders are absent from the decision-making process. Not only that they provide the lion's share of Islamic banks' resources, they are the first to be adversely affected by non-Shari'ah compliance (Al-Jarhi, 2018)[1]. It is probably about time to remedy this by recomposing bank boards of directors to include proportional representation of this group, which presumably would be interested in applying the Islamic finance paradigm.

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[1] When an Islamic bank mimics conventional finance, it earns the current rate of interest, which is presumably below the profit rate on investment. Investment account holders would suffer, while shareholders would stand to earn Mudareb fees that supplement their return on capital.

Other Challenges

One of the common challenges of Islamic finance arises when an Islamic bank is a subsidiary of a conventional financial institution, which is an obvious conflict of interest. Another challenge arises with Sukuk which have been securitized along the lines of asset-backed bonds, sometimes through the purchase of assets from an originator, then leasing them back to him without "real sale". Generally, Sukuk holders have no property rights over securitized assets.

Another challenge lies in the classification of companies according to their Shari'ah compliance, for equity investment. The questionable criterion commonly adopted for the dominance of Shari'ah-compliant assets (one-third) has no Shari'ah justification whatsoever [2]. Besides, Islamic banks are automatically classified as Shari'ah compliant, regardless of the composition of their assets.

Perhaps the most serious of all challenges is the inactive role assumed by central banks, especially their staying aloof from Shari'ah compliance. The central banking, commercial, and financial market laws are more often than not devoid of any reference to the principles of Islamic finance. Central banks cannot claim Shari'ah neutrality while providing licenses to supposedly Shari'ah-compliant Islamic banks. Monetary authorities, must ensure that such banks do not violate their licenses, and even nullifies the license of any violator.

Monetary policy & Islamic finance

Monetary authorities are almost unanimous in treating Islamic and conventional banks similarly from the regulatory vantage point. This has entailed focusing on financial viability while ignoring investment viability and Shari'ah compliance. The regulatory perception redefines the Islamic finance paradigm as void of investment with almost no concern for the Shari'ah-compliance side. The central banking approach to Islamic finance regulation must be reformed.

First, the regulatory authority must consider the propriety of Islamic banks operations from the banking, investment as well as Shari'ah conformity sides as integral parts of Islamic banking. Shying away from the last two aspects has allowed Islamic banks to drift away to the conventional side.

Second, Islamic banks are totally excluded from the concerns of monetary policy. To exclude the Islamic finance sector form monetary policy considerations is rather extreme, especially in countries where the share of Islamic finance in total assets approaches or exceeds %25. The reason is that financial innovation in the money market has been limited to conventional instruments. To remedy this, we have for long proposed that the monetary authority apportions the money supply into two Islamic and conventional shares. The Islamic share can be placed as central (investment) deposits (CDs) with Islamic banks, based on Mudaraba. This would be subject to total reserves and should be used to provide

[2] It would have been reasonable to adopt 51 percent as a majority rule, or even higher.

finance in partnership and sale modes (Al-Jarhi, 2018). The central bank can direct the sectoral allocation of this finance according to national economic priorities.

In parallel, the central bank should issue a monetary instrument under the name of central deposit certificates (CDCs), which would be tradable by Islamic banks and the public. Their proceeds would be added to CDs. Monetary policy related to the Islamic finance industry would be conducted through open market operations in CDCs. The rate of return on CDC's, or RCDC would be market-determined in contrast to the rate of interest (Al-Jarhi, 2018).

conclusions

Islamic finance has covered a good distance towards convergence to conventional finance, depriving itself of much of its meaning and rationale. Along this road the national economy is losing macroeconomic advantages. Shari'ah compliance is increasingly becoming a misnomer under which conventional finance is boldly practiced. The Islamic finance industry is exposing itself to mockery, cynicism, and disillusionment. Solutions must be designed to roll back the convergence between the two finance systems to secure the macroeconomic benefits that justify the switch from conventional to Islamic finance.

Despite claims that Islamic finance has a higher cost than conventional finance at the microeconomic level (more documentation, roundabout procedures), it has a credible theoretical rationale as well as substantial macroeconomic advantages. Yet, Islamic bankers and finance officers balk at applying the Islamic finance paradigm. Such a paradigm can only be enforced through regulation and supervision. This must be accompanied by serious reforms in the legal and regulatory environment, in addition to taking bold steps to restructure corporate and Shari'ah governance.

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