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Tense Dichotomy between Shari'ah Compliance and the Economic Goals of Islamic Finance Institutions

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Abstract: Islamic banking has crossed the milestone of forty years since the Dubai Islamic Bank and the Islamic Development Bank were established in 1975. Islamic banking windows, standalone Islamic banking systems and even full-fledged Islamic banks, may be termed as IBIs as a whole, are operating as a part of global finance industry in the scenario wherein interest based institutions capture the overwhelming part of the business. They use Islamic equivalents of almost all conventional finance products for financing and liquidity and risk management devices, from "over draft" to the most toxic derivatives like swaps to compete with the conventional banks in profitability. The tense dichotomy between *Shari'ah* compliance and the economic goals of an IBI produces a proliferation of reverse engineered products, which are barely in compliance with Islamic law. As a commercial necessity and the need to compete for profitability, many Islamic finance professionals, academics and some Shariah scholars advocate for the use of such products and devices, despite severe criticism with regard to their non-*Shari'ah* compliance, treating it "hajah" for risk hedging on the basis of "maslaha" or "umum balwa". The path dependency syndrome may lead to credibility loss to Islamic finance resulting in persistent financial exclusion of the faith based clients/investors. This paper discusses the severity of the dichotomy and suggests some policy initiatives and steps to lessen it and make Islamic banking and finance an increasingly sustainable global discipline based on sound principles. It recommends that the Shariah fraternity and Islamic finance professionals should explore the Shari'ah rules and real business potentials to find the answers to the current Islamic banking conundrum and lead the industry on the right path of developing Shari'ah based products and using Shari'ah devices to hedge risk.

Key words: Islamic finance; *shari'ah* compliance; financial derivatives; maqasid al shariah; Islamic swaps; financial stability; structured products; maslaha

JEL codes: E44, E52, E58, G15, G21, G28

1. Introduction

The now forty years old Islamic finance industry that is growing at a long term rate of around 15% per year is also facing the challenge with regard to integrity. According to a survey by consultancy PWC, published in

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October 2014, 52 percent of Islamic banking customers in the Gulf region believed that their bank lived up to their religious values. “*But with this success have come doubts over whether Islamic finance is living up to all of its principles. After all, it was launched not merely to make money, but to promote Muslim values such as equity, risk-sharing and social inclusion*”, says Bernardo Vizcaino or Reuters/Zawya in a recently written blog[1]. Based on the prohibition of *riba*, *gharar*, with complete transparency and disclosure on the terms of the contracts, Islamic banking and finance has to promote real economic activity instead of monetary speculation. The prime values of Islamic finance are lost when the financial engineers tend to replicate the synthetic products of conventional products, including, inter alia, financial tawarruq, financial derivatives and other structured products based on sale of debts, receivables and the Forex. The main rationale for this lax approach is the demand of the market, the corporate clients dealing in speculative markets and the need to operate with profitability in competitive environment. Here lies the dichotomy between Shari’ah Compliance, the *raison d’etre* or the main concern of Islamic finance, and the economic goals of Islamic banking and non-banking financial institutions.

This paper aims to explore the trade-off between *Shari’ah* compliance and economic goals in the development of Islamic financial products, analyze the dichotomy and suggest possible policy initiatives and steps to lessen it and make Islamic banking and finance an increasingly sustainable global discipline based on sound principles. It examines the dilemma surrounding usage of derivatives in conventional finance, outbreak of Islamic alternatives to derivatives along with some other structured and maneuvered products, and the importance of risk management, asset-liability management and liquidity as ingredients of economic goals of any bank–conventional or Islamic.

With the purpose of bringing an agreement between the Islamic finance scholars and the practitioners regarding the structured products, the paper analyses the business instruments used by the Islamic financial institutions (IFIs) in the light of the principles of Shariah and the available literature on Islamic finance. It consists of five sections; the section 1 after introduction explores the colossal growth of conventional finance over the last three decades that coincided with the exponential growth of Islamic finance during last two decades, particularly in terms of structured products aimed at earning profits from money placements in the costume of trade practices. Section 2 discusses the principles of conventional and Islamic finance and the economic goals of IFIs that they have set in competitive environment of proliferated global finance. Section 3 discusses some major structured products/contracts that IFIs have introduced replicating the conventional products and tools. Section 4 suggests some policy options and steps that might be helpful in developing solid *Shari’ah* based products and tools to finance the real economy, do business to earn *halal* profits and to hedge the business risks. The last Section 5 concludes the paper with some recommendations to ensure sustainable growth of Islamic finance broad based enough to support the real economy at national and global levels.

2. Coincidence of Growth of Islamic and Innovative Conventional Finance

2.1 Explosive Growth of Innovative Finance

The last two decades of the 20th Century were marked with explosive growth of finance at global level. The increasingly innovative financial products were the main driving force of this growth as a result of which the tools of earning money by way of creating and lending interest based money transformed into the new tool of earnings

[1] Bernardo Vizcaino; “Islamic finance looks to outgrow bad habits as it expands”; Feb. 2, 2015, available online at: https://www.zawya.com/story/Islamic_finance_looks_to_outgrow_bad_habits_as_it_expands-TR20150201nL6N0T400WX2.

even without actual investments, i.e., through "notionals". This was through creating and selling risk, short selling and multi-layer securitization. Traditionally, banks and financial institutions' income and returns come from fund-based and non-fund-based activities. In the fund-based category, a major part of the income emerges from the money created out of thin air by dint of fractional reserve system and lent in the form of "overdrafts" for general purposes, and project financing for specific purposes[2]. This in itself has been a problem due to being source of interest income on money created out of thin air. But with the advent of financial derivatives[3] in 1990s, practically a new non-fund-based category on account of notional assets and netting-off in the "short contracts" led to speculative income that candidly be termed as "gamble takings". The new category particularly pertains to the so-called hedge funds that are not supervised as heavily as banks, but all hedge funds are owned by the big banks. Under this category, swaps have been the smartest of the structured derivatives excessively used by financial institutions over the last two decades. They provide the highest degree of leverage than any other categories of derivatives and can lead to insolvency of any big financial institution and even distort the whole system. Practically, these are being used less for "hedging" and more as a tool of speculation for extraordinary benefits to innovators of the increasingly complicated synthetic products and the related market players.

Alfred Steinherr (1998, p. 200) cautioned about the dangers associated with the new category of instruments in the following words: "*Derivatives are Dynamite for financial crises and the fuse-wire of the international transmission at the same time. Unfortunately, the ignition trigger does not seem to be under control.*" [4] It was due to high speculative benefits that swap deals increased exponentially; starting from 1981, the swap transactions reached approximately US$ 4.6 trillion by the end of 1992 and to more than US$ 415.2 trillion by the end of 2006[5]. As the derivatives market is dominated by the insured banks, the big banks moved aggressively for risk free ever increasing profits. According to ISDA Market survey, total Interest Rate, Currency and Credit Default Swap outstandings amounted to US$ 457,177.71 billion as at the end of 2009. As reported by "*The Economist*", over-the-counter (OTC) derivatives were approximately $700 trillion as of June 2011, while the size of the derivatives traded on exchanges totaled an additional $83 trillion.[6] The huge amounts of money flowing through derivatives channel could be gauged from the fact that the total budgeted expenditure of the US government during 2012 was $ 3.5 trillion, the total current value of the U.S. stock market was estimated at $ 23 trillion, while annual GDP of the world was about $ 65 trillion. As against this, the notional value of the CDS alone amounted to $25.5 trillion in early 2012, down from $ 55 trillion in 2008.

As derivatives developed quickly over the last three decades, they accentuated the problems like the one that initiated from sub-prime mortgages during 2007-08 to take the form of global financial crisis. Actually, replacing the Glass Steagall Act of 1933 with the Financial Services Modernization Act in 1999 in USA opened the

[2] Banks create and lend money through the deposits and other placement earnings from customers, banks and other financial institutions (Ford et al., 2003).

[3] Although the world of derivatives comprises a wide variety of financial instruments, the most common derivatives fall into four categories: Swaps: Counterparties agree to exchange a series of cash flows at a future date; Options: Counterparties have the right, but not the obligation, to buy (or sell) an asset at a future date; Futures: Counterparties are bound by a standardized obligation to buy (or sell) an asset at a future date; and Forwards: Counterparties are bound by a non-standardized obligation to buy (or sell) an asset at a future date (Goldman Sachs Asset Management — A Pocket Guide to Derivatives). For evolution of derivative products, please see: Dusuki, 2009 and Al Swailum, 2006.

[4] Steinherr, Alfred, 2000, p. 194.

[5] Based on the statistical reports issued by the Office of the Comptroller of the Currency (OCC), 97.3% of the total derivatives are used by dealers, i.e., speculators; Al-Suwailem, 2006, p. 43.

[6] "Clear and present danger: Centrally cleared derivatives. (clearing houses)", *The Economist* (Economist Newspaper Ltd), April 12, 2012.

floodgates of engineered financial products for American banks giving huge returns without actual funding even. Use of financial derivatives, generally dubbed as the toxic products, particularly interest rate, currency and credit default swaps and the short selling based speculative activities of brokers and institutional investors exposed vulnerability of the system. It was ironically said in the context that "*the horse of financial innovation was much ahead of the mule of supervision*". The exotic financial derivatives that crippled the economy in 2008 started roaring back in US big banks who dragged 7.5 billion Dollars in revenue from derivatives trading during the first quarter of 2013, but critics worry that there are too few rules to protect taxpayers from a market dominated by a handful of banks (Douglas, 2013).

The dilemmas of capitalism and disasters of financial markets became increasingly intolerable on account of this over-financialization creating a structure that supported speculative trading without any value addition to the system. The main cause of anti-capitalist rhetoric in recent years has been the high speculative finance and too much secondary-market dealing in financial assets by creating and shifting the risk. John Plender, formerly working for "*The Economist*", and presently a columnist with the *Financial Times* writes in his book, "Money, Morals and Markets", "*bankers have undoubtedly done their best to give capitalism a bad name. The extraordinary scale on which big banks have been rigging interest rates and foreign-exchange markets and ripping off their customers is almost beyond comprehension*." (Plender, 2015) An obvious outcome is the extreme nature of concentration of wealth in fewer hands in all developing as also developed economies. While individuals and institutions earned billions without any value addition to the economies/societies, the corporations grew bigger and bigger-some bigger than some economies even (Ethica 2014-b).

2.2 Simultaneous Growth of Islamic Finance Industry

It is pertinent to note that Islamic finance industry also emerged at global level in the last decade of the 20th century and developed fast with the dawn of 21st century when financial engineers were able to develop "debt-based" *sukuk*[7], organized *tawarruq* and *wa΄ad* based liquidity management and hedging instruments. They adopted the approach of replicating the conventional instruments with addition of Islamic terms for structuring money market/hedging instruments including Islamic Cross-Currency swaps, profit rate swaps, credit default swaps, Islamic repos, and fund index-linked derivatives etc. Organized tawarruq became popular in mid-1990s with the formal tool of "*commodity murabaha*"[8]. This is why, the Islamic financial institutions, although had not ventured into the derivatives by that time, were not immune to the economic downturn/global crisis in 2008 and suffered due to the very nature of some sukuk structures that were not Shari'ah-compliant (Norman, 2009). Deutsche Bank (DB) that had been structuring "Islamic" swaps since 2005 published a white paper on the use of reciprocal *w΄ad* (promise) by the parties in January, 2007 for structuring Islamic swaps.

The Shariah Advisory Council (SAC) of the Securities Commission of Malaysia in its meetings during the period August, 1996 to July, 2005 passed certain resolutions on validity of *bay al dayn*, regulated short selling (RSS), securities' borrowing and lending (SBL), Composite Index Futures Contracts, financial hedging, use of Tawarruq for deposits mobilization and money market investments, etc. on the basis of *maslahah* and *istihsan*

[7] As per AAOIFI's Standard No. 17, sukuk are based on Mudaraba principles; it is the use of the funds so mobilized on the basis of which sukuk are termed as Ijarah sukuk, Salam sukuk, Istisna΄a sukuk, Murabaha sukuk, etc. Hence, sukuk represent common undivided shares in the ownership of underlying assets by the Sukuk holders (see: Taqi Usmani, 2007; Ayub, 2007, p. 396).

[8] In tawarruq, the monetizer (mustawriq) buys any commodity at a deferred price in order to sell it in cash at a lower price to the third party. According to the jurists, this kind of transaction is permissible provided laws and rules of a valid legal sale are fulfilled. However, if the buyer sells the item back to the seller for immediate payment of a lower price, it becomes bai al Inah, prohibited as per the mainstream approach in Islamic law.

(public interest at individual and general levels, *ta'wil* (allegorical or esoteric interpretation of the tenets), *umum al balwa* (unavoidable wide spread practice/situation), *fasad al-zaman, urf* (custom), and combination of some such principles[9]. Financial derivatives that were considered as prohibited in the beginning, came into the grey area particularly after the above fatawa. M. Hashim Kamali also discussed the possibility of options and futures in Islamic Commercial Law in 1997 on the basis of *maslahah*, *ibāha* and the need for *ijtihād*[10].

As a first step, hedging and short-selling mechanisms were approved using the concept of promise. To give the concept practical shape, the financial engineers trained in the conventional set-up, later engaged by the Islamic finance industry, first tried to develop "Islamic" derivatives during 2000-2005 on the basis of *salam*, *murabaha*, *wakalah*, *ibāha*, *maslahah*, *ba'i al'arbun* and *ba'i al-khiyar* along with *tawarruq* / commodity *murabaha*.[11] As the detailed principles applicable to *w'ad* were laid down in recent years around 1990s, they took liberty to transform the accessory nature of *w'ad* to the full-fledged contractual structures comprising complicated contracts and deals along with excessive use of *wakalah* on the basis of which 'Islamic' derivatives started emerging. In November 2006, Bank Islam Berhad and Bank Mumalat Malaysia Berhad agreed on a derivative Master Agreement for documentation of Islamic derivatives. The BNA, the central bank of Malaysia, issued the Islamic Derivative Master Agreement (IDMA) in 2007. It was followed by the *Ta'hawwut* (Islamic hedging and risk management) agreement (TMA) jointly developed by IIFM and ISDA that was drafted by the *'Clifford Chance'* law firm. It is important to observe that IIFM Shari'ah Advisory committee gave Shari'ah approval on the agreement structure only leaving the assurance of Shariah compliance on the parties to any such arrangement. In case of any dispute resolution no reference can be made of the Shariah law. Since then, they have developed a number of standards to facilitate hedging by the IFIs. Quite recent of such standards has been the "ISDA/IIFM Islamic Cross Currency Swap Standard" that utilizes commodity Murabahah and reverse Murabahah, linked with multiple but unilateral *W'ad* committed separately by each of the counterparties. As regards usage of the TMA, any definitive data is not readily available because derivatives transactions are bilateral and privately negotiated.

A. A. Jobst of the IMF (2008) accepts with regard to the practice of derivatives, "Derivatives almost never involve delivery by both parties to the contract. Often, parties reverse the transaction and cash settle the price difference only, which transforms a derivative contract into a paper transaction without the element of a genuine sale". Notwithstanding the reality as confessed by him, he gives in a paper written subsequently (2012) five axioms of "Shari'ah-compliant Financial Derivatives" as given below:

In principle, financial derivatives may be compatible with *shari'ah* law if they:

(1) address genuine hedging demand associated with effective and intended ownership (*qabd*) in an identifiable asset or venture,

(2) guarantee certainty of payment obligations arising from contingent claims on assets with clearly defined object characteristics,

(3) disavow deferment of contractual obligations (*nasi'a*) from the actual and direct transfer of a physical asset as the object of an unconditional transaction, except for cases when the doctrine of extreme necessity applies,

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9 SAC of Securities Commission, Resolutions; cf: Ahcene Lahsasna, 2013, pp. 321-337.

10 Kamali, Mohammad Hashim; Islamic Commercial Law: An Analysis of Futures and Options; Islamic Texts Society, UK, 2000.

11 Edwards, Waren, 2007; Edwardes is of the view that *all banking products are built from four pillars: deposits, exchange, forwards and options. ..... as almost anything is permitted in conventional banking, Islamic banking is no different, merely a special case. Just as conventional products can be built from the four pillars so too can Islamic products be built using Islamic equivalents. ...* "*Instead of using back-to-back loans, Islamic products can be created using Islamic equivalents of back-to-back murabaha, back-to-back ijara, or back-to-back sukuk*".

(4) contain collateralized payment for the use of risk protection but rule out provisions aimed at generating unilateral gains from interim price changes of the underlying asset beyond the original scope of risk sharing *(sharik*) among counterparties parties, which favors win-win situations from changes in the value of the reference asset, and

(5) eschew all prohibited sinful activities *(haram)*, in particular those deemed similar to gambling *(maisir)* and speculation due to uncertainty *(gharar)* by means of clearly stated object characteristics and/or delivery results, which mitigate the risk of exploitation from ignorance *(jahl)*.

In addition, *shari'ah*-compliant derivatives must also be employed in keeping with the precept of maintaining an equitable system of distributive justice as a public good *(maslahah)*.

However, the contention point is that as "derivatives almost never involve delivery by both parties to the contract" as he himself accepted, how Islamic financial institutions could be expected to abide by the above rules when they tend to use them to get competitive returns as their conventional counterparts do. The case is similar to that of organized tawarruq that was not practiced with the conditions as required by Islamic law, and hence the permission withdrawn by the Jeddah and the Makkah based Islamic Fiqh Councils. Other areas of concern with regard to Shariah compliance of derivatives according to Jobst are: (1) the selection of reference assets that are nonexistent at the time of contract; (2) the requirement of taking possession of the item prior to resale; (3) mutual deferment of both sides of the bargain, which turns a derivative contract into a sale of one debt for another; and (4) excessive uncertainty or speculation that verges on gambling, resulting in zero-sum payoffs of both sides of the bargain. While giving the above axioms, Jobst himself does not seem to be clear when he laments the view point of the majority of the Shariah scholars who do not accept financial derivatives despite the general principle of permissibility (*ibahah*), by declaring it religious censure (*taqlid*) [12]. According to Al-Suwailem (2006, p. 40) such speculative activity of risk transfer leads to a form of eating wealth for nothing (*akl al-mal bi'l-batil*) that is prohibited expressly by the Holy Qur'an (4:29).

Overall, the tools used to replicate the conventional liquidity management/investment products pertained to securitization, credit enhancements, guarantees, re-purchase undertakings and agreements by using the basic concepts of wakalah/brokerage, multiple promises, *muqassah* (netting-off), back-to-back murabaha, sale of debt/receivables, *salam* in currencies and hedging through Forex trade in general based on *w'ad* and netting-off. Another notable development has been that permissions granted by Islamic finance scholars on case-by-case situations are sometimes used by the industry practitioners as rule rather than exception or any specific permission. From here the term "*fatwa shopping*" evolved referring to using any specially granted permission in specific case as a vanilla liquidity management product whereby the institutions who invest for taking fatwa for any product sells it to others on charge (Omar A. Osani & A.U. Farooq, 2013). If this trend is not controlled with joint efforts of the Shariah scholars and the policy makers at apex levels, this might ultimately expose Islamic finance to the colossal risk of *Shari'ah* noncompliance and extreme loss of credibility.

3. Principles, Shariah Compliance and Economic Goals

While the value neutral conventional finance separates all business activities from religion and ethics and concentrates on mere earnings management and profit maximization, Islamic finance is based on divine principles and values. Banking and finance companies working in capitalistic environment focus on short term results to get more and more profits rather than long-term policies aimed at sustainable development (Tim Montgomarie, 2015).

[12] Jobst A. A., available online at: http://www.eurekahedge.com/NewsAndEvents/News/728/Derivatives_in_Islamic_Finance.

As regards the socio-economic justice or social welfare, it is not included in their objectives, although it could be a separate agenda item of some individuals, any State departments and the NGOs. Reference to justice is made in conventional economic and finance as well, but the principles of justice in conventional system have their roots in self-interest; so the objective that prevails is "profit maximization" *per se*.

The first step to achieving that objective is to ensure Shariah compliance. Sharī´ah compliance is the basic cause of coming into being of Islamic finance and their ultimate objective. Sharī´ah compliance, along with risk management, prudential and profitability related measures, implies avoiding *riba*[13], *gharar*[14] *maisir*[15] and all other unjust and unethical practices. These prohibitions are based on rationale (*hikmah*) of social justice, avoiding exploitation, equality of opportunities to all irrespective of race, colour and creed, and the property rights determining rights and liabilities of all stakeholders minutely. The *'illah* (effective cause of prohibition) that is a tool for application/implementing the prohibition of riba being excess claimed over and above the principal is based on the *hikmah* and would be decided keeping in view certain parameters on case to case basis. But the crux of the matter is that all Divine tenets are based on *hikmah*. This requires specific principles and a code of ethics to be introduced and implemented by the banking and financial companies, regulators and other institutions to ensure that all stakeholders behave as per Shariah commandments and everyone gets its due share from the Almighty's bounties. Accordingly, AAOIFI and IFSB have suggested comprehensive structures of code of ethics for the IFIs and their employees (Lahsasna 2013). Other principles are indicated below:

(a) Through the prohibitions, *sharī´ah* tends to ensure that no party should be allowed to get undue return or made to suffer any undue burden or loss to other party of a transaction. It accepts risk and uncertainty as an inalienable feature of life and as a genuine part of the businesses. The requirement of the *sharī´ah* that risk must not be separated from the real transactions is crucial, natural and conforms to economic reality (Al-Suwailem, 2006, p. 59; Ayub, 2007, pp. 53, 81, 82). It is based on hadith of the Holy prophet (pbuh), "do not sell what you do not possess" and the famous principle of Islamic law of contract that one cannot sell what does not own and has its risk (daman). The rationale behind this is that the seller should take risk and reward of his trade activity.[16] So long as the sold commodity remains with the seller — the buyer neither made payment nor took its possession, its risk and reward would be that of seller. The classical legal maxim, "*Al Kharaj bil-daman*" links valid gains and incomes to such risk taking which is exposure to loss of value in cash as per the agreement of trade or business. All transactions must be leading to value creation in one way or the other–any *'abath* transaction (without any value creation) is not allowed (Kahf, 2006).

(b) Risk as the probability of loss in a business is considered in Islamic law of contracts as *ḍamān* vis-à-vis profit, meaning that accepting liability of business loss justifies the profit taking.[17] Claiming or seeking any return from any investment/project without being liable to taking risk of possible loss in that investment is not

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[13] *Ribā* broadly means and includes any increase over and above the principal amount payable in a contract obligation, not covered by a corresponding increase in labour, commodity, risk or expertise" (Ayub, 2007)

[14] G*harar* means ignorance of the parties involved in the contract about their obligations and responsibilities to one another, as well as the outcome of the contract or the compensation to be received. It implies that a contract must not be doubtful and uncertain as far as rights and obligations of the parties are concerned, otherwise it would be tantamount to deceiving any of the parties.

[15] *Maisir* includes all types of hazard and gambling and refers to acquisition of wealth by chance/easily (without paying an equivalent compensation ('*iwad*) for it.

[16] Tirmidhi, 1988, No. 1308-1033, p. 25.

[17] The classical legal maxim, "*Al Kharaj bil-daman*" links valid gains and incomes to such risk taking. In financial perspective, risk is an exposure to loss of value in cash as per the agreement of trade or business. In business, risk is the probability of loss that is considered in Islamic law of contracts as *ḍamān* vis-à-vis profit, meaning that accepting liability of business loss justifies the profit taking.

allowed due to being *riba*[18]. However, risk taking or *ḍamān* in a business has to be distinguished from *gharar* that means risk creation and dealing in risk.

(c) Creating or taking abstract risk leading to any ambiguity with regard to rights and liabilities of the contracting parties is prohibited due to being *gharar*, which is very wide term applicable to lack of clarity in commercial transactions in commodities or financial markets, and contrived non-delivery of the exchange items or non-fulfillment of the contract just to avoid loss. It implies that the contracts in which price has not been finalized or future performance has been kept vague for availing of or avoiding the result of any movement in the market price involve Gharar rendering the transaction void from Islamic perspective[19]. It further implies that "short selling" is not allowed that creates absolute uncertainty with regard to enforceability of the contract — delivery of the subject matter and payment of the exchange value[20]. All contracts relating to commodities and stocks must be intended for delivery and transfer of risk and reward;

(d) Money/monetary units (Forex), cash, and receivables cannot be traded except at par (in case of same currency on both sides) and that too "hand to hand"; an additional condition with regard to loans and debts is that they could be sold (at face value) with recourse to the original debtor, making it effectively assignment (*hawalah)* of the debt. Shares of joint stock companies or other instruments that represent joint ownership (*Musha'a*) like that of Mudaraba/Musharaka/Ijarah Sukuk, can be traded at a market price based on the rule of majority — the majority of a company's assets are real/tangible assets and not receivables and cash; [for example: IDB's mixed sukuk (Ayub, 2007)].

(e) Last, but not the least, complete clarity, disclosure and transparency is needed with regard to the subject matter in the contracts and rights and obligations of the contracting parties; any such ambiguity would invoke prohibition due to possible injustice and *gharar*.

3.1 Objectives of Islamic Finance in Line with the above Principles

(1) Facilitation of the real sector through supply of sufficient purchasing power to properly explore the potential of growth in an economy without involvement of interest, *gharar* and other unethical and unjust elements; it implies that while avoidance from Riba is the basic objective, taking profits or maximize earnings is not the objective *per se* meaning that IFIs are not allowed to get return by circumventing the prohibitions and the Shariah principles.

(2) Channeling of funds from the resource surplus units in an economy to the production sectors instead of enticing financial and human resources from the productive sectors to speculation (Kahf, 2011). It also means creating value for the society and parties to the business contracts[21].

(3) Providing requisite finance to small businesses and medium size enterprises, generally grouped as SMEs, and the agriculturists/the farming community that are the basic producing units in any economy. Providing them finance on any of the non-exploitative bases is the basic objective of Islamic banking and finance (CII, 1980).

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[18] It must be clear, however, that prohibition of Riba /interest never meant to be a prohibition of rewarding financing in general and debt-creating financing in specific. The nature of reward must be risk based.

[19] Nabel A. Saleh (1986, pp. 49-56) has discussed definitions of *gharar* by some eminent classical and modern jurists, and concluded that *gharar* means lack of knowledge (*jahl*) regarding (i) existence of the exchanged counter values and (ii) characteristics of the counter values, and (iii) ineffective control of the parties over the counter values.

[20] Exemption to forward sale/purchase of certain types of fungible goods, (not including money or monetary units), is allowed, rather approved by the Holy Prophet (pbuh) himself, subject to observing the conditions of "*salam*" — the quality, quantity, price and the time of delivery must be settled, price fully paid in advance at the time of contract, and delivery to be effected necessarily.

[21] Financial *tawarruq*, dealing in abstract indices, "futures" and various kinds of "swaps" that do not create value and only transfer wealth between the contracting parties based on interest and chance are misfit in terms of the *maqasid al shariah*.

(4) Serving for the cause of the society and welfare of the human beings as Corporate Social Responsibility (CSR) which is being increasingly focused in the corporate sector at global level pertains more to the IFIs than to the conventional finance institutions because of the commandments of the Shariah with regard to halal and haram, business ethics, social and moral values.

3.2 The Economic Goals of Islamic Financial Institutions

Various prohibitions like that of riba, gharar and gambling and the tenets for ethical, honest and straightforward behavior, transparency and disclosure are the means to healthy and stable growth of economies and the human societies and not to prohibit profit taking (Quran, 2:275). To be specific, prohibition of riba/interest never meant prohibition of rewarding finance in general and debt-creating financing in specific (Kahf, 2006). Islam likes efficiency, profitability and efforts to enhance value of the business in competitive environment and as per requirement of the parties it provides principles for both cash and credit businesses and the markets.

The profit/business activities can be undertaken by banking, non-banking and trading firms and companies directly or through intermediation between various sectors having a surplus or deficit of savings and liquidity. The modes of business and the contracts for intermediation could be partnership[22] based as also debt creating as a result of trading and leasing activities (Chapra, 1998). Islamic finance, while encourages for this intermediation, a greater reliance on the former category–profit and loss sharing through mudarabah, musharakah and other equity based modes, it allows the latter category-debt creating modes like credit and forward trading (*mu'ajjal murabaha, salam* and *istisna'*) *ijarah* and service based modes. Collectively, these modes fulfill all types of financial needs of the production and services sectors in an economy. The latter types of modes are rather crux of business concerns and activities that are undertaken in sole proprietorship or partnership structures. Trading that pertains to purchasing and selling the wares for profit has been considered a respectable profession by Islam. Professor Constant Mews of the Monash University confessed with regard to this feature of Islamic economics and finance by saying, "*The interesting thing about Islam is that it was a much more commercial culture from the outset than Christianity.*" It was by dint of this culture that from around the middle of the eighth century to the middle of the 13th, the Islamic world enjoyed a golden age, while European Christians were struggling through the Dark Ages (c. f: Mike Seccombe, 2012).

It implies that profits can be earned in a business as much as possible remaining within the limits imposed in the Islamic law of contracts. When comes to banks, however, it needs utmost care so that it might not transform to prohibited activities involving riba and appetite for leveraging. Hence, while doing any profitable business, debt can be created through credit or forward sales subject to fulfillment of the relevant conditions. That way, the quantum of debt will remain in a limit and not lead to instability and financial and economic crises. The economic goals as accepted by Islam subject to observance of the relevant principles and rules include earning valid profits in genuine businesses and, in case of corporate business, increasing the shareholders' value remaining within the Shariah constraints.

For efficiency, sustainability and valid profits, the banking, finance or other business institutions would also be doing or resort to:

(a) Controlling the risks, minimizing the operational costs and avoiding the losses;

(b) Enhancing quality of products and services;

[22] It includes all forms of business organization where two or more persons pool together their financial resources, entrepreneurship, skills and goodwill to do business.

(c) Offering competitive financial products and services;

(d) Facilitating and encouraging the customers to do business and undertake productive activities in socially responsible manner; and

(e) Enhancing the outreach through balanced and just policies for all sectors of the economy focusing on agriculture, SMEs, micro business and the infrastructure development sub-sectors.

3.2.1 The Economic Goals as Being Pursued by the IFIs

On the basis of objectives and economic goals as indicated above, it was expected that Islamic finance industry could contribute to financial stability both at national and global levels. Its success or failure would be assessed on the basis of the extent to which the modes and contracts are designed to realize the objectives for prohibition of riba and other unearned returns. Professor Michael Skully, of the faculty of Business & Economics at Monash University, while accepting that the '*financials'* were the main culprit behind the global crisis observed, "When we talk about the Islamic funds doing better, it was a function of them not being exposed to *financials* and highly levered companies" (Sadiq K. & Ann Black, 2012) . But what emerged practically, we discuss briefly in the following sub-section.

Islamic finance that was originally conceived to work on the basis of two-tier Mudaraba model commenced working on mixed equity and debt model in 1980s, but started replicating the conventional products in mid-1990s to compete in the profitability, and with that objective resorted to almost same tools and instruments with all complex deals as in the conventional financial markets. They neglected the requirement of clearly differentiating the permissible and prohibited instruments by adapting almost all innovations in capital markets in a value-neutral scenario, although by getting clearance from the Shariah scholars who might not fully understand such products.

In that perspective, there has been a proliferation of "*Shari'ah* compliant" products, which mimic conventional financial tools with an objective to earn risk-free return as far as possible. IFIs resorted not only to currency related hedging instruments, but also to the fantasy-created speculation-based index market, neglecting the fact that indices are neither real assets nor goods or services. It must be kept in view that Shari`ah recognizes real things and real growth, whether by the nature of a real asset or by the effect of market forces on real assets, goods, or services (Kahf, 2006). No effort was initiated to bring about the structural changes in the modus operandi for effective intermediation between the real and the financial sectors of the economies. It limited the scope for truly *shari'ah* based banking as they had to manage risks and continue liquidity management function to remain competitive and profitable. Working under the conventional structures, Islamic banks were subjected to the same capital adequacy regulations and constrained by the reality of working in an interest-based culture resulting in a tense dichotomy between *Shari'ah* compliance and remaining competitive and solvent.

4. Major Categories of Structured Islamic Finance Products

4.1 Use of Multiple Promises

Using multiple *w'ads* to construct practically a full-fledged contract creating a right and a liability of the parties to the contract was the first step that served as foundation of all synthetic/structured products. Besides, netting-out (muqassah) has been an integral part of such products, using w'*ad* and/or organized *Tawarruq.* It is the *muqassah* that leads to a full-fledged contract through acting upon any of the reciprocal promises. Although unilateral promise is considered as a necessary and valid risk mitigation technique in *murabaha*, *ijarah* and diminishing *musharakah,* binding bilateral promises (*muwa'adah*) or the multiple promises (given reciprocally by both parties with the effect that each one is the promisor as well as promisee) are not valid as per the *sharī´ah* principles. The rationale of prohibition is that such multiple promises in a sale lead to the sale transaction itself, in which case the requisite condition is that the seller must be the owner of the commodity being sold so that the prohibition by the Holy Prophet (peace be upon him) for the people selling what they do not possess is not circumvented[23]. To AAOIFI, accordingly, bilateral promises are not permissible, unless the option to annul is granted to one or both parties[24].

4.2 Financial/Organized Tawarruq

Organized *tawarruq* is the major vanilla tool used in a number of structures of Islamic finance in vogue also including financial derivatives. According to the "*Ethica*", a well-known institute of training in Islamic finance, one of the main reasons due to which customers question the credibility of Islamic finance is the use of *tawarruq*. "A product that began as the industry's somewhat embarrassing black sheep over a decade ago has now grown into the *'Eight Hundred Pound'* darling of many Islamic banks. Despite permissibility of juristic *tawarruq* or its use in unavoidable cases of cash crunch, a question was generally raised: if it becomes a regular product, is it still Islamic finance? Jeddah based Islamic Fiqh Academy whose resolutions and decisions are the basis of the AAOIFI's Shariah standards discussed the issue and took back its permissibility in 2009 (19/5: Resolution 179). AAOIFI still allows *tawarruq* with some strict conditions fulfillment of which is almost impossible.

Malaysia based IFSB also issued guideline for *Commodity Murabaha Transactions* (CMT) as a tool for liquidity management and noted with concern that the IFIs expanded its use to other areas despite serious difference of opinions [Guidance Note on CMT, 2010]. The use of CMT may expose them to substantial counterparty credit risk and have a significant influence on liquidity and prices in the specific segments of the commodities market in which they are investing. The IFSB also noted, "some central banks/supervisory authorities have served as facilitators of CMT for specific purposes, such as by providing a platform (i.e., liquidity management infrastructure) — and by using CMT in central bank operations with IIFS, such as those undertaken as a Shari'ah-compliant lender of last resort (SLOLR)".

The reality is that fulfilling the conditions advised by AAOIFI or Fiqh Academy renders the *tawarruq* economically unviable. As such, the IFIs seemingly enter into a number of separate transactions, but typically operate a netting facility by using and reusing the same stock many times in a day in numerous consecutive sales — *"rather than specifically identifying and subsequently 'releasing' the metal for each transaction, all the transactions for a certain day are carried out without such demarcation and hence even this minimal transfer of constructive ownership does not really happen in most cases. Daily net positions dictate the overall net stock balances, i.e. how much is encumbered and how much is free to be used for new tawarruq transactions*"[25]. Malaysian scholar Aznan Hasan has explained how the *sharī´ah* auditors managed to uncover non-*sharī´ah tawarruq* practices by brokers on the LME. Hasan discovered the frequent overlapping ownership of underlying assets and exposed what he termed "Fictitious *Murabaha*" activities undertaken by some LME brokers. "After a *sharī´ah* audit he illustrated how commodity broker (A) when selling a commodity, involved multiple and simultaneous ownership, meaning one particular commodity was sold to more than one buyer" (Khnifer, 2009).

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[23] Council of the Islamic Fiqh Academy, "*Resolutions and Recommendations*" (1985-2000), IRTI, IDB, Jeddah, 2000, pp. 86, 87 (Resolution 40 & 41 (2/5, 3/5).

[24] For further details on w´*ad*, see Ayub, 2012.

[25] Salman H. Khan, Organized Tawarruq in Practice: A Sharī´ah Non-compliant and Unjustified Transaction, New Horizon, October-December, 2010.

IFSB in it Guiding Note as indicated above recognized that the IFIs might "structure CMT very simply or in a highly complicated way, often resulting in complex structures that may pose additional prudential risks and raise capital requirements issues".

4.3 Islamic Financial Derivatives

The permissions granted by some scholars for the tools as indicated above enabled the financial engineers to replicate almost all structured products of the conventional finance for offering competitive payouts and exposure to all conventional asset classes available in the global finance, the most importantly, exotic derivatives like credit default, interest rate and currency swaps. Some writers on Islamic finance favoured such innovative move, the most eminent among them included, Hashim Kamali and Obiyathulla. We analyze briefly the stance of the both the learned authors. Their gut instinct was to propose the use of derivatives to mitigate risks. However, they missed the point that using derivatives could violate the *Shari'ah* and that the same have been used overwhelmingly for speculative purpose. In fact, even Warren Buffet took a stronger stance against derivatives than some Islamic academics and referred to derivatives as "financial weapons of mass destruction, carrying dangers that, while now latent are potentially lethal". Similarly, Alan Greenspan recognizes that the derivatives are highly leveraged by construction and that this leverage makes the financial system highly vulnerable. Greenspan says, "Leveraging always carries with it the remote possibility of a chain reaction, a cascading sequence of defaults that will culminate in financial implosion if it proceeds unchecked" (Al-Suwailem, 2006, p. 50).

The tension between *Shari'ah* compliance and the mimicry or use of conventional products in Islamic finance is well illustrated by Kamali's argument for the use of financial derivatives, which can be easily picked-up and utilized by Islamic finance practitioners for the use of otherwise forbidden products. Defining the hedging by way of illustration of holding the bushels of wheat, Kamali (2000) contends that by way of hedging, the holder of wheat eliminates the risk of price fluctuation. But, Paul H. Cootner from whom Kamali takes the illustration, exposes the erroneous version of hedging that emphasizes two supposed properties of the hedge: (a) price movements of the warehouse inventory and the futures contract will be exactly offsetting (the expected value of the hedged position is zero), and (b) the hedge "eliminates the risk of price fluctuation" (that there is no variance around this expected value). To Cootner, both of these ideas are incorrect. In normal hedging practice, price changes are not expected to be offsetting, and while risks will be reduced, they will not be eliminated.

Kamali (2000, p. 39) argues that the arrangements such as clearing houses reduce the uncertainty element of futures contracts and that the regulation of the trading activity combined with standardized contracts, the margin deposit and marked-to-market or daily settlement procedure somehow allow the 'futures' the ability to evade the necessity of *Shari'ah* compliance in respect of possession and short selling — the objections, among other, that in futures, no goods are delivered and hence no price is paid. He purports that, "hedging allows the risk of price changes to be shifted or shared; hence the costs of production, marketing and processing are reduced and this is ultimately beneficial to the public." He reiterates that hedgers provide actual goods and services to the economy and futures and options enable them to provide these goods and services more efficiently. Besides the point that risk shifting to others without shifting ownership is invalid, it is, conversely, questionable that hedgers provide real goods and services to the economy using options and futures as this involves the sale of unbundled risks, which separates the transaction from the real economy.

Although Kamali addresses pertinent issues in Islamic law of contracts, but he doesn't give adequate weightage to the importance of the rules found in *Shari'ah* and fails to acknowledge the adverse effects of hedging and speculation and the long term costs to the society. Although Kamali argues that the option's premium transforms the unbundled risk into a bundled risk as he says the premium price constitutes property (*mal*), Al-Suwailem (2006, p. 40) contradicts by saying that derivatives involve separating risk from economic activity, thereby opening the door for pure speculation and potentially leading to the destabilization of the entire global financial system. Furthermore, the cost of doing business may actually go up as the business's core activity may shift to speculation for profit, exposing real capital to major risks totally unrelated to their normal business (Al-Suwailem, 2006, p. 53). Kamali also admits that "*In addition to transferring risk, hedging can also be used to make a profit, which is why it is difficult to draw a clear distinction between the hedger and the speculator, for hedging is also a form of speculation*." Therefore, there is no real distinction between hedging and speculation, as hedging is a gamble.

Derivatives allow for unbundling and repackaging risks in any manner players find suitable for their preferences. According to Al-Suwailem (2006, p. 53), derivatives may provide value through management and distribution of risk, but they are also perfect tools for gambling, and consequently would distort incentives in a manner that defeat their legitimate purpose. He explains that derivatives unbundle risk from real economic activity and make it trade separately, thereby transforming risk into a commodity. He says that commoditizing the risk is likely to make risk multiply and proliferate, making the economy more risky and less stable. According to Al-Suwailem (2006, p. 40), this feature means that derivatives end up with risk-reward structures that differ greatly from those of the underlying real assets. He elaborates that as a consequence, "*artificial risk structures create artificial arbitrage opportunities that can be exploited through pure speculation with no connection to real economic activities.*" Accordingly, derivatives result in the creation of a pure speculative market totally separated from the real economy.

Obiyathulla (2004, p. 73) took a stance similar to that of Kamali and argued that disallowing derivatives' use in Islamic finance would have adverse implications for the industry including value loss and inability to compete. He contends that in a system where conventional banks hedge and Islamic banks do not hedge, the wealth is transferred from the un-hedged to the hedged. He further asserts that un-hedged equity risk "stunts capital market growth, denies businesses easy access to capital in order to grow and allocates resources into non-tradable assets, which are amenable to asset bubbles." Practically, however, derivatives are instruments of loss and not gain as 70% of derivatives trading ends up in loss (Al-Suwailem, 2006, p. 53) and therefore may be more detrimental to wealth creation than using other risk mitigation techniques. The learned author should have given weightage to the fact that derivatives are not 'real' transactions since no transfer of ownership takes place and therefore they result in the selling of unbundled risk, which leads to the distortion of asset prices, leading to negative impacts on real investment opportunities. The speculative activity may expose the real capital of the business to major risks totally unrelated to the normal business and increase the costs of the business as a result (Al-Suwailem, 2006, p. 53). Therefore, in actuality, derivatives will render businesses less competitive in the long-run.

While Obiyathulla's passion to facilitate the IFIs would be appreciated, he should have taken into consideration the very objective of Islamic finance, i.e., Shariah compliant/halal return, instead of mere returns, and that genuine risk mitigation solutions for real sectors' financing by the IFIs could be found within the *Shari'ah* itself. He does not acknowledge or admit in his analysis that the sale of something one does not own, unbundled risk, and debt-for-debt as well as getting return without transferring ownership and taking possession are expressly prohibited by the *Shari'ah.*

In the above perspective when some cases of sukuk default occurred due mainly to their debt based structure, the call for Islamic Credit Default Swaps (CDS) was made only months after the conventional CDS industry had brought down the international financial system. Mahmoud El-Gamal commented on this call in the following words, "*So, the most recent crisis has not taught the participants and experts of today's 'Islamic finance' much (I use the quotation marks because they do Islam a great disservice by using it as a brand name to market their grossly inferior and poorly construed products for a profit). Will the customers at least finally see that this is not an infant industry that needs to grow*?" [26] Although there might be some legal possibility to use CDS for genuine hedging, as long as there is direct link between the amount of the underlying assets held on creditors' books and the notional amount of the CDS; yet they certainly are open to manipulation as practically happens in the derivatives markets. Similarly, to replicate the conventional profit rate swap, the parties only settle their respective obligations by *muqāssah* (offsetting net value)-neither party pays the real value[27]. In the so-called Islamic Total Return Swap (TRS), a client invests in *sharī΄ah*-compliant assets, but the exposure is swapped for that of another asset that may be non-*sharī΄ah* compliant. "*Because the client's money is directly invested in sharī΄ah-compliant assets, and the TRS is based on accepted Islamic principles, the investor is able to gain exposure to assets that, if invested in directly, would be forbidden*". This way, the TRS opened the market to a whole array of underlyings that would otherwise be prohibited[28]. The more serious issue is that the permission once granted, though limited, may lead to mass level unauthorized use by IFIs as has been experienced in case of organized *tawarruq*.

The main issues of concern in so-called Islamic derivatives pertain to separation of risk from ownership, trading in excessive risk, short selling and netting-off to avoid impacts and implication of transfer of possession (*qabd)* that resulted in collapse of big corporate in recent years. The financial engineers did not concede the reality and claimed, "One of the main innovations in the market has been the ability to *benefit from conventional yields, like index products, whereby the underlying index need not necessarily be sharia-compliant*. It can be a hedge fund, for example, and the investment will still be *sharī΄ah*-compliant if so approved by a scholar".[29]

As per the specific mechanism outlined in the Deutsche Bank's White Paper, the *w΄ad* based Islamic swap is an agreement between the bank and the investor to swap the returns from two baskets of performing assets (one haram and the other *sharī΄ah* compliant). "The investors will receive a profit or loss on their investment in the Securities based on the performance of the specified underlying reference asset or index (the "Reference Asset" or "Index") rather than the performance of the Shares in the Islamic Account". The Islamic investor takes the risk that the sharī΄ah compliant assets he deposited with the bank could outperform the *haram* returns he will receive when the swap is conducted. The transactions do not actually take place and are deemed to take place as per promise to sell or purchase, as indicated in the Paper, "Following receipt of the relevant notice to perform the obligations of either Promise 1 or Promise 2 ... Islamic Account and DB *shall be deemed to enter into an agreement on the terms of the form* …" (p. 3).

It is also important to observe here that all permissions for 'Islamic' swaps have reportedly been given for the purpose of genuine hedging by observing relevant rules of Islamic business and trade. Five, rather six axioms suggested by Jobst A. A. (2012) also qualify Islamic derivative with such conditions observance of which will not yield the profits that IFIS tend to earn while competing with the conventional hedge funds. Hence, expectation that the axioms will be taken into account reflects wishful approach as practically no genuine trading takes place.

[26] http://elgamal.blogspot.com/2010/01/have-we-learned-nothing-here-come.html; the Blogspot of Dr. Mahmoud El-Gamal (January 03, 2010).
[27] Dusuki and Shabnam, ISRA Paper No. 14/2010; pp. 37-39.
[28] For further details, see Ayub, M; 2012; *Use of W΄ad and Tawarruq — Finance*.
[29] Luma Saqqaf, available online at: http://www.risk.net/risk-magazine/feature/1506267/structuring-sharia.

The reality is that limiting the practitioners to the permitted and *sharī'ah* conforming purpose is next to impossible because of the *tawarruq* and *w'ad* based complicated but money-spinning structures. It is more likely that with limited permission, IFIs' major activities might concentrate on synthesized products leading ultimately to derivative-driven system and debt contracts instead of the real sector business.

5. Alternative Policy Options and Steps

5.1 Proper Risk Management: A Necessity

Risk management (RM) serves several important functions, including implementation of strategy, development of competitive advantage; measure of capital adequacy; aid to decision making, aid to pricing decisions, reporting and control of risks, and management of portfolio of transactions. According to the IFSB's guidelines on risk management (2005), the main risk categories facing IFIs include credit risk, market risk, liquidity risk, operational risk, Shariah compliance risk, equity investment risk, rate of return risk and displaced commercial risk. IFSB subdivided the risk management practices into "Risk Policy and Environment", "Risk Measurement" and "Risk Mitigation". Basel II, and subsequently Basel III tended to establish more market discipline along with risk weighted capital requirements on banks to reduce the probability and severity of future crises. Basel III combines micro and macro prudential reforms to address both institutional and system level risks. It focuses on the most problematic risks like trading book exposures, counterparty credit risk, derivatives and other securitization activities implying that its spirit seems to be moving away from the complex hybrid products.

While Shariah encourages proper measures for safeguarding the resources and wealth of the societies as also of individuals, it draws a clear line between halal and haram and recommends avoiding doubtful things and activities[30]. Quran also warns that the "LIMITS" (Hudood) set by Allah Almighty must not be breached (2:187). Risk-free returns stemming from riba and gharar that add no value to the wealth of the society tend to breach the 'LIMITS' set by the Almighty. The expresses permission of forward sale (*bai al-salam*) with specific conditions as imposed by the Holy Prophet (pbuh) himself, implies that "ambiguity" and "uncertainty" has to be differentiated from normal business risk for earning valid profits and avoidance from invalid gains.

Risk structure of financial institutions has close relevance with capital adequacy structure as required by the Basel for ensuring solvency and stability of global finance. To be considered adequately capitalized, Basel requires international banks to hold a minimum total capital equal to 8 percent of risk-adjusted assets. Investments in exotic instruments could further heighten vulnerability of the IFIs. This is why, the IFSB indicated in its amended capital adequacy standard that as Islamic finance is closely linked to real assets, it is less prone to credit bubbles, and Islamic banks do not engage in highly speculative trading. However, as commodity prices could change, Islamic banks need to build up countercyclical capital buffers in good times as per the provisions of Basel III. It is incomprehensible, however, that the IFSB also indicated how to calculate the exposure to derivatives like profit rate swaps, the replica of interest rate swaps in conventional finance.

5.2 Available Risk Management Tools

Having conceded the point that proper risk management is a pre-requisite for a successful business, and

[30] "What is lawful (halal) is evident and what is unlawful (haram) is evident, and in between them are the things doubtful which many people do not know. So he who guards against doubtful things keeps his religion and honour blameless, and he who indulges in doubtful things indulges in fact in unlawful things, just as a shepherd who pastures his animals round a preserve will soon pasture them in it. Beware, every king has a preserve, and the things Allah has declared unlawful are His preserves. …" (Bukhari, Vol. 3, No. 267). In another hadith, Prophet said that the person should leave what causes them doubt, for that which does not cause them doubt.

Islam encourages both cooperative and managerial styles of risk management to avoid losses to life, limbs and property, the approach, the strategy and the processes of risk management need to be changed to make the financial sector a facilitator for real sectors of the national and global economies. During last three decades, emphasis in global finance has shifted from balance sheet risk management to off B/S risk management, relying heavily on financial derivatives. For IFIs, balance sheet risk management is still vital due to prohibition of exotic financial derivatives.

The main rationale for using the derivatives is said to be risk management and hedging from the potential losses. But distinction has to be made between the real business risk and the external risks created and traded without any accompanying real assets or projects. The internal risk that shariah allows to be managed by observing some general rules may be the credit risk, market risk, liquidity risks and the operational risks. Such risks can be measured by applying various tools and techniques and managed keeping in view the nature of the transactions and the risks involved. It may involve proper reviewing, monitoring, communication, and regular feedback at all steps which are all Shariah neutral measures and hence allowed to be used.

The principles of Islāmic finance offer different possibilities to manage risks other than just replicating the complex derivatives and conventional hedging products. The seminal source of injustice, exploitation and instability is the creation of purchasing power, money and credit irrespective of the availability and potential of goods and services. As Islamic financial institutions have to avoid interest, gambling and all such returns that accrue without taking due risk and making value addition, they must abstain from such financing/investments that are not backed by the useful assets or real economic activity. Creating private money by the banks by dint of fractional reserve system, or the central banks' money issued to finance fiscal deficits without any increase in the goods and services in an economy could be the destabilizing factors for Islamic finance as in the case of conventional finance.

Any system that claims to be shunning interest and *gharar* must choose an alternative money creation and currency system that structurally eliminates interest and other exploitative returns as Islām, Catholic Church and other divine religions so require[31]. While Corporate Social Responsibility (CSR) is being discussed in the global finance, it's more a pre-requisite for the IFIs that they must make it a part of their business. Taking one step ahead, they need to adopt stakeholders approach to include society and all its segments among the beneficiaries, and expand the scope of CSR to include the banking and finance sectors so that they are made to observe economic, ethical, legal, social and philanthropic responsibilities (Ayub M. 2015a).

Accordingly, the practitioners need to focus on choosing the truly compliant and the most adequate risk management tools that broadly include *rahan* (collateral), personal guarantee, pledge, *hamish jiddiyah*, promise, agency, *khayyārāt* (option to rescind any contract), parallel forward transactions like in *salam*, *takāful*, *shart al jazā'ī* in *istisnā'* etc. The non-systematic risks can be mitigated by ensuring cost effectiveness, by providing requisite training to the practitioners, by resorting to suitable *takāful* policies, by choosing good clients, by adopting suitable capital budgeting and by prudent and Sharī'ah compliant liquidity management policies.

In addition to the permission for managerial types of risk management techniques, encouragement for the cooperative risk management measures is evident from the Holy Prophet's approving the historical systems of al-nahd (النهد) (partnership in the provisions on mutual cooperation basis) and liking his *'ash`ari* Companions who

[31] As from 1971, money is created by making loans depending upon banks' own reserve ratios and the discount rate, and through the purchase and sale of government securities by the central banks" (JIBM Editorial, June, 2015).

put forward a mutual help concept and practiced it in their life as explained by Imam Nawavi in Sharah Sahih Muslim: 62/16) (JIBM, June 2013). Accordingly, IFIs in various areas and jurisdictions may establish risk study and awareness centres and cooperative risk management pools to be funded by their contributions for payment of claims of defined losses.

5.3 Effective Regulation, Implementation, Clarity & Surveillance Needed

Islamic banks need to adopt better management skills and operational systems to mitigate the risks of losses in their business. In addition to risk and capital structure management, providing for strong internal and external controls may create a more stable risk mitigation system. EY World Competitiveness Report 2013 indicated the weak risk culture a hindrance to sustainable growth of Islamic banking. Furthermore, effective regulation of the Islamic banking industry requires change in approach of the structural institutions and the regulators.

5.4 Developing Secondary Market for Islamic Finance Instruments

The dichotomy that exists between the objective of *Shari'ah* compliance and the need to compete in a conventional system can also be relieved through creation of an active secondary market for Islamic finance instruments. IFIs may exchange funds among themselves on the basis of *mudaraba* instead of strengthening the interest based system by way of tawarruq and other ruses and this cannot be accomplished except with efforts of the regulators and global structural institutions like IDB, AAOIFI, IFSB and Shariah advisory and consultancy firms operating at broader levels. Such means of obtaining liquidity could be through Tradable Inventory Certificates (Kahf & Maha M. Khan, 2015), securitization of both short and long term Islamic financial contracts and by developing *Shari'ah* approved liquid secondary market for these securitized instruments (Vogel & Hayes, 2006, p. 238). The increased liquidity provided by such a market would relieve pressure on banks in fulfilling their liquidity function and lessen the pressure for risk mitigation while at the same time lowering the levels of required capital.

6. Conclusion

The paper discussed that Islamic finance is fast on growth and innovations but slow on establishing its credibility. The practitioners as also the regulators generally think that by using synthetic and exotic products like organized tawarruq, financial derivatives and the returns swap procedure what some call "*Sharīʹah Conversion Technology*", they attract customers, but in reality they lose them in the long term (Ethica, 2014). This emphasis on form over substance has led to abuse of Shariah principles to justify the contracts which undermine the objectives of the Shariah (Wajdi, 2009). It has stopped journey of financial system to real sector economy to help resolve serious problems facing the economies. It seems that the tendency of a few Islamic scholars to lean towards conventional products has perhaps misled Islamic banking professionals in the wrong direction. A recent IMF Working Paper draws such conclusion while discussing the impact of Islamic finance, "*In theory, Islamic finance is resilient to shocks because of its emphasis on risk sharing, limits on excessive risk taking, and strong link to real activities. Empirical evidence on the stability of Islamic banks, however, is so far mixed. While these banks face similar risks as conventional banks do, they are also exposed to idiosyncratic risks, necessitating a tailoring of current risk management practices*" (Hussain M.; WP/15/120).

The Muslim investors are becoming distrustful of *sharīʹah* compliant investment products: "*They feel they are being given conventional products with Islamic labels*". "*Islamic financing is also subject to high judicial risk, as clients may turn to Shari'ah courts that rule on a case-by-case basis, as well as seek redress in regular courts*" the IMF W/P cautions. A clear lesson is that IFIs have to avoid speculative exposures and all means for earning money on money. It is possible only if they abide by the rational principles of Islamic finance that ensure sustainable growth and halal returns, though lesser than the short term excessive and cyclical returns as experienced by the global finance industry during the last two decades. However, they can use such conventional tools that do not conflict with the *Shari'ah* principles that may, inter alia, include internal rating systems, risk reports, internal control systems, external audits, maturity matching, and GAP analysis (Hussain; WP/15/120).

Sharī´ah compliance is the basic cause of coming into being of Islamic finance institutions and their ultimate objective; if it is not taken care of, there would be no need for any separate system within the conventional finance. Implementation of Islamic finance principles determines the level of Shariah compliance, in letter, in spirit, in both letter and spirit, or sometimes none of them. Financial derivative do not involve genuine sale / purchase and even the subject matter, except notionals, making shariah compliance doubtful even in legal sense; what to talk of the *Maqasid*. The ban on selling which one doesn't have or on selling before possession implies that consequent upon a sale agreement, delivery has to be given and possession taken, implying that settling only the differences in prices is against the rules for valid transactions. Al-Bashir (2008, p. 299) concludes his book *'Risk Management in Islamic Finance: An Analysis of Derivatives Instruments in Commodity Markets'* by contending that the forward, futures and options contracts in currencies, interest rate and stock indices are not permissible in Islamic law due to the clear involvement of *ribā* or excessive risk which is a form of *gharar*. He accepts the possibility of shares and commodities based derivatives and this is the area in which Islamic finance experts may explore on the basis of cushion provided by the Shariah by way of *salam* principles. Al-Bashir contends that development of a viable Islamic future market is possible if we adapt the conventional commodity forward contracts on the basis of *salam* principles. In this context he validly refers to the resolution of the Jeddah based Islamic Fiqh Academy [No. 107 (1/12) 23-28 September 2000] which maintained in its rejection of the forward contract in commodity that "if the subject matter in the forward contract is a commodity that need manufacturing, the transaction must fulfill the conditions of *'istiṣnā*. If does not need manufacturing, then the price must be paid in the spot and the transaction must fulfill the conditions of *salam*. However, if the price is not paid at the spot, the transaction will be illegal because it is a kind of *bai al-kāli bi al-kāli*. On the other hand, if the transaction is just a promise and not binding upon either parties or at least one of them, it will be permissible".

Proper risk management involves and requires a clear policy and process of decision making, transparency, properly availing the opportunities for profit, and overseeing the performance of the personnel involved along with accountability. For the IFIs, the risk of Shari'a non-compliance is also important and needs to be taken care of in addition to the common credit, liquidity and operational risks. It is imperative that the Shariah scholars and financial engineers abandon the practice of justifying non-*Shari'ah* compliance for commercial reasons and instead devote their intellect to deciphering the tools and products that are available in the *Shari'ah*. The dichotomy between developing *Shari'ah* based products and competing in the conventional market can be resolved by strengthening the regulatory regime(s), creating secondary market for Islamic finance, implementing *Shari'ah* based risk mitigation techniques, and strengthening internal and external controls and Shariah certification SOPs and procedures. Banks may also diversify financing and investments for the purpose of risk mitigation.

Better risk management also requires better monetary management by the monetary authorities and the regulators to ensure that the human and material resources are diverted from speculative/exploitative activities to the real economy to help enhance wealth creation activities. The money or the purchasing power created at national and global levels must represent the present or the potential real assets in the spot and forward markets to ensure that all economic agents get return based on genuine risk-reward structures. The last but not the least is that the management and personnel of the IFIs should not become a part of the self-centered conventional business model, which "*made it easier to operate in one's own narrow interests, without the usual feelings of empathy that alerts us to the pain of others and define us as humans*." (Abdullah & Mirakhor, 2013). They must stick to some moral and rational principles to become flag bearers for prevention of harm to the human beings. Only then, we can persuade the global community to work for universal values for application of the 'golden rule' and equitable fair dealing[32].

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[32] For details on the need for such universal values, see: Abdullah, Daud Vicary and Abbas Mirakhor.

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