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ISLAMIC FINANCE AT CROSSROADS

MABID AL-JARHI

Abstract:

After more than 40 years of practice, the Islamic finance industry is riddled with products that have a camouflage of Islamic form, but lack Shari'ah validity of purpose. The increasing tendency to mimic conventional finance, had the industry converging to its conventional counterpart. It is therefore seriously threatened with increasing cynicism and popular decline in interest.

The paper looks into the essence of Reba prohibition from an economic perspective, using a concise classification of transactions, and how popular monetary theory looks on a positive rate of interest with disfavor. It evaluates Shari'ah scholars approach to the validation of contracts as well as the attitude of monetary authorities towards the Shari'ah content of Islamic finance transactions. It reviews the macroeconomic advantages of Islamic finance within an Islamic macroeconomic environment. Then it tries to explain why managers of Islamic banking and finance institutions, IBFI, mimic conventional products despite such advantages. The paper surveys the literature that measures the extent of conversion as well as provides an alternative explanation.

The study finds that IBFI violate the true paradigm of Islamic finance, because its advantages are all external and impossible to internalize. It lists several pieces of empirical evidence on increasing convergence.

The paper concludes by drawing a plan composed of regulatory actions, research agenda as well as a series of dialogues with stakeholders.

Keywords

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

The economic meaning of the prohibition of Reba

Muslims struggled with the meaning of Reba prohibition early in the second half of the last century. The Islamic awakening dawned on the fact that all Muslim countries had an interest-based monetary and financial system, established through contacts with the west. In particular, the newly independent Muslim countries adopted the commercial banking system that had prevailed in Anglo-Saxon countries. Even those colonized by countries with universal banking, like North African countries colonized by France and Indonesia colonized by the Netherlands, ignored universal banking and opted for commercial banking.

During the early fifties of the last century, economists started to struggle with how to introduce money into the theory of value, as such theory at the time did not have anything that would allow for a medium of exchange. It was therefore understandable that the Muslim world did not ask the right questions with regard to the prohibition of Reba, as economists did not have any clue about

it.

The debate ensued during that period, which coincided with Islamic revival, focused on whether or not “interest” is Reba. The majority reasoned that Reba is a sort of benefit that accrues to the lender from providing a loan, which conforms to the textual prohibition of Reba “any loan that brings benefit to the lender is Reba”. Hindsight tells that perhaps we asked the wrong question at the wrong time. Being interested in establishing Islamic finance, the right question to ask would have been what it meant to prohibit Reba, not whether Reba was interest or not. After forty years of Islamic finance, we go back to the fundamental question: What does it mean to prohibit Reba?

Friedman (1969) observes that a positive rate of interest causes people to economize on the use of money in transactions, in order to increase interest earnings. To do so, they substitute real resources for money in transactions. An illustration would be if a supermarket were to be faced with an increase in interest rates, it would attempt to collect cash faster from its tellers and rush it more often to the bank, using more labor (people who collect cash as well as security guards) and capital (armored cars). Obviously, the withdrawal of real resources from production into transactions reduces total output and efficiency.

Friedman’s theory of the optimal supply of money attempts to avoid such inefficient behavior by deflating the economy at a rate equal to the real rate of interest, in order to bring the nominal rate of interest down to zero. This appeared to be a clever solution indeed, especially since it contained no institutional changes in the contemporary market economy. The interest-based monetary and

financial sector would continue to operate, but with a zero nominal rate of interest.

However, this solution brought in a bombardment of articles that indicated serious difficulties in adopting Friedman's optimal monetary policy rule. A zero-bound interest rate is something that is yet to find any workable policy (Ullersma, 2001). Our major objection is that a policy rule that puts the economy on a deflationary path would result in a variety of inefficiencies due to deflation. That of course would not be acceptable *prima facie*.

This is where Islamic finance comes in with its institutional changes. We can use Al-Jarhi's model (1981) to outline such changes. According to Al-Jarhi's model, the proposed institutional change replaces the lending bases for creating money with productivity bases. In particular, the central bank stops lending the money it creates to the government to use in covering its budget deficit. Instead, the central bank would regain its exclusive right to issue money through total reserves and place all newly issued money in investment accounts with its member banks. In addition, the classical loan contract would be done away with and replaced by twenty investment and finance contracts.

Friedman's optimal monetary policy rule brings forth two important surprises. The proponents of the interest-based monetary system would be surprised to know that their system cannot be efficient, because a zero-interest rate would be a necessary and sufficient condition for its efficiency. Since Friedman's rule brings up more questions than answers, the system must be restructured to avoid trading present for future money. The second surprise is

to those in Islamic economics who claimed that Islamic finance could work through benevolent (interest-free) loans.

The real issue here is that the meaning of the prohibition of Reba is exactly the prohibition of trading present for future money at a premium (which is called the rate of interest). Such a prohibition requires a radical institutional change, i. e., a reform of the prevailing system. However, that appears to be only the first step. By going deeper into understanding the prohibition of Reba, one would discover that the real culprit in the system is what we call nominal transactions.

Nominal transactions on one hand have nominal (monetary) counter values. One example of a nominal transaction is when spot money is traded against future money. This is a case of debt trade. Another example is when the price of a gamble is paid as present money against the payoff of the gamble which is usually paid in the future. This is clear in the case of derivatives, including futures and swaps.

It is also clear when both counter values are deferred. In this case, market authorities set safeguards to ensure that both parties to the gamble will pay their obligations. Such transactions are carried in the financial sector, with effects on the real sector that depend on the resulting wealth redistribution between winners and losers of zero-sum games. Whether nominal transactions are carried out in an organized financial market or in a gambling casino, their ultimate results are distributional between gambling parties. Winners are supposed to spend more on commodities as well as gambling games. Losers would curtail their spending.

The macroeconomic effects of nominal transactions take two forms. In the first form, the growth in the volume of nominal transactions will encourage investments in the gambling industries and associated services. More investment would also be directed to accounting, clearing mechanisms, strategic trading mechanisms and enforcement mechanisms usually associated with this type of transactions. In the second form, the redistribution of wealth would have effects on the consumption pattern in the economy and motivate reallocation of resources that caters to the tastes and preferences of the social group that gains wealth against the rest of the society.

What is important is that trading present for future money is always done through nominal transactions. Whether a debt instrument or a pure risk associated with some gamble is traded in the financial market, the related transaction has two nominal counter values, one on each side.

We can therefore interpret the prohibition of Reba from the economic perspective as the prohibition of trading present nominal (monetary) values against future nominal (monetary) values. This is equivalent to the prohibition of all nominal transactions, which would encompass both debt and risk trading.

Real transactions on the other hand have only one nominal or monetary counter value, while the other is always a commodity. Such transactions provide important indicators for the allocation of resources. In economy where only real transactions are allowed, an increase in the rate of monetary expansion passes its effects exclusively through the real sector. Real transactions become the chariot of the transmission mechanism from the changes in money supply to

commodity markets directly. Such markets would move to a new equilibrium quickly.

When the supply of money increases, financing increases. In Islamic finance, finance is provided only through real transactions, which would have direct bearing on the real sector. Both supply and demand sides get financed. The quantity and price speeds of adjustment are balanced in a way that only when full employment output is exceeded, can inflation occur. In contrast, conventional finance has only a remote relationship with the real sector. Its immediate effect would be on the demand side. Price speeds of adjustment would be higher while quantity speeds of adjustments lag behind. Inflation would be the ultimate result, even when the economy is below full employment.

Nominal transactions on the other hand do not carry the transmission mechanism of changes in the money supply to the commodity markets. They represent something like a leakage from the system that reduces the speed of adjustments in the commodity markets.

We can therefore summarize that the prohibition of Reba is tantamount to the prohibition of nominal transactions, which includes the trading of spot against future monetary values in addition to all transactions related to risk trading.

Convergence of Islamic finance

The Qur'an tells the story of the children of Prophet Jacob , when they were tested by God who prohibited them from working on Saturdays (Sabt or Sabbath). On weekdays, fish went completely absent from the seashores. On

Saturdays, fish came in flocks. The command of God, not to work on Saturdays, meant that fishing was made impossible. Instead of obeying, they chose to develop a clever ruse, by which they could fish on Saturdays without appearing to do any work at all. They dug holes next to the seashore on Fridays. When the tide carried the fish to the shore on Saturday+, it fell into the holes they had dug. God condemned them in the Qur'an for doing so, as the ruse they developed implied an indirect violation of the Saturday prohibition as well as an attempt to deceive the Almighty God, who is by nature undeceivable.

This is a lesson for Muslims. To adhere to the prohibition of Reba, Muslims must avoid transactions that lead directly or indirectly to nominal transactions. Indeed, members of Shari'ah boards of Islamic banks developed several ingenious ruses that construct transactions that appear formally adherent to the prohibition of Reba, but ultimately lead to some type of nominal transactions. They use artificial sale contracts that are not intended to transfer titles of commodities to trading parties, but only a stepping stone to trade one nominal value for another. Such ruses are obviously equivalent to fishing on Saturday by ancient Jews.

One type of ruse is 'Eina sale, where a purchaser of present money buys some commodity in which he/she is not interested, on credit. Then he/she sells it back to the seller against spot payment. In appearance, this person carried out a purchase, followed by a sale of some commodity. In reality, the ultimate result is trading present for future money.

Another type of ruse is more sophisticated, because in contrast to the

person committing "Eina, the trader does not sell the commodity bought on credit to its original seller but, he/she sells it to a third party. This is called Tawarruq. It ultimately leads to the sale of present for future money. A third type is practiced through international Murabaha, which is a sort of reverse Tawarruq. The person who wants to "lend" money in return for a premium, uses funds to buy commodities, usually in a metal exchange, and sell the same commodities against future payment, which would exceed the present value. Neither buyers nor sellers in this case take delivery of the goods involved. The transaction of international Murabaha becomes a camouflage of interest-based loan.

Shari'ah validation of transactions

Jacob's Children, had their own clerics who were able to design and implement ruses for them. So do Muslims of today.. Although we know that Islam has no clergy - it assigns no holiness or infallibility to anyone, except for prophets- our Islamic Shari'ah scholars have acquired a de facto right of the interpretation of the holy text. They have developed a discipline under the title of "Fiqh," meaning scholar understanding, that authenticates narratives about the Prophet's sayings and deeds. They use the authenticated narration, together with the relevant qur'anic verses, as evidence from which to draw Shari'ah rules, according to a well-defined methodology. Shari'ah scholars have never explicitly claimed they are clergy, and they do not act like one. However, through time, they established schools of thought and had followers who revered them immensely. Although constrained by its textual nature, their Fiqh heritage is a

substantial wealth of rigorous intellectual effort, which would justify their intellectual authority, at least by specialization.

Of special interest in this context is their methodology in validating transactions. The general rules they apply are of great value, which can be summarized as follows:

1. In principle, everything is permissible, unless there is a text or evidence that makes it impermissible;
2. What ultimately leads to impermissibility must be impermissible;
3. Harm, Gharar (gambling), Ghabn (deceit) and Reba render transactions invalid;
4. Every transaction contract, e.g., sale, collateral, and guarantee, has its own conditions for its validity of form;
5. Ultimate consequences are the guide to the validity of purpose. They must be judged against the five general objectives of Shari'ah, or Maqassed al-Shari'ah.

The methodology of Shari'ah scholars does not seem to be faulty. To the contrary, it involves a strong intellectual discipline. However, it must be applied consistently. Shari'ah scholars generally do apply such methodology with sufficient consistency. Ruses in Islamic finance mentioned above are not acceptable for the majority of Shari'ah scholars, who can be divided in an ad hoc manner into two schools of thought: one includes a very small minority who are members of Shari'ah boards, and the other includes the majority of Shari'ah scholars, who are mostly academics.

Shari'ah board members seem to have opinions that differ from what is accepted by the majority outside their membership. Sympathetic understanding would indicate the following:

1. They fall under the pressure of the top echelon in Islamic banks and financial institutions (IBFI).
2. They consider the Islamic finance industry as an infant industry, which requires facilitation and magnanimity rather than tough restrictions.
3. In this spirit, they provide the industry with licenses that would not usually be acceptable in ordinary circumstances. Perhaps such licenses should be provisional, until the industry comes of age.
4. However, such licenses are not temporary; they seem to assume the status of permanent rules. They are usually issued with no time horizon, to be modified as the industry develops.

Officials in IBFI have been originally trained in the conventional (commercial banking) school. They find Islamic finance procedures to be more laborious and costly than the direct and simple use of the classical loan contract. While they would be willing to accept any claim of the macroeconomic benefits of Islamic banking properly applied, they would recognize only such benefits that have direct bearing on their financial statements. Since most of such benefits are far removed from their financial statements, they prefer to focus on maximizing their profit. Their pressure on Shari'ah boards would be merely to provide patterns of transactions that mimic the classical loan contract in order to cut costs and maximize profits.

Conventional banking habits have gained a reputation, perhaps undeservingly, that the industry leans to safety, even though profits would be low. Getting a margin between lending and borrowing interest rates would do if volume is sufficiently large. Business risks are shunned and information asymmetry is confronted with the use of collateral. Islamic finance meanwhile immerses itself in business risk, handling the lemon problem with feasibility studies and financial analysis, and information asymmetry with product structuring and governance. While this can be understood, at least partially, by universal banks, it appears as a remote practice to commercial bankers. Therefore, shunning Islamic finance and mimicking conventional finance is based on an illusionary perception that the latter has a bigger promise of profit, with less risk.

Theoretically, Shari'ah boards in IBFI are independent and cannot be pressured. However, transactions and contracts requiring approval are usually presented to the Shari'ah board meeting by one of the senior bankers (usually the CEO or the head of investment or treasury department). Presentation involves discussions and persuasion. The dialectics between the leadership in Islamic banks and finance institutions and Shari'ah-board members result in a strong push to mimic conventional finance products. This is only a rational choice, not motivated by any ill feeling towards Islamic finance.

Monetary authorities & Islamic finance

In conventional finance, monetary policy tools include direct instruments, like fixing profit rates on Islamic finance contracts in a fashion similar to fixing

the rate of interest. While the rate of interest is a price administered by the central bank, the rates of profit on Islamic finance contracts should be market-determined. Administering them would be contrary to Shari'ah rule. Central banks in mixed conventional and Islamic finance systems lack the monetary policy tool that can play the same role as government debt.

We have proposed in other places that the central bank issue central deposit certificates (CDCs) whose proceeds would be placed in investment accounts with banks, in addition to placing some of the money supply, in proportion to the Islamic finance market share, in investment accounts. Monetary policy would be conducted through open market operations in CDC's. The rate of return on CDC's, or RCDC would be market determined in contrast to the rate of interest.

This issue becomes even more critical in countries adopting a completely Islamic finance system such as Iran and Sudan that claim to have a finance system which is totally Islamic.

Monetary Policy in Iran and the Sudan

In Iran, the central bank takes more liberties in issuing rules that could run contrary to the formal validity of Islamic finance contracts, e.g., fixing the profit rates of Mudaraba or Murabaha. According to the central bank of Iran, direct monetary policy tools include setting minimum and maximum banks profit rates on any of the twenty Islamic finance contracts, in addition to setting credit ceilings. This means that Islamic banks in Iran are ultimately forced to violate the rules of Shari'ah (CBIRI, 2017).

The central bank of Sudan issues Government Investment Certificates (GICs), which are long term Ijarah Sukuk involving payment of rentals by the government for durable assets it sells to a Special Purpose Vehicle, SPV, which then leases them back to the government, while issuing Sukuk. The structure of the GICs raises serious Shari'ah issues. In addition, they are not designed as a monetary policy tool, but rather to absorb excess liquidity from Islamic banks (Khatat, 2016).

In some countries, like Bahrain and Malaysia, the central bank takes a positive interest in facilitating Islamic finance. They have adopted ambitious targets for its growth and development. However, their national Shari'ah boards behave in ways similar to individual Shari'ah boards in Islamic banks, in allowing for products that mimic conventional finance. This has not caused yet any worries to the central banks.

Generally, central banks are careful about maintaining the financial stability of Islamic banks. Yet, they do not have explicit policy to keep Islamic finance Shari'ah-compliant, and they leave it completely up to the Shari'ah boards.

Advantages of Islamic Finance

In this section, we annotate the basic advantages of Islamic finance, based on Al-Jarhi (2004).

i. Efficiency

Samuelson (1958) and Friedman (1969) have shown that a positive interest rate leads to macroeconomic inefficiency. In a conventional economy, a

zero-interest rate has been shown to be a necessary and sufficient condition for efficiency under a variety of assumptions (Cole and Kocherlakota, 1998; Chari, Christiano and Kehoe 1996; Wilson, 1979).

Inefficiency results from the substitution of real resources for money in transactions, in order to allow money holders to increase their interest earnings. In Islamic finance, money is placed with banks, based on profit and loss sharing (PLS) or Mudaraba. Neither the principal nor the returns on such investment accounts is guaranteed. Investment balances would change only in response to fundamentals.

The rate of return on Mudaraba accounts itself is neither predetermined nor certain. While the rate of interest is administered by the central bank, return on Mudaraba is market determined. Expectations about such a stochastic variable would be subject to differences of opinions. Consequently, the incentive to substitute real resources for money in transactions in response to expectations would be unlikely. Since the RCDC replaces the rate of interest as an anchor to monetary policy, even if expectations are unanimous regarding its rise, the central bank would automatically increase the money supply which would compensate for any tendency to substitute real resources for money (Al-Jarhi, 2017).

While money is created and allocated in a conventional economic system based on lending criteria, in Islamic finance (Al-Jarhi, 1981) money created by the monetary authority is placed in investment accounts held by the central bank with other banks. The classical loan contract would be replaced by one or

more of the twenty Islamic investment and finance contracts. While the single classical loan contract has its intrinsic risks related to information asymmetry, Islamic finance contracts can be mixed and matched to rid the financing process from such risks. Extra risks would impose on the system lower efficiency due to extra risk-mitigating costs. The Islamic system has relatively more effective risk-mitigating means through mixing and matching of finance contracts to avoid extra risks and their costs. Such means of risk mitigation are not available to conventional finance.

Another factor influencing efficiency is how financial resources are allocated among different uses. In partnership finance, Islamic finance allocates financial resources based on feasibility. In the case of sale finance of both investment and consumption goods, competition among fund users will eventually equate the cost of finance (the markup on Murabaha, the profit margin on Bai Bethaman Ajel, the rental rate, the price differential in Istisna' and Salam) with the marginal value in use (drawn from consumption or investment). This ensures that financial resources are allocated efficiently. Being an administered price, the rate of interest role in resource allocation would not produce efficiency.

ii. Stability

By virtue of the fact that the liability side of the balance sheet of every IBFI is based on PLS, the risks associated with its assets are shared with investment account holders. This makes the possibility of a bank failure much more remote than in the case of conventional banks and financial institutions(CBFI).

Therefore, bank stability improves with the application of Islamic finance.

Meanwhile, as explained above, the prohibition of Reba in itself rules out debt and risk trading. Financial markets in an Islamic economic system would not include integrated debt markets or derivatives. No allocation therefore would be set aside for hot money to enter and exit at will in and out of the macro economy. An important source of macroeconomic instability and contagion is thus removed.

Some Islamic finance contracts may create debt. However, debt is not traded. This results in a fragmented debt market, where it is not possible to purchase debt instruments or speculate on their prices. This stands in contrast with conventional finance. As debt is traded in the form of bonds, there is an integrated debt market with its gates wide open to the entry and exit of hot money.

Another stability feature of Islamic finance is that every finance transaction involves a commodity in the real sector. The act of financing is not usually to provide cash to the fund user. Customarily, finance through partnership in profit provides for the injection of cash. Finance through partnership in product provides resources in kind, like fertilizers, seeds, trees, and workmanship. Sale finance provides commodities in return for payments. Only Mudaraba and Wakala involve the transfer of cash to fund users. We have proposed elsewhere certain procedures to avoid moral hazard in these cases (Al-Jarhi 2014), in addition to using both contracts in conjunction with Musharaka. The strong connection between finance operations and commodities prevents the

movement of financial resources independently in order to leak into debt and risk trading. This provides an additional source of stability to the system.

iii. Dealing with information-asymmetry risks

It is generally known that debt finance through the use of the classical loan contract suffers from information asymmetry. This subjects the financing process to intrinsic risks of adverse selection and moral hazard. To rid finance from such risk, it is necessary for the lender to monitor the borrower. Monitoring is a costly process that requires continuous collection of information and evaluation. Conventional commercial banks have no alternative to monitoring. It can be done with large-scale financing deals, where project finance is monitored through disbursement of the loan divided at stages, and not released unless consultants provide signed proof at every stage of completion.

Universal banks have a lower-cost alternative, which is to provide joint equity and debt finance to the same customer. Equity finance affords the universal bank a share in management. This would provide a free and a continuous flow of information about the progress of the fund user in using the received funds. Additional debt finance could be provided without the need for extra monitoring. The experience of universal banking shows that equity finance, when properly used, will provide sufficient monitoring to render the additional debt finance free from information asymmetry.

Islamic banks meanwhile have twenty finance contracts, some of which are free from information asymmetry and some are not. We can single out the three Mudaraba contracts, two Wakala contracts and one Salam contract as

subject to information asymmetry. The rest of the twenty contracts that include partnership in profit and product as well as sale finance enjoy information symmetry . Islamic banks can mix and match the contracts they use to insure symmetry of information between fund providers and users. This means that when Islamic banking is practiced by bankers and supervised by regulators who understand the consequences of information asymmetry, the risks of adverse selection and moral hazard are significantly avoided.

However, there are some obstacles in establishing this type of practice. First, central banks have been accustomed to look with apprehension on Musharaka or equity finance. As a supervisory and regulatory authority, they assign heavy risk weights to equity finance. In addition, Islamic bankers, having had their initial education and experience in the commercial banking school, where universal banking is almost unheard of within the banking environment, share with their regulators an equal suspicion of equity finance. Therefore, in order for Islamic finance to make use of this advantage, both regulators and bankers must re-evaluate their mistaken concepts regarding partnership finance.

In addition, both Musharaka and Mudaraba require rehabilitation, in order to place additional safeguards in favor of fund providers (Al-Jarhi, 2016). This could go a long way in making such finance modes more popular.

iv. Financing economic development

We can argue here that Islamic finance is equipped to play an economic role in promoting economic growth and employment. The tools available in this

regard are partnership finance (in both profit and product), profit and loss finance or Mudaraba and the finance of acquiring assets. In addition, the financing of either supply alone or demand and supply simultaneously has its positive effects.

Finance through partnership in both product and profit is done on the basis of economic feasibility. The ability to pay plays a much less role than it does in conventional finance. Finance here is synonymous with investment and its rate of return is of paramount importance. Mudaraba is also a form of partnership in profit, where feasibility should be the most important criterion. All types of partnership finance directly influence supply. It provides more goods and services while increasing the incomes of the owners of factors of production. We can therefore argue that partner finance expands output, employment and growth.

Lease and sale finance is ideal to facilitate the acquisition or the manufacture of investment goods. The assets involved can serve as collateral, which makes it easier to obtain credit by providing a self-mitigating mechanism for the finance risk. The ability to create new investment goods through Istisna' is a powerful tool in the same field. Therefore, we can agree that lease and sale finance enforces the favorable effects of partnership finance on output, growth and employment. Wakala finance or investment agency, when properly carried out through feasibility studies and sufficient safeguards, could also prompt more output, growth and employment (Al-Jarhi, 2016).

A developing economy would find Islamic finance working in its favor by

promoting economic development in the most direct fashion.

The effectiveness of IBFI in reaching economic development will eventually depend on their ability to mobilize resources. In this regard, we find that, as they apply Shari'ah rules, they are found to maintain ethical standards on their investments. By the nature of the rules, they are not supposed to invest their funds in pork, alcohol, illegal weapons, narcotics, human trafficking, and activities that harm the living beings or the environment.

All things being equal, the followers of Hinduism, Buddhism, and the three revealed religions who abhor interest, as well as those who wish to invest ethically would find Islamic finance more attractive. However, such attraction requires good salesmanship for resource mobilization.

v. Systemic integrity

A conventional system is like a spectator's sport. In the soccer field, for example, a few specialized players dominate the field, while the rest are audience watching either from stadium seats or in front of their televisions. They may have an emotional stake in the winning of their favorite team, and sometimes a pecuniary stake, when they gamble on the result of the game. At the end, the result of the game will affect specialized players much more drastically than the spectators.

In conventional finance, fund owners leave finance risks to be shouldered by banks, as they provide their funds in the form of loans which banks guarantee in principal and interest. In turn, bankers take risks only on collateral and leave the rest of the risk to borrowers. Financial transactions themselves do not involve

commodities most of the time. They are provided on the basis of the ability to pay, supported by suitable collateral.

A significant part of the financial operations conducted by conventional banks and financial institutions, goes to finance transactions in the financial markets that have little to do with the real sector, e.g., financing trading in debt and derivatives.

This means that the finance and real sectors are not strongly bonded together. Each sector has its own fundamentals. In particular, the finance sector can grow astronomically in a way that cannot be matched by the real sector.

An Islamic economic system would be effectively tied together through the internal risk sharing among all agents and sectors in the economy. People place their funds in banks on the basis of PLS. A good part of the financial resources are allocated directly on the risk-sharing implicit in partnership finance. The rest that is provided in the form of sale finance involves variant degrees of risk sharing among fund users and the IBFI. In addition, financial transactions involve and must pass through the real sector, wielding a strong tie between the financial and the real sector.

Institutional integrity is important. Financial transactions that fall into debt and risk trading leak out of the real sector. Adjustments in commodity markets in reaction to changes in the money supply would place more pressure on demand and price adjustment. The speeds of adjustment in the real sector would be lower than if they would have been if all financial transactions were tied to the real sector. In other words, conventional finance has some negative

effects on the market mechanism. In Islamic finance, systemic integrity leads to a better and stronger market mechanism. It inhibits the ability of the financial sector to dwarf the real sector. This has significant implications on stability and policy.

vi. Role in establishing equity

IBFI have three roles to play in establishing equity and reducing poverty in an economy. The first starts with the bank itself. As Islamic banks have strict Shari'ah rules to follow, they may make mistakes that would render some financial operations Shari'ah non-compliant. In this case, the resulting profit from such operations are considered as unlawful income which must be given to charity. In addition, it is mandatory that the bank sets aside Zakah proceeds on shareholders' funds. Investment-account holders can also pay Zakah on their accounts to the bank if they wish to do so. The charity fund is usually used to provide charity assistance under the supervision of the Shari'ah board. Poverty eradication would be most effective if Islamic banks use their Zakah and charity funds to establish micro projects whose titles would be transferred to the poor.

The second role would be applicable in countries where Muslims live. They can organize the collection of Zakah payments using IBFIs as custodians of the proceeds. Proceeds would be similarly used to establish micro projects for the poor. The community can supply the relevant IBFI with a list of the deserving poor in their area.

The third role can be performed conscientiously by Islamic IBFIs. When providing partnership finance, their concern about feasibility must be

paramount. Projects presented for finance must be carefully evaluated. The wealth of the finance user should not play a role in finance provision. This would afford the poor a better chance to obtain finance. In providing sale finance, IBFIs should use the assets to be acquired as collateral whenever possible and schedule repayments in a way that suits the cash flows of the customer, in order to enable the poor to acquire productive assets.

vii. Sustainability

Market economies have shown that they are prone to crises. When crises come about, some rules are relaxed in order to protect the system from disintegration. In the latest international financial crisis (2007-2012) the United States and Europe faced an imminent possibility of total failure of their financial system. A disproportionate number of borrowers became unable to meet their payments. Some banks collapsed and many others approached a precipice. The US and Europe dished out astronomical sums of money at the expense of taxpayers in order to bailout CBFIs and prevent a run on banks.

The main source of the crises was the systemic problems that manifested themselves in financial markets turning into gambling casinos, thanks to debt and risk trading. The political powers the firms imposed on governments unduly misplaced priorities for bailing out big market players.

Had a similar crisis taken place in a hypothetical Islamic economic system, the financial market would not have been the source of trouble. Nonetheless, such an economy could face a crisis at the same scale, e.g., due to a natural disaster, like an earthquake or a big failure of crops. But even in this case, the

scenario of confronting the crisis would be totally different. The first and foremost attention would be directed to debtors who cannot meet their obligation because of temporary insolvency. In such an economy, insolvent debtors would be provided free rescheduling. Those who are sufficiently poor would receive charity assistance to meet their basic needs. The government would shoulder only the cost of rescheduling. IBFIs would continue to receive payments albeit at a slower pace. In addition, the central bank would add to the money supply through augmenting its investment deposits with banks. At the end, banks would stay afloat; they would also continue the same level of their investment finance. People would continue their purchases, so that aggregate demand would not fall. The possibility of a recession would be remote. The crisis would pass more easily and quickly, because it is not caused by systemic deficiencies.

We can therefore say that Islamic finance is sustainable, meaning it has no institutional features that cause it to be crises prone. When a crisis occurs, there are tools available to attenuate its effects. Meanwhile the sustainability of conventional finance is impossible without significant changes in the institutional structure.

viii. A blueprint for international monetary & financial reform

Islamic finance has become a revolutionary formula for reforming market economies. Its agenda includes the following items:

1. Replacing the classical loan contract by the 20 Islamic finance contracts,
2. Exclusive monopoly of the issuing of money through a government-

owned central bank,

3. All issued money is to be placed in PLS investment accounts with banks,

4. The central bank issues central investment certificates, to be held by banks and the public and traded in an open market as an interbank and monetary policy instrument,

5. Debt trading as well as the use of all risk-trading contracts is prohibited in financial markets,

6. Debtors would be granted free rescheduling in case of temporary illiquidity, but penalized in case of delinquency.

The Islamic finance industry could have set an example to the whole world had they applied the Islamic finance paradigm to the letter. Now it is rather difficult to convince the world that Islamic finance works, when the Islamic finance industry itself has been converging to conventional finance.

Convergence

i. convergence manifestations

Until the nineties of the last century, few researchers/scholars expressed serious concern regarding the possibilities of Islamic finance converging to conventional finance. However, the onset of the twenty-first century witnessed wide use of shady Islamic finance products that employ sale contracts artificially in order to provide formal validity to products. Concern for the validity of purpose of such products fizzle out gradually, and little is usually done to ascertain compliance with the objectives of Shari'ah.

Artificial sale contracts have been used through Islamic finance to shroud products like 'Eina, Tawarruq, debt sale, international Murabaha and some risk trading. The value of assets created by Islamic banks and finance institutions in this manner has currently risen to very high proportions. Such practices lead us to believe that Islamic banks are becoming less distinguishable from conventional banks. The introduction of ruses in Islamic finance did not happen from the start. It evolved at different speeds in different countries. However, from the very beginning, Islamic finance eschewed risk and profits from partnership investment and immersed itself into risk free methods of leveraged finance (Garner, 2017). Later on, such debt-creating products came to involve the camouflage of interest.

ii. Why worry about convergence?

Admittedly, Islamic finance uses contracting and documentation procedures that are more complicated than in the case of the classical loan contract. The results could be higher operating costs for IBFI. Yet, it has real benefits that are obviously convincing at the macroeconomic level. Based on the fact that Islamic banks are private firms that seek profit maximization, their interest in Islamic finance would be bounded by their desire to maximize profits. Mimicking conventional finance would of course be consistent with bankers' desires to reach profitability. However, it could lead to two unintended but serious consequences.

The first and most obvious consequence is that mimicking conventional finance would completely cancel out the benefits of Islamic finance, which will

be briefly elaborated below. The whole economy would suffer, as it misses the opportunity of cashing in on such benefits. The second and less apparent result would be a conspicuous exploitation of the investment account holders. These provide financial resources under the rule of Mudaraba which means that they will share in the profit and loss that may take place on the asset side. Meanwhile, the asset side of IBFI mimicking conventional finance would remain subject to default risks similar to those faced by conventional institutions. In addition, the risks faced by these assets are significantly higher because of the use of the classical loan contract without resorting to either monitoring or governance. In this case, information asymmetry would aggravate the risks of adverse selection and moral hazard. Therefore, the investment account holders would bear higher risks which they have to share, without enjoying higher returns associated with real investments. In the meantime, shareholders would continue to maximize profits, while leaving investment account holders to shoulder a bigger share of the risk. This is an obvious redistribution of wealth in favor of the former group.

Pessimists believe that the Islamic finance industry (IFI) is clinically dead, awaiting announcement of demise and burial. This will occur precisely when the public realizes that the industry has converted itself into some other industry that mostly deals with selling present for future money through contrived sale contracts.

While the pessimistic opinion may reflect exaggerated concern, the warning signals are plenty all around. We need to listen and respond seriously. It appears that saving the IBFI is no longer a long-term objective. It has

increasingly become an urgent need that affords no delay. Resources and effort must be mobilized towards such a goal.

Evidence of convergence

i. Islamic Finance through the public eyes

An interest investigation by Majeed and Abida (2017) in Pakistan, Widigdo et al (2016) in Indonesia and Red et al (2015) in Indonesia, to see “how Islamic” is Islamic finance as perceived by employees and the public. As expected, Islamic bank employees have a favorable perception, but the public have mixed opinions. Such studies fail to measure Islamic finance against its true paradigm. Latiff et al (2015) classify public grievances towards Islamic finance in four categories. First, IBFIs prefer debt-based financing modes. Second, IBFIs understanding of the Islamic finance products is inadequate. Third, customers have doubts whether IBFIs comply with Shari'ah. Fourth, customers complain from lack of product innovations and wanting service quality at IBFIs. Latiff et al findings point a finger towards the lack of adherence to the Islamic finance paradigm.

Azmata et al (2015) compare conventional finance with a pure Murabaha Islamic finance and find that competition would eventually lead to convergence. The conventional structure crowds out the Islamic financial structure, which finally produces “Shari'ah-compliant” replicas. They also find significant empirical evidence for this crowding out. Their conclusion is that Islamic finance products have little structural difference when compared with conventional products. Ahmed et al () find there is no significant difference between the

monthly average lending rates of Islamic banks and conventional banks, confirming strong similarity.

ii. Other empirical evidence

By comparing financial ratios between Islamic and conventional banks, Olson and Zoubi (2008) find that such ratios can distinguish between Islamic and conventional banks. This can be interpreted as evidence against the existence of convergence. However, there is more substantial evidence to the contrary, as we will see below.

Some economists propose that financial globalization can be an element in the convergence between Islamic and conventional finance (Mirakhor, 2007; Askari et al, 2010). While globalization can have benefits, Mirakhor (2007) believes that such benefits depend on the degree of risk-sharing around the world. Mirakhor remarks that the potential of financial integration to promote welfare has not reached its potential because of the lack of instruments as well as financial, legal, and institutional requirements for greater risk sharing. However, financial globalization has been associated with innovations in trading debt and pure risk. Little however has transpired in the area of risk sharing.

Askari et al (2010) cite the vulnerability of the conventional financial system that has been exposed by the international financial crisis, the rise of international capital flows, the growth of Islamic financial institutions in non-Moslim countries and the surplus capital gathering in oil producing Islamic countries, all as factors that encourage conventional finance to more risk sharing.

While globalization may provide Islamic finance an opportunity to offer risk-sharing a wider scope in the world, internal factors that motivate Islamic finance to mimic conventional finance are major inhibitors.

How can convergence that we asserted above be identified, despite the lack of transparency in Islamic banks' financial statements? Conventional finance products used by Islamic banks would be listed under Shari'ah-based sale contracts. Tawarruq, 'Eina and international Murabaha (commonly known as reverse Tawarruq) would be considered Murabaha. Speculation in stock exchanges would be similarly listed. However, a simple test of convergence that calculates the percentage of such products of ill-repute to total assets is not possible.

Alternatively, indirect tests can be carried out. Hamza (2015) finds that capital ratios and interest rates positively influence return on Mudaraba accounts. This implies that returns come mainly from bank assets that are interest-based debts. There is no impact from the board of directors and Sharia board. Hamza used generalized moment test (GMM), to confirm the presence of the debt financing channel of monetary policy where interest rate variation affects Islamic bank financing. Furthermore, he found that the negative effects of interest rates on debt-financing growth were mitigated by growth enjoyed by investment accounts. In summary, such indirect evidence exposes the conventional nature of Islamic banking assets that is well camouflaged under Murabaha terminology. Hamza and Saadaoui (2017) in a later study confirm these results.

Empirically, Rajhi, and Hassairi (2013) find that a higher share of loans in the asset structure contributes to increasing bank insolvency for large banks in MENA countries. In addition, Islamic banks have been found to enjoy a stable depository base at times of crises (Farooq and Zaheer, 2015). Čihák and Hesse (2008) find small Islamic banks to be relatively more stable and large ones less stable than their conventional counterparts. To start with, Beck et al (2010) find few significant differences in business orientation, efficiency, asset quality, or stability between Islamic and conventional banks. This implies that convergence of Islamic

finance to conventional finance has blurred the differences between the two systems, thus supporting our basic claim of convergence and its consequences. To reiterate, our claims regarding stability hinge upon the proper adherence to the Islamic finance paradigm. Similarly, Chakroun and Gallali (2013) in terms of the impact of Islamic finance on macroeconomic stability found mixed results that depended on bank size; in addition, their work also revealed negative results. Such results, when combined with Beck et al's work give an indication of how the violation of the Islamic banking paradigm cancels out potential stability benefits.

Why the promised dream is fading away?

i. The role of bankers and finance officers

The question that needs to be addressed is why are IBFIs increasingly becoming a distorted picture of CBFIs. Some relevant points must be noted in this regard.

First, we must admit that procedures of conventional finance are less costly than those of Islamic finance. In addition, they are more in line with the mentality of bankers who have been practicing these procedures for many decades. Like their counterparts, Islamic bankers and finance officers also want to maximize the profits of their firms. Unfortunately, the advantages of Islamic finance listed above do not bear directly on their financial statements. They are all external effects. In order to convince Islamic bankers and finance officers to abide by the rules of Islamic finance, such effects must first be internalized in order to discourage them from mimicking conventional finance. Since such internalization is not quite possible, the adherence of the rules of Islamic finance must be insured by regulation and supervision.

Islamic bankers and finance officers use their strong influence to pressure the members of their Shari'ah boards to design the products that short-circuit the rules of Islamic finance. Some economists accuse Islamic bankers and finance officers of Shari'ah arbitrage meaning they

appoint as members of Shari'ah boards those who would be expected to be most lenient in designing products (El-Gamal, 2005). This perhaps is an extreme perception, as bankers and finance officers in IBFIs have sufficient influence to demand the design of questionable products.

ii. The role of Shari'ah boards

The first layer of regulation and supervision of IBFIs is entrusted to their Shari'ah boards. However, Shari'ah boards until today have perceived the IFI as an infant industry, despite its being more than 40 years old. Such perception has inspired Shari'ah boards to provide the Islamic finance industry with products that reflect a sympathetic attitude more than strict supervision of the industry. Licensing has become the major theme of such products rather than strict adherence. Even if we accept the argument that it is an infant industry, licenses should be offered on a temporary basis and should be attached to a time framework, so that conditions can be tightened or eliminated in the future.

Another problem stems from the way members of Shari'ah boards exercise their scholarship. As is commonly known, Fiqh methodology is based on the verification and interpretation of the Divine text. A substantial wealth of Fiqh writings has been inherited from past generations, which are rich in both documentation and logical deduction. Such wealth can be used to solve cases in a way similar to those settled by previous generations.

This opens the door for using excerpts from old Fiqh texts to prove validity. This is generally understandable and should even be encouraged under three conditions. First, the contemporary Faqih must adapt the old opinions for changing times and circumstances. Second, the contemporary Faqih should consider all direct and indirect consequences of using the excerpts. Third, such excerpts should not represent a minority or an exceptional opinion.

Fundamentally, the methodology of Fiqh for validating transactions is impeccable. Each transaction is considered as a contractual form. Every contract must be valid in both form and purpose. Conditions of the formal validity of contracts have been eloquently stated for many contracts by old Fuqaha' and has become a part of the Islamic Fiqh legacy. Conditions for the validity of purpose cannot be taken completely from Fiqh, as such conditions depend on times and circumstances and their 'discovery' requires special expertise.

The last factor is of special importance. An example would be the sale of antibiotics by a retailer. When done without prescription, the direct consequence may be the possible harm inflicted upon the buyer in exposing his/her body to life threatening allergies and the weakening of his/her natural immunity system. The indirect effects could be manifested in the general increase of resistance of certain microbes or bacteria to antibiotics, which would render them ineffective in combating diseases. Therefore, the sale contract of antibiotics without prescription is formally valid, but its validity of purpose requires the expertise of a specialist in medical science.

Shari'ah board members usually consider the direct effects of transactions, which are easily understood by non-economists. However, the Fuqaha' have no tools from their training to foresee the indirect macroeconomic effects. Such effects get little or no attention, not because they are not important, but because of the nature of training of the Fuqaha'.

Unlike the majority of academic Shari'ah scholars, members of Shari'ah boards have been overly absorbed into verifying formal validity. They have employed their knowledge and skills to find forms that lead to the ultimate conclusions usually reached by conventional finance while appearing to be Shari'ah compliant. This ingenuity brought to the IBFI a series of products that placed an Islamic garb on exchanging present for future money. Such products run against

economic logic, because they employ artificial sales contract as a façade to camouflage the conventional nature of transactions. It is therefore not surprising that the majority of Shari'ah scholars in universities and Fiqh academies take a dim view of the opinions of Shari'ah board members.

Had Shari'ah board members taken Maqassed al-Shari'ah seriously, they would not have found justification for using ruses to mimic conventional finance. Instead, they seem to consider Maqassed al-Shari'ah as loose rules, not as exact principles fit for application. In particular, no Shari'ah board member has ever blocked a transaction because it could lead to instability or inflation or unemployment, or even because it would redistribute income to the disadvantage of the poor.

iii. Shari'ah board governance

There has been a conspicuous and long absence of qualified economists from Shari'ah-board membership. This undoubtedly has caused Shari'ah boards to be generally unaware of the macroeconomic consequences of the products they design. Without an economist in the Shari'ah board, members would be more vulnerable to bankers' pressures.

Another conspicuous phenomenon of Shari'ah boards is that their members serve for life. The same group of people hovers around these boards. Some members have even been able to bring their children into the boards right after their graduation. Some members serve in too many Shari'ah boards that it is obviously impossible for them to attend all the meetings.

The most serious problem with Shari'ah board governance is that each of them behaves like an authoritative Fiqh academy. None has so far abided by the rules of the International Fiqh Academy. Some even dare to state that they would not be bound by such resolutions.

Shari'ah board members are supposed to be part of the wider community of Shari'ah scholars. However, we notice an intellectual hiatus between board members and academic scholars. For example, a product alike Tawarruq is strongly condemned by Shari'ah academics, while easily accepted by the majority of board members.

Furthermore, Shari'ah board members are appointed without any specific standards of academic qualifications. Scholarship in any discipline is usually verified by obtaining a PhD degree from an accredited and preferably, a ranked university. In addition, a scholar must have the experience of teaching graduate students and should have published in refereed journals. Such criteria are generally not applied to Shari'ah board members. It is not therefore uncommon to find board members without one or more of such qualifications.

Other Challenges to Islamic finance

Having scrutinized in great depth the advantages of Islamic finance, we shall now turn to the challenges that face it.

i. Islamic finance as subsidiaries

An interesting phenomenon is that some conventional banking groups initiate Islamic banking subsidiaries. Presumably, in a mixed system where Islamic and conventional banks exist, both types of banks should be competing. Having both types of banks as subsidiaries to the same holding firm would be an obvious conflict of interest. It also serves as an insurance against depositors moving their funds from conventional to Islamic banks. However, this may also be an element that encourages convergence of Islamic finance towards conventional finance.

Asset-based and asset backed sukuk

Another challenging issue lies in the area of securitization. Sukuk still largely mimics asset-backed bonds. A completely “real sale” in Islamic finance securitization ranges from being vague to being totally absent. The SPV is invariably outside the authority of sukuk-holders. This makes it impossible for them to exercise their property rights over securitized assets. Sometimes, legal techniques are used to avoid the “real sale” of securitized assets, especially in the case of securitizing government owned assets or “leasehold” instead of “freehold” real estates.

ii. Company classification

Another challenge lies in Shari'ah boards working with financial markets. When companies are classified according to their Shari'ah compliance, the logical approach would be that its total assets must be dominated by Shari'ah-compliant assets. However, Shari'ah boards use a questionable criterion of dominance which is, one-third. Such criterion is borrowed from the percentage of bequest to be willed to non-heirs.

A rather critical point in company classification is that IBFIs are automatically classified as Shari'ah compliant, on the basis that they have their own Shari'ah boards. This is rather unfortunate, for it allows such IBFIs to get the Shari'ah compliance label no matter what type of asset composition they have.

As an added measure, we propose that Islamic banks and firms to be classified as Shari'ah-compliant should be required to acquire the HALAL label. In this case, the central bank must mandate that in order for an Islamic bank to keep its license, it must also be able to keep its Halal label.

In order to make such proposals effective in preventing the convergence of Islamic to conventional finance, its requirements must be modified. This should include the expansion of the HALAL trademark to reflect the extent that Islamic finance institutions base their

operations on Shari'ah (and not just compliance). In other words, offering the trademark must be associated with Islamic banks completely avoiding trading present for future money. In addition, Shari'ah based classification of firms (and not just compliance) must be strengthened to include the prohibition of the use of additives, carcinogens, artificial colors and flavors and everything that causes harm to life and environment.

The role of monetary authorities

The failure of Islamic finance to live up to its paradigm owes a great deal to the inactive role of the central bank. Monetary authorities from the very beginning have stayed aloof from Shari'ah compliance. They limited their supervision of Islamic finance to the accounting side only. In most cases, we notice the absence of Shari'ah boards within monetary authorities. Meanwhile, in cases where the monetary authority has its national Shari'ah board, the central bank seems to find no yardstick for vetting the board decisions.

The main reason is that in most cases the central banking law is devoid from any reference to principles of Islamic finance. In particular, the definitions of lawful Islamic finance products and the unlawful ones, e.g. Tawarruq, are absent, leaving the central bank to rely on the national Shari'ah board, if it exists, or leave this matter to Shari'ah boards in individual IBFIs.

Can we then conclude that monetary authorities maintain Shari'ah neutrality? If so, then on what basis do they provide licenses to Islamic banks which are supposed to be Shari'ah compliant? It should be only intuitive that monetary authorities, being charged with the protection of public interests, should make sure that IBFIs do not violate their licenses, which should be revoked under serious or repetitive violations.

Neutrality of monetary authorities towards Shari'ah has serious implications. Ideally, if monetary authorities are aware of the macroeconomic advantages emanating from an honest

application of Islamic finance, they must not allow any violations. Otherwise, they should not be considered the lawful guardians of public interest. It would then be legitimate to ask whether monetary authorities are seriously and continuously concerned with macroeconomic objectives or are they totally immersed in their daily routines.

Another important aspect of the role of monetary authorities is to what extent they include the Islamic finance sector in their monetary policy considerations. According to Al-jarhi's model (1981), money created in an Islamic economic system should be placed by the central bank (as central deposits) in the form of investment accounts. The central bank issues central deposit certificates (CDCs) to be held by banks as well as the public, and whose proceeds would also be added to central deposits. Monetary policy would be conducted through open market operations via CDCs. The market-determined rate of return on CDCs would replace the policy-determined rate of interest.

Supposing the market share of the Islamic finance sector, measured by assets, is only 20 percent, how should monetary policy be designed and conducted? On the assumption that the transmission mechanism through which monetary policy influences income and employment would not be similar through Islamic and conventional finance, the action of excluding Islamic finance from monetary policy consideration would rely partly on its effects through conventional finance.

Under this assumption, we propose that the central bank deposit 20 percent of the money supply as central deposits with Islamic banks. Meanwhile, it issues the equivalent of 20 percent of domestic government debt in the form of CDCs. In other words, such CDCs would replace an equal amount of government debt; they can be swapped for an equal value of government debt with bond holders.

Let us assume the central bank wishes to add 5 million units of currency to the money supply. It should do so by buying 4 million units worth of government bonds from the public and augmenting its central deposits by one million. In this way, monetary policy would be carried out via two means, Islamic and conventional finance. Maintaining such proportionality would go a long way towards achieving an inclusive monetary policy.

A proposed social dialogue

The seriousness of the current problems of the Islamic finance industry requires a society-wide dialogue in every country that has a stake in Islamic finance. A national committee should organize the dialogue and follow up on the implementation of its results. The participants should include legislators, monetary and financial authorities, bankers and finance executives, Shari'ah board members and representatives from the International Fiqh Academy, AAOIFI, IFSB, the Islamic Development Bank (IDB), the International Association for Islamic economics, the IMF and the World Bank. Such a dialogue would discuss the current state and the future of the IBFIs. It should set an agenda of reforming the current state in all respects.

Summary and conclusions

Islamic finance has now crossed the threshold of convergence to conventional finance. The system is losing its meaning and rationale. It is becoming increasingly devoid of any macroeconomic advantages which it can claim. 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 in order to secure the macroeconomic benefits that justify the switch from conventional to Islamic finance.

We have reasoned that, by nature, and at the microeconomic level, Islamic finance has a higher cost than conventional finance, thanks to more documentation and roundabout procedures. This leads us to believe that the substantial macroeconomic advantages of Islamic finance cannot induce bankers and finance officers to apply the paradigm of Islamic finance to the letter. It appears that only incentives provided through regulation and supervision will work.

We have placed the responsibility for implementing Islamic finance on all parties involved. Starting with bankers and finance officers, Shari'ah board members and then monetary authorities, each must take responsibility for what happens and act quickly and effectively in order to remedy the situation. (Appendix 1 lists some detail recommendations that should be considered.)

Appendix 1

I. A NATIONAL ISLAMIC FINANCE REFORM COMMITTEE

1. Organize a national dialogue about the status of the Islamic finance industry.
2. Set a timetable for:
 - 2.1. Legislatures, monetary and financial-market authorities to introduce the necessary changes in laws and regulations
 - 2.2. IBFIs to adapt themselves to the new laws and regulations
3. Follow up on the implementation of the results of the dialogue.

II. LEGISLATORS

4. Amend banking, financial market, civil and commercial laws in order to include
 - 4.1. The meaning of the prohibition of Reba as any transaction that leads directly or indirectly

to the sale of present for future cash at a premium.

4.2. The definitions of lawful Islamic finance products as well as those of unlawful products, like 'Eina, Tawarruq and debt sale.

5. Provide powers to monetary authorities to apply such laws on all IBFIs, and if necessary, withdraw Islamic finance licenses from violators.
6. Allow financial market authorities to block any Sukuk that does not envisage a true sale of the securitized assets. All SPVs must be owned and managed by Sukuk holders.
7. Set standards for choosing scholars in economics & Shari'ah as Shari'ah board members such as having a PhD from a ranked university, teaching graduate students and publishing in refereed journals
8. Set guidelines for Shari'ah board membership in order to include an equal number of economics and Shari'ah scholars.
9. Set governance rules for Shari'ah boards that limit the period of service and the number of Shari'ah board membership for any scholar.
10. Establish a national Shari'ah board as part of the monetary authority, which would have the right to vet and veto any decisions made by individual Shari'ah boards. In addition, it should work on harmonizing Islamic finance products.
11. Make it unlawful to act contrary to the decisions of the International Fiqh academies.

III. MONETARY AUTHORITIES

12. Take a more proactive role in insuring Shari'ah compliance.
13. Develop an all-inclusive monetary policy that is conducted proportionately through the channels of Islamic and conventional finance.
14. Act on any Shari'ah violations with decisiveness.

15. Formulate proper rules to rehabilitate partner finance in order to place the burden of proof, in cases of negligence and violation of contract, on fund users.
16. Take a more realistic view of equity finance, and allow its use in conjunction with other Islamic modes of finance as a means to reduce information asymmetry.

IV. RESEARCH AGENDA

17. Need for more theoretical papers regarding:
 - 17.1. Prohibition of Reba and its relationship to the sale of present for future money
 - 17.2. Lawful and unlawful transactions in Islamic economics & their effects on equilibrium, stability and market mechanism
 - 17.3. Islamic finance survival in mixed systems
 - 17.4. Banks' incentives to follow Shari'ah
18. Need for more applied research regarding:
 - 18.1. the effects of controversial transactions on the efficiency and stability of Islamic banks
 - 18.2. The interdependence between interest rates paid on conventional bank deposits and rates of return paid on Islamic bank saving and investment accounts
 - 18.3. The convergence between conventional and Islamic finance
 - 18.4. Benchmarks for Islamic finance instead of LIBOR
 - 18.5. Classification criteria for IBFIs and other business enterprises that insure Shari'ah-based operations
 - 18.6. The role of financing stock market transactions and destabilizing speculations
 - 18.7. The transmission mechanism involving Shari'ah-compliant and Shari'ah-based IBFIs

- 18.8. Alternative modes of operations for Islamic financial institutions.
 - 18.9. Guidelines to make Mudaraba, Wakala and Musharaka contracts more applicable in Islamic finance
 - 18.10. The experience of universal banking in non-Anglo-Saxon countries and its relevance to Islamic finance
 - 18.11. Innovative ways to use product structuring in Islamic finance
 - 18.12. The uses of partnership in product
 - 18.13. Islamic finance as a proposal for reforming the world economic order
 - 18.14. Prohibition of Reba as a way to prevent the substitution of real resources for money in transactions
 - 18.15. The switch from lending to productivity criteria in the creation and allocation of money
 - 18.16. The establishment of an unbreakable bridge between the commodity and real sectors
 - 18.17. Debt and risk trading and its relationship to instability and contagion
 - 18.18. Stability-oriented procedures to handle financial crises: banks' bailout versus borrowers' bailout
 - 18.19. An Islamic finance agenda for international monetary reform
 - 18.20. Classification of IBFIs according to Shari'ah-based criteria, e.g.:
 - 18.21. Asset composition and content of suspicious products
 - 18.22. Disparity of rates of returns on deposits and interest rates
19. Use of interest rates as benchmarks
 20. Use of a new dominance criterion in company classification standards

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