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The Internal Challenges Facing Islamic Finance Industry

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Abstract

Islamic finance is undoubtedly one of the fastest growing financial industries. Its total assets have exceeded two trillion dollars, and the number of Islamic financial institutions is approaching 600 around the globe. Nevertheless, Islamic finance is facing various challenges that are impeding its further growth. Some of these challenges are from outside the Islamic finance while others are internal and they cannot be attributed to external factors. The most serious internal challenges are the ones that relate to the lack of enforceable robust Shariah governance, which in turn has led to creating an avenue for fatwa (Shariah opinions given by Shariah scholars) shopping and invasion of controversial products endorsed by Shariah scholars using peculiar justifications. The internal challenges also relate to the methodology used in Islamic banks in structuring their financing products. The existing product development methodology has yielded a number of products borrowing their Shariah legitimacy from the mere adherence to certain useless and perplexing technicalities. The paper comes to highlight these challenges and outline the prospectus of what constitutes a sound Islamic banking product in terms of both its Shariah control and products development methodology.

Introduction

Since its start, Islamic finance industry has been facing various challenges. Some of these challenges are external and are of legal nature, and they result from failure to recognize the special nature of Islamic banking and finance as an industry that cannot sell cash but rather assets and services. For example, some jurisdictions do not allow Islamic banks to trade in assets, while other laws allow Islamic banks to own assets but impose some taxes upon every transfer of asset title. This has forced some banks tend to avoid payment of taxes by reducing some necessary contractual steps, which potentially raises some Shariah concerns. Laws may also prohibit banks from leasing assets to clients and therefore, Islamic banks are left with no choice but to dodge and execute Ijarah (lease) in the form of sale. Besides, the market of a vital Islamic capital market tool like sukuk is not yet regularized to the full extent due to various legal constraints. Furthermore, many courts do not recognize Islamic law (Shariah) while dealing with disputes relating to Islamic finance. Notwithstanding the seriousness of the above-mentioned legal challenges, Islamic finance is also facing internal challenges that may put at stake its credibility and pose a more serious threat to its long-term success and its very survival. These challenges come from inside the industry and cannot be blamed on external factors. They include ones pertaining to the lack of enforceable robust Shariah governance, creating thus an avenue for fatwa (Shariah opinions given by Shariah scholars) shopping and invasion of some controversial products. In addition, they also relate to the methodology used in Islamic banks in structuring their financing products since this methodology has yielded a number of products borrowing their legitimacy from the mere adherence to certain useless and perplexing technicalities, only to make them look different from their conventional counterparts. Such challenges necessitate a diligent approach to Shariah endorsement of products and transactions, especially with the growing Shariah awareness of the average client and the existence of unprecedented court cases of Shariah-compliance nature. The following discussions address these internal challenges by first highlighting the deficiencies in the existing Shariah supervisory work and then the deficiencies in the product-development methodology followed in Islamic banks.

I. The absence of a proper Shariah governance

It is no secret that Islamic finance is facing challenges related to lack of proper and effective Shariah governance and that the industry of Islamic banking and finance has been regulating itself since its start, without the supervision or intervention of genuinely independent authorities. AAOIFI (Auditing and Accounting for Islamic Financial Institutions) is a regulatory authority from within the industry, and it has introduced a standard for *Tawarruq*[1] though this product has been ruled as categorically unlawful by the Fiqh Academy; the largest representative of the cotemporary Shariah scholars! IFSB (Islamic Financial Service Board), another regulatory authority from within the industry, has dodged the issue of setting governance rules for Shariah boards to weed out the unqualified Shariah supervisory board members (Aljarhi, 2009). This shows that the self-regulation of this industry has been unpractical and unreliable. The intervention of central banks has also proved unsuccessful, because the core problem Islamic banking is facing relates to the credibility of its products and their resemblance to the conventional banking products. Naturally, central banks will not be pleased with Islamic banks offering genuinely Islamic products, because these products will then inherently carry various business risks. Therefore, a balanced Shariah regulation is required, and the full independence of any potential Shariah regulatory authority from the Islamic financial institutions is a must.

The basic elements of Shariah governance

Shariah governance involves a variety of issues; the focus in this paper will be on two basic elements: Islamic banking products and Shariah control.

1. Islamic banking products and transactions

What necessitates subjecting Islamic banking and finance products to Shariah governance is the invasion of many controversial products as well as the unjustified conflict in endorsing the products. The same Islamic banking or financial product could be deemed lawful and permissible in one bank but unlawful and as conducive to Riba (usury/interest) in another! This is simply due to having differences in the views of each bank's Shariah board. It is true that the

[1] Tawarruq is basically a sale used as a legal device to indirectly deal in Riba (usury/interest).

traditional Fiqh (Islamic law) schools had differed in many areas of Islamic law, but never had their differences reached this level of clash and conflict, especially in the Riba related matters. Schools of Islamic law did differ in validating certain Riba-related transactions to the extent of the ability of such transactions to produce their legal consequences, but they never differed in deeming the permissibility (non-sinfulness) of the contract conditional on the essence of the contract or the intention of the contractors.[2]

Furthermore, some of what was perceived in the early stage of Islamic finance as '*unIslamiseable'* due to its essence being in blatant conflict with the principles of the Shariah entered latter the sphere of Islamic finance and received Shariah endorsement in some institutions. Examples can be found in the many financial derivatives that attracted the attention of many Shariah advisory firms to turn them into allegedly Shariah-compliant speculating instruments! [3]

Besides introducing products that were unperceivable Shariah-wise before, some Islamic financial institutions have loosen up rules they set before. For example, the 5% benchmark set for tolerating the unlawful income in stock trading or REITs has been increased to 10%. Similarly, the 30% benchmark set for the assets composition ratio of the tradable assets to the total assets, in order for Sukuk (Islamic Bonds) or stocks to be tradable, has been reduced in more recent standards to 10%! (Al-Jarhi, 2009; Abozaid, 2012). This subjective and unjustifiable leniency towards Islamic finance rules has raised more doubts as it became evident to the public that such rules were groundless and lacked textual evidences.

Hence, the volatility and conflict in fatwas pertaining to Islamic banking and finance products have created confusion in the minds of the public and triggered some suspicions over their legitimacy. Based on recent surveys, a wide spectrum of Muslims refrain from dealing with Islamic banks altogether or avoid some of their services for the said reasons. Other Muslims

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[2] For more details on this issue and the difference between a valid contract and a permissible contract see "Ilam al-Muwaqi'een" by Ibn al-Qaiyyem 3/200; "Contemporary Islamic Financing Modes between Contracts Technicalities and Shariah Objectives", Journal of Islamic Economics Studies, Islamic Research and Training Institute, Islamic Development Bank, Volume 17, No2. Jan, 2010.

[3] For examples on the attempts to Islamize derivatives see "Shariah Analysis of Financial Derivatives". Islamic Economic Research Journal, Volume 27, No 3, 2014.

deal with Islamic banks not out of confidence in them but rather as a commission of the lesser of the two evils, the other evil being dealing with conventional banks.[4]

In fact, the intellectual discourse on Islamic banking reflects a deep disappointment, concern and an increasing resentment. A lot of the writings on Islamic banking and finance critically address issues like the ethics and morality of Islamic banking. Several academic institutions have introduced courses on Islamic finance and the general *Maqasid* (objectives) of the Shariah to critically review the performance of Islamic finance in light of the established objectives and philosophy of Islamic law.

The said resentment and concern over the ethical performance of Islamic banking and finance is more evidently manifested in the recent themes selected for the academic conferences on Islamic banking and finance. Among these themes are ones like: "Islamic Finance: Reality v. Expectations"; "The Social Responsibility of Islamic Banking & Finance". Such themes reflect a huge perplexity and concern over the performance of Islamic banks among the educated class, and that if Islamic banking products could have been somehow technically labeled Shariah compliant, then there is something beyond the Shariah technical requirements in finance; it is the essence and spirit of this finance which until now has been far from achieving the social justice believed to be imbedded in the Islamic economics system.

In conclusion, it can be said that with the increasing contrast and conflict in endorsing Islamic financial products from one side, and with the increasing resentment of the public towards such disorder, standardization of Islamic banking products has become critical to restore and maintain the credibility of Islamic banking and finance. However, the standardization has to be limited to the products only and it cannot be extended to the day-to-day transactions of the Islamic financial institutions, because most of these transactions are tailored according to the requirements of the clients and in consideration of the special conditions governing these transactions. Nevertheless, certain contracts may be fundamentally ruled as unlawful to be used

[4] Surveys conducted in different countries have shown that Islamic banks' customers and people in general have many doubts over what is marketed to them as Shariah compliant products. See for example, Rahman (2012) (Survey done in UK).

as underlying contract in structuring any transaction. These include the contracts that are commonly used as subterfuge to Riba, like *eina* or *tawarruq*.[5]

Finally, standardizing products can be handled by some existing regulatory authorities like Fiqh Academy or by AAOIFI after restructuring these authorities in a way that ensures professionalism, scholarship, integrity and full independence. Then, some mechanism needs to be worked out to get the Islamic banks and financial institutions to abide by the standardized products, preferably by the force of law; but if not feasible then by blacklisting the non-abiding banks.

2. Shariah control and supervision

Logically, Shariah control over Islamic financial institutions is supposed to be a legal requirement in every institution to ensure the compliance of the institution's activities with the rules of Shariah. However, Shariah control in many countries has been left to the discretion of the Islamic financial institutions, and the interference of the higher authorities has been technical and superficial, which means that the Islamic financial institutions have effectively been self-regulated in terms of Shariah control.

Being self-regulated, Islamic financial institutions have exercised self-Shariah control only to the extent that would enable them to market themselves as institutions complying with Shariah rules. This requested banks to hire some people known to be Shariah specialists to execute some Shariah supervision and audit. These Shariah controllers would be requested to basically review the products and activities of the financial institutions and supervise the right implementation of their fatwas and pronouncements.

However, although the above arrangement seems to be fine and acceptable, it harbors in fact a lot of avenues to manipulation and deviousness to realize the self-interest of these institutions.

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[5] Eina is a sale that is mostly resorted to for the purpose of circumventing the prohibition of *riba* by selling a commodity to the person seeking financing at a deferred price then instantly buying it back at a lesser spot price. *Tawarruq* is to purchase a commodity from one party on credit then sell it immediately to another for cash. Thus, *tawarruq* shares the same objective of *eina* as both are meant for extending cash money. However, *Tawarruq* remains technically distinguished from *eina* as in the later the commodity is resold to its original seller, while in *tawarruq* it is sold to a third party.

This starts from the selection of the Shariah supervisory board members when banks *naturally* tend to hire those who are known in the market to be lenient, influential but not necessarily competent. Then it is the same banking institution that is effectively capable of dismissing or replacing a Shariah board member to its own convenience. Besides, all internal Shariah auditors or compliance officers effectively report to the management of the bank. These practices combined would create conflicts of interest and render Shariah control work neither independent nor transparent, and it would open the door to the manipulation of the Shariah control work to realize the self-interests of the banks.

This, in fact, explains why Shariah supervisory boards are dominated by a very limited number of Shariah specialists, despite the existence of a huge number of highly-qualified Shariah scholars and specialists worldwide.

Therefore, in order to tackle this problem it is necessary to break the bond of interest or the marriage of convenience between bankers and Shariah scholars and to also ensure the genuine independence of the Shariah control personnel. Doing so would put things in perspective and make Shariah control work in line with the general norms of Shariah. In fact, it is unprecedented in Islam that one whose job is to pronounce binding Shariah rules is selected and paid by the same entity bound by those rules.[6] The judge in Islam, for example, can never be selected by those who are to be bound by his judgments nor can he be paid or even gifted by them. Obviously, Islamic financial institutions are bound by the pronouncement of their Shariah boards but oddly enough, they are the ones who select them, dismiss them and pay them salaries! In fact, it is very wrong to consider these pronounces as merely Shariah advises or even fatwas,[7] because unlike the advice or the fatwa, these pronouncement bind the institutions. Besides, Islam does not attach infallibility to anyone but to prophets, so no Shariah scholar is

[6] The relative silence of Muslim about this unprecedented existing practice can be attributed to a variety of reasons; most importantly, the fact that Muslims pegged a big hope on Islamic banks when they were first established, for they represented to them a glimpse of hope after decades of economic and cultural deterioration and therefore, they were not willing to criticize the initiative by any means. However, recently there have been an increasing criticism and objection to this practice in the wake of the controversial fatwas sweeping the industry.

[7] Fatwa refers to the Shariah opinion given by a Shariah specialist over something. Unlike the judgment given in the court of law, it is non-binding and so it is left to the one who seeks it to apply it, ignore it or seek for a different fatwa from a different Shariah scholar.

immune against the temptation of wealth or other worldly gains, especially if we refer to the multi-million dollars annual income a Shariah scholar may get! [8]

Some proposed governance rules:

To help solve the above Shariah governance deficiencies, the following can be suggested:

a) Accreditation of Shariah board members

Shariah boards should have only accredited Shariah scholars so that not any holder of some Shariah or Islamic studies degree can jump in and pose as a Shariah board member. As a prerequisite, a Shariah board member should have an MA or Ph.D. in Islamic financial law, in addition to some basic knowledge in banking and finance (Al-Jarhi, 2009). He or she must also be accredited by an institution set up for this purpose, through passing some exams and taking some intensive courses if necessary. It is true that there exist in the world many learnt Shariah scholars who have no academic degrees in Shariah, but we still need to demand a high university degree in all Shariah board members in order to protect this industry from intruders, especially that many Muslims still fail to realize that a preacher is not necessarily a Shariah scholar, and that Islamic law is of different branches the most sophisticated of which is the Islamic law of transactions, so specialization is required.

b) Independence of Shariah boards and internal Shariah controllers

As pointed out earlier, the independence of Shariah boards and all Shariah controllers is vital and indispensible for the integrity and credibility of their work. To ensure independence and avoid conflict of interest, Shariah board members must be selected, appointed and possibly dismissed by an independent third party, like the central bank or by an international institution like CIBAFI (Council for Islamic Banking and Financial Institutions) for example. This step is extremely important especially to ensure the integrity of Shariah boards, because if the Shariah board member finds himself appointed by the bank, paid by the bank and possibly dismissed by

[8] The annual income a Shariah scholar can make from sitting on scores of financial institutions may reach a couple of millions of dollars knowing that the average salary he gets from sitting on one board is around 25-30 thousand dollars. Some scholars have been reported to have been sitting on around 100 boards!

the bank he is giving fatwa to, then his human nature will drag him towards taking a lenient approach in fatwas in order to maintain his position and attract other Islamic banks to him.

c) Adding to Shariah boards financial and legal experts

Shariah boards should also include financial and legal experts with no voting right to advise the Shariah scholars and brief them on any relevant financial or legal concerns as well as the possible implications of any Shariah resolutions. This step is particularly important when the Shariah board members do not have adequate legal, finance or market experience, so they need to consult trustworthy and independent experts before they can make a decision. In point of fact, a wrong fatwa in many cases could be a result of a misrepresentation by the bankers or a misunderstanding by the Shariah board members.

d) Limiting the number of Shariah boards on person may join:

It is commonly observed that a few Shariah scholars are monopolizing Shariah boards. This is due to various reasons, but primarily because of the proven convenience of their fatwas and the fact that newly-opened institutions usually ask existing ones to recommend scholars for their Shariah governance boards – a practice that ends up with the same scholars working for a number of institutions (Al-Jarhi, 2009). This phenomenon is far from professional as it carries the seeds of many negative implications on the industry; being some of them the subjection of the whole industry to the views of limited dominating figures, and the incapability of them to efficiently and fully discharge their responsibilities. Therefore, the number of boards one person may join must be limited to a reasonable number, in order to also give the chance to other brains to join and benefit the industry.

e) Setting an international Shariah supervisory board

To help solve the problem of conflicts in Islamic products universally, an international Shariah supervisory board needs to be established. Its responsibility shall then be to endorse products only, since it would not be feasible for it to look into the daily customized transactions of the operating Islamic banks. It should have a specific number of the most credible, experienced and qualified Shariah scholars from various jurisdictions and school of thoughts. They must be fully

independent and not sitting on any individual Shariah board. Such a committee could also be made affiliated to the OIC (Organization of Islamic Cooperation) and also paid by the OIC. Its resolution should be binding on the individual Islamic banks, and in case of a proven infringement by one of these banks it should have an authority to declare the violating bank as non-operating according to Shariah rules. Individual Shariah boards should also be empowered to report to this international board any infringement by their respective banks. Even if this international board is not given the legal power to withdraw the license of the non-compliant bank or cause it to be withdrawn, it will still have a great influence over the banks and their Shariah boards when it declares a particular bank as one not complying with Shariah; because both the bank and its Shariah board will then lose credibility in the eyes of the public. To ensure compliance with its regulations, this board should have its audit arm to carry out unannounced inspecting visits to the banks to scrutinize their products and report any infringement.

II. The methodology used for product development in Islamic Finance

Another challenge facing Islamic banking and finance industry is the methodology used for product development in this industry. While Shariah enjoins that its rules must be observed in contracts, some of these rules are not genuinely observed in the process of product development.

To elaborate, Sharia dictates that in any structure, the underlying contract must fulfill the essential Sharia requirements in contracts. Some of these requirements relate to the contractors, like being eligible to initiate agreements and possessors of the necessary legal capacity. Others relate to the contract itself being independent and absolute; unconditional on the occurrence of any event. The subject matter of the contract needs also to be in line with the Shariah, most importantly being permissible itself and meant for permissible use. Having fulfilled all the structural requirements, the contract must also harmonize itself to meet, or at least not to be in conflict with, the general objectives of Sharia since an apparently valid contract may be misused to reach an evil end, or its implementation may result in causing serious harms and negative impacts. Therefore, it is indispensable to distinguish in Sharia validation of contracts between two elements, the form of the contract and the substance of the contract. The first relates to the structure of the contract, and the second relates to the essence, the spirit and the implications of

the contract. Both are equally important and essential in product development; however, this equation has not been fully observed in many of the developed products.

In fact, the current methodology of product development in Islamic finance in general is commonly criticized for not looking beyond the product formal and structural conditions. Although maintaining a proper form is a *Shariah* requirement, but it is also a more important *Shariah* requirement to maintain a proper substance. In fact, a careful review of the literature of Islamic law leads to unveiling the fact that in contracts the form is meant to protect the substance. In many *Fiqh* applications, it is noticeable that the schools of Islamic law have somehow compromised some aspects of the contract's form but never compromised the contract's essence or spirit. (Abozaid, 2004: 367). This implies that jurists viewed form as something not meant for itself but rather to help protect the essence of contracts and agreements. Some modern practices of Islamic financing product development have implied the opposite; taking care of the form and neglecting the substance of the contracts.

The negligence of contract substance is manifested in different practices as in the following:

1. **Negligence of the contract substance by the deactivation of some contract rules**

Undoubtedly, Shariah contract rules and conditions are meant to enable the contract to serve its purpose in fulfilling the contractors' needs in a just, positive and productive manner. This explains why contractors in *Shariah* are not allowed to make personal stipulations that may annul the contract rules (Ibn Qudamah, 2002: 4/167). Naturally, a contractor, when given an absolute right in making stipulations, inclines to tilt the scale to his favor, probably at the expense of the other contractor. However, we find in some cases, especially in *uqud al-ez'an* (contracts of subjection) where only one party to the contract formulates the contract, that some contracts rules are indirectly neutralized by means of adjusting some clauses or incorporating new ones as in the following example.

Example: *Ijarah Muntahia Bittamlik*[9]

[9] This type of Ijarah (lease) is not found in classical books of *Fiqh*. It comprises two different contracts: contract of leasing (*ijarah*), and contract of sale. (*bay'*). Bank promises the client that upon the successful completion of *the* Ijarah, bank will sell the asset to the client at a nominal price or will gift it to him.

Being basically a contract of lease, *Ijarah Muntahia Bittamlik* in the Islamic banking application is supposed to fulfill the following basic *Shariah* structural conditions:

- The leased asset requested for financing is valuable from *Shariah* perspective and not declared by the client to be used for Haram (unlawful) purposes. This would exclude for example financing clients in acquiring machineries that process tobacco products.

- The leased asset is clearly identified by the parties, and the rent is specified in the contract. If there is any *gharar* (uncertainty) involved with respect to the asset or the rent payment, then it shall not be excessive, for Shariah tolerates minor *gharar* only.

- The leased property remains in the ownership of the lessor for the duration of the *Ijarah* period, and then it is transferred to the lessee by virtue of a completely independent contract, like sale or gift.

- The bank, as lessor, bears all liabilities related to ownership, like property taxes and major maintenance required for keeping the asset valid for usage by the client.

- The lease period commences from the date on which the leased asset has been delivered to the lessee.[10]

These are the basic rules of *Ijarah Muntahia Bittamlik*, and a general investigation of any of its contracts in Islamic banks will prove consistency and full abidance. However, some apparently-valid clauses are added to this contract, leading to the deactivation of some of these basic rules and thus, to the negligence and distortion of the *Ijarah* essence. One clause relates to the division of lease rental into three elements: fixed, variable and complementary. The problem, however, lies with the complementary rent and to a certain extent with the variable rent. The complementary rent represents any cost the bank as owner has incurred in the past *Ijarah* period. The cost includes taxes, insurance and major maintenance expenses. Although these are

[10] -These detailed *Shariah* rules can be soursed from main *Fiqh* books like Al-Shafi'i. *Al-Um*, 3/14; Ibn Abedeen. *Hashiyat (Rad al-Mukhtar ala al-Dur al-Mukhtar*) 4/88; Al-Kasani. *Badai' Al-Sanai'* 5/67; 6/71; Al-Bahuti. *Kashaf Al-Qina'*, 3/53; Al-Dasuqi, *Hashiyah* 3/143.

supposedly the responsibility of the bank as the owner of the leased asset, the bank after paying them reclaims the same from the client by adding it up to the next *Ijarah* rental under this clause!

Obviously this paralyzes and renders ineffective the basic contract *Shariah* rules pertaining to the liability of the owner in *Ijarah* for the property risks. In fact, this practice of effectively shifting property risks to the lessee is especially critical in the application of *Ijarah Muntahia Bittamlik* since it brings this financing instrument closer to conventional financing after removing the justification for profiting, which is based on the notion of "*al-Kharaj bid Daman*"[11] (liability justifies the gain). The core difference between *Riba* and trade remains risk taking which is normally embedded in trade. This risk taking is totally eliminated when the bank indirectly shifts the leased property liabilities to the client, and even in case of property partial or total damage, it is the client who bears the damage as he is the one who effectively pays the insurance premiums.

On the other hand, the problem with the variable element of *Ijarah* rental relates to the uncertainty (gharar) this practice involves. Banks tie this element to an interest rate benchmark like LIBOR. The problem starts when the Islamic banks tend to cap only one end of this excessively volatile benchmark, i.e. its floor. However, a ceiling needs also to be set and capped at a certain figure in order to minimize the *gharar* (uncertainty) then involved in order to maintain the validity of the contract. Nevertheless, banks tend to only protect themselves from the undesirable movements of the interest rate benchmark by capping the minimum amounts payable by their clients, and they have no desire to cap the maximum amounts payable by their clients. This practice creates excessive *gharar* and leads to breaching the *Shariah* requirement of determining the lease rental beforehand in any *Ijarah* contract, not to mention the injustice involved therein.

Moreover, the above deviation *from Ijarah Muntahia Bittamlik* rules manifests itself more blatantly in cases where the asset leased in *Ijarah Muntahia Bittamlik* has been originated from the same client. A client who needs cash or refinancing will be instructed by the bank to sell to it an asset or a common share thereof, then to lease it back from the bank through *Ijarah*

[11] "*Al-Kharaj bid Daman"* is originally a *Hadith* narrated from the prophet (peace be upon him); however, it was recorded as a *Fiqh* maxim by Al-Soyoti in his "*Al-Ashbah Wal Naza'ir*", p 154.

Muntahia Bittamlik. The bank frees itself from all the asset liability in the manner described above, and the client repays with a mark-up the financed amount in form of rentals. This transaction has been widely used recently to enable banks to restructure non-performing debts in the wake of the recent financial crisis.

Thus, we see how the same clause in one contract can be neutralized by another, leading eventually to the distortion of the contract substance and thus to stripping the contract of its *Shariah* spirit and objective. Although Islamic finance has developed *Ijarah* contract into a new model and helped maintain most *Ijarah* rules in this innovative instrument, it has however left a room for the Islamic banks to twist the substance of the contract and deprive it of its nature as lease.

2. Negligence of the contract substance by attaching another contract

Contracts of financial transactions in the *Shariah* are meant to fulfill the various needs of contractors, like acquiring an asset, acquiring an asset's usufruct, investment of capital and delegation of authority. However, it can be observed that some of these contracts are driven totally out of their objectives when they are prearranged to be followed by other reversing contracts.

Murabaha[12], which is a sale contract originally designed in its banking application to finance clients in their acquisition of assets, is used sometimes for a different objective altogether. It is used to provide clients with cash money through a stratagem to sell them assets on *Murabaha* basis in order to immediately sell the same assets on their behalf for cash price in the market. Clients get the desired cash and remain indebted to the bank for the *Murabaha* deferred price. Herein we have two independent sale contracts each of them is lawful in itself but the end result of executing them consecutively is a cash financing technique which is effectively no different from the conventional cash financing. Obviously, the result of this transaction is against the objective and essence of *Murabaha* sale contract. *Murabaha* in this transaction does not lead to real holding of asset ownership by the client. This is a deviation from the objective and

[12] *Murabaha* in the banking application refers to a sale contract preceded by an agreement with client to buy the desired commodity from its supplier then to sell it to the client at the cost plus a markup (*Ribh*).

substance of *Murabaha*, which is a commodity financing instrument that helps clients own their desired assets.

3. Negligence of the contract substance by the misapplication of the contract

Contemporary collective fatwas have helped structure many products that are essential for the operations of Islamic financial institutions. However, the application of some of these products may have deviated from what these prodcuts were originally designed for. A good example would be in using for speculation what was designed for hedging.

To explain, Islamic finance has developed certain tools to hedge against some inevitable excessive market risks. These tools include unilateral binding promises and tools whose underlying contracts are *Salam*[13] contract and *Urbun*[14] sale. Now, a part from the *Shariah* debate over the validity of these tools to be used as hedging instruments in contemporary Islamic finance or Islamic capital market, some of these tools have been misapplied and used for speculation as well, although speculation is considered an invalid domain in what is known as "Islamic derivatives".

Recently one Islamic financial institution has offered a product whose structure is basically as follows: The client opens a designated investment account with the bank. The bank operates the designated account in its capacity as investment manager. The investment manager then uses the amount deposited in the said account to purchase *Shariah* compliant assets at some prevailing market prices. In most cases the assets will be shares selected from an Islamic stock index.

The client gives a unilateral promise to the bank to sell the shares at a predefined price called the "Settlement Price". The bank in return gives a unilateral promise to the client to buy the shares at the Settlement Price.

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[13] *Salam* is the sale of future delivered goods against upfront paid price.

[14] *Urbun* is a sale with the condition that buyer has the right to revoke the agreement in return of forfeiting the advanced down payment, which is called *urbun*. If, however, the sale is concluded, then the *urbun* advanced is deemed as part of the price.

The settlement price relates to the performance of some specified underlying reference asset (the "Reference Asset", which could be an index) rather than the performance of the Shares in the Islamic Account. Thus, two scenarios can be perceived:

Scenario I: The value of the relevant shares goes up more than the performance of the Reference Asset. In this case, the bank can purchase the relevant Shares from the client at a price lower than the market value for such shares at that time. Thus, the bank would hold the client to his promise, while the client would not be interested in holding the bank to its promise as selling the shares at a value which is lower than the market value at that time would incur a loss.

Scenario II: The value of the relevant shares goes less than the performance of the Reference Asset. In this case, the bank can purchase the relevant shares from the client at a price higher than the market value for such shares at that time. Naturally, the bank in this case would not be interested in holding the client to his promise, while the later would hold the bank to its promise as he can then sell the relevant shares at a value higher than the market value for such shares at that time.

Therefore, in both scenarios noted above the client will sell the relevant shares to the bank for the settlement price as agreed on the basis of the performance of the reference asset. This sale is certain as it will serve the interest of either the bank or the client. The certainty of this sale makes the mutual promises to execute the sale biding on both parties and thus, such promises tantamount to a forward sale contract, which is a breach of *Shariah* laws of sale contract.

Obviously, the substance of this transaction is hardly distinguishable from that of any conventional derivative with the speculation element embedded therein; both contractors are speculating on the movement of the value of the reference asset, which is mostly an index. It is very likely that such a structure may even develop to involve financing the client to purchase the shares, then settling the deal by paying the price difference by the losing party to the other.

In conclusion, this transaction involves a misapplication of the promise which can originally function as a hedging tool for risk mitigation

Reasons for neglecting the contract's substance in some Islamic financing products

A direct examination of the Islamic banking market conditions, challenges and products identifies the following reasons for any deviation from the true rules of Sharia.

a. The desire to offer the same financing facilities of conventional banks

Conventional banks treat money as commodity, therefore they have no problem in providing cash financing with profit to clients. This cash financing can take the form of personal loans, over draft facility or refinancing, all through interest-bearing loans. However, since lending money on interest is unlawful in Islam, the Islamic banks willing to offer these profitable financing facilities had to design certain products that would serve the same purposes. Logically, the designed products would necessarily lose *Shariah* spirit and breach contracts essence, because they are basically meant to fulfill unlawful objectives, i.e. profiting from providing cash to clients. The structured products relied on bogus operations of selling and buying commodities, using mostly the highly controversial *eina* and *tawarruq* sales as their underlying contracts. (Al-Jarhi, 2009; Abozaid, 2004)[15]. In fact, sale contract is designed to help people acquire commodities for their own use or to resell them and make profit thereof, and it is not designed to justify unlawful dealing in cash by buying then selling simultaneously as is the case in *eina* or *tawarruq* sales. This is a deviation from the very rationale of the sale contract and a defeat of the purpose behind *Riba* prohibition. If engaging in cash financing with a mark-up through the technicalities of sale contracts like *eina* or *tawarruq* is halal, then the whole purpose behind *Riba* prohibition will be defeated. Any two willing to deal in loans with a return would simply do so through *eina* or *tawarruq*-like sale contract, the end result being exactly the same.

b. The unwillingness to bear genuine property/contracts risks

Being commercial financial institutions, Islamic banks tend to avoid as much as possible the risk that is normally embedded in the *Shariah* contracts used in financing products structuring.

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[15] For details on these sales see Abozaid, Abdulazeem. (2004). "*Contemporary Eina is it a sale or usury*" a book published in Arabic by Dar Al-Multaqa, Aleppo, Syria; Abozaid, Abdulazeem. (2008). *"Contemporary Islamic Financing Modes between Contracts Technicalities and Shari'ah Objectives"*, Eighth Harvard University Forum on Islamic Finance, Harvard Law School – Austin Hall, April 19-20, Boston, USA.

This avoidance of risk may lead to depriving contracts of their *Shariah* identity and rendering them spiritless. The application of *Ijarah Muntahia Bittamlik* in the manner described earlier is an example. Therein, the liability risk related to the ownership of the leased asset is effectively transferred from the bank to the client and thus, the essence of the lease contract is distorted. *Murabaha* is another example when the bank frees itself from the *Murabaha* commodity liabilities. Neglecting the sale essence in *Murabaha* product is at its peak when the *Murabaha* client is appointed as the bank's agent to buy the commodity from its supplier, then to take delivery and deliver to himself, without the bank being responsible for even the commodity defects. In this scenario the bank's role is limited to only advancing money to the property supplier, mimicking thus the limited role of conventional banks.

c. Legal constraints facing the right application of Shariah rules in products

In some countries the legal system stands as a stumbling block to the proper application of *Shariah* rules required in product structuring in Islamic finance. Some Islamic banks for example find it inescapable to make the purchase of commodities appear in the client's name rather than the bank's name, because according to some laws banks are not allowed to trade in assets. Other laws prohibit Islamic banks from leasing assets to clients and therefore, they are left with no choice but to dodge and execute *Ijarah* in the form of sale. Imposing high taxes on registration of assets purchased is also a legal constraint as it eventually leads to increasing costs on clients when banks are commanded by law to register in their names what they buy before they sell to clients. Some banks tend to avoid payment of high taxes by reducing some necessary contractual steps or faking some contracts.

Conclusion

From the past discussions it can be concluded that Islamic banking and finance is facing some internal challenges which require immediate action. While facing the external challenges may be beyond the capacity of the industry players, Islamic banks have no excuse to overlook or turn a blind eye to their internal challenges, which can be faced by enacting Shariah governance for both products and Shariah control. Reform of the methodology of

product development is also within the capability of Islamic banks, and most of the burden falls on the shoulders of the Shariah boards for they have to ensure before endorsing a product that it passes in essence as well as implication the Shariah core requirements. If the existing challenges remain untackled, it is feared that a day may come when people would totally lose confidence in Islamic finance, and then Islamic banks and financial institutions would lose their biggest asset; i.e. their Islamic identity, which gave them a firm foothold in the global financial industry.

In final analysis, having the industry players realize and appreciate the necessity for urgent Shariah governance and product methodology reform is the real challenge, while working out a solution mechanism is easy, because even though it does not take a genius to assess the problem, there is no genuine will by market players to change the status quo for the reasons described in this article.

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