ISLAMIC COMMERCIAL LAW REPORT 2016

An Annual Publication Assessing the Key Issues and Trends in Islamic Commercial Law for the Broader Islamic Finance Industry

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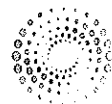

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APPROACHES IN DEVELOPING ISLAMIC FINANCIAL SERVICES

By Prof Dr Engku Rabiah Adawiyah Engku Ali
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The Islamic finance industry has grown by leaps and bounds since its introduction in the 1960s and 1970s. The range of Islamic financial services and products has broadened, the volume deepened and the players many times multiplied. The development of Islamic financial products has come largely as a result of the dynamic interaction between the needs of the industry and the ability of the market practitioners, in consultation with Shariah scholars to produce relevant solutions.

This productive interaction between practitioners and scholars in their attempt to respond and provide solutions to market requirements requires a re-examination of the principles of Islamic commercial law in the context of their immediate application to financial market transactions. Diverse approaches can be observed in the exercise and this article attempts to study these approaches as part of the so-called "legal reform" in Islamic financial thought.

BRAVING UNCHARTERED WATERS WITHIN AN INTEREST-BASED ECO-SYSTEM

The first phase of the development of Islamic financial services, beginning in the 1960s leading to the 1980s, was perhaps the most challenging due to the sheer uncertainty of the road ahead. This phase was characterized by almost zero awareness by the market about Islamic finance and how it was supposed to work. The recurring question posed by many at the time was: "How can a bank work without interest?" The whole banking business at the time was all about lending and borrowing. Interest was integral and deeply ingrained in the ensuing loan transactions. So entrenched was interest in the banking industry that it was almost unthinkable that any banking business or financial intermediary could ever be conducted sans interest.

Hence, Islamic bankers and scholars had to brave unchartered waters to come out with Islamic financial services and products that could work and survive within the existing eco-system. At that time, numerous literature by Islamic economists suggest that Islamic banking should be based on the principle of sharing where the contracts of *mudarabah* and *musharakah* had been proposed to be the main underlying contracts for both deposit and financing purposes. Yet, the actual products developed and offered by the Islamic banks were not necessarily so. The choices that they had were not that straight forward. They had to accommodate the existing eco-system that had been essentially tailored for interest-based financial intermediation, with almost no precedent to rely on. It was more of a "trial and error" approach.

ADAPTING AND FITTING IN

The approach adopted by most of the Shariah scholars during the early stage had been "reconciliatory" or "accommodating". The main concern was: "How to reconcile between strict Shariah requirements and market norms or legal constraints?"

The first line of response was to see whether or not the Islamic financial product could be

allowed to depart from the market norm or a legal requirement. This might require some exemptions or regulatory relief to be granted. If the first line of response was not achievable, the next approach was to find an "opening" or "breakthrough" via Shariah-compliant transactions that could meet the desired features as dictated by market norms or legal framework.

In the first line of response, we have seen the passage of legislations, granting of tax exemptions and regulatory changes being made to accommodate Islamic banking and financial transactions. These legal and regulatory changes were necessary to accord legal recognition to Islamic banking transactions that necessarily involve trade activities, partnerships and joint ventures that would not otherwise be recognized as banking transactions. The tax exemptions had also allowed Islamic banks to compete on a level playing field with their conventional counterparts.

Unfortunately, not everything could be adjusted to accommodate Islamic finance. For instance, capital adequacy requirements and the high risk weightage assigned to risk sharing contracts such as *mudarabah* and *musharakah* financing rendered the two contracts almost impossible in Islamic banks.

Debt-creating contracts like *murabahah* sale with deferred payment of the price became the contract of choice, simply because they maintain credit risk with similar risk weightage to the conventional loan contracts. Cash financing products would have to resort to very controversial arrangements like *bai' al-'inah* and more recently, *murabahah* with *tawarruq* arrangements because pure *qard hasan* (interest-free loan) would be contrary to the commercial nature of banks.

Even in deposit products, we see constraints. The legal definition necessitates capital guarantee on bank deposits. It follows that most Islamic banks responded by offering either "guaranteed safe keeping" (*wadi'ah yad damanah*) or "interest-free loan" (*qard hasan*) for their deposit products. Both allow guarantee on the deposits, thus fitting well within the legal definition.

Unfortunately, they are commercially "handicapped" because according to Shariah principles, they are necessarily non-profit making contracts and cannot promise any return on the deposits. Since these deposits are guaranteed, depositors take no liability and thus, must not take profit. This adversely affects the competitiveness of Islamic banks that are operating in a dual banking environment where their competitors are able to guarantee deposits as well as give fixed return on them. This led to many Islamic banks' practice of awarding "*hibah*" to their depositors to remain competitive, despite criticisms by some other scholars.

Islamic banks also offer Islamic investment accounts using *mudarabah* contracts to meet the appetite of depositors who want return on their deposits. These Islamic investment accounts allow for profit payments to the "depositors" based on pre-agreed profit-sharing ratios, with the rate of profit normally indicated as "expected rate" based on previous rates of profits paid in preceding months.

However, these profits are not guaranteed and may change based on actual profits made. In addition, the capital in these *mudarabah* investment accounts must not be guaranteed by the Islamic bank in line with the principle of risk sharing and liability-taking envisaged in the Islamic legal maxim of "gains must accompany liability for loss".

Yet, the banks' inability to guarantee the capital may be construed as going against the basic feature of deposits as per the market norm. The inability to guarantee profits also adversely affects the competitiveness of Islamic banks and creates "displaced commercial risk"[1] within these banks.

The above examples illustrate the less than ideal environment within which Islamic banks work. In most instances they have to choose between strict Shariah compliance or conforming to the market norms that are more often than not, dictated by the interest-based financial system. Thus, incongruities are bound to happen, unless certain compromises could be worked out.

> "Debt-creating contracts like murabahah sale with deferred payment of the price became the contract of choice, simply because they maintain credit risk with similar risk weightage to the conventional loan contracts."

In response, compromises had been made, and their examples are plenty.

In the case of *mudarabah* investment accounts, arrangement had been made for third-party guarantee on the *mudarabah* capital by deposit insurance bodies and the like. The need to "fix" the profit rate also led to the practice of "profit equalisation reserve"' (PER) to smoothen profit payment. In the case of current and savings accounts (CASA) based on *wadi'ah yad damanah* or *qard hasan*, Islamic banks give "*hibah*" to the depositors based on their own discretion without any pre-condition.

Some of the deposit products use *bai' al-'inah* and later *murabahah* with *tawarruq* arrangement to effectively allow Islamic banks to guarantee the amount deposited, with a fixed amount of profit pre-determined in the *murabahah* price. Some of these arrangements have been criticized as synthetic, organized and not genuine. Yet, they have been approved by the respective Shariah bodies because their approach was to develop the Islamic market by finding solutions that meet both Shariah requirements and market norms.

AUTHENTICITY AND CREDIBILITY

By mid-2000, the overall growth of Islamic finance had been remarkable, be it in terms of asset size; number of players; range of products; market understanding and awareness; improvement in legal and regulatory flexibility; and consumer acceptance. By this time, Islamic finance had proven to be commercially viable; and in some sectors and markets, had achieved critical mass.

Nonetheless, these developments were received with mixed feelings. There was and still is a growing sentiment that Islamic finance is increasingly similar to the interest-based conventional finance, especially in term of its economic and commercial behavior. Islamic finance was accused of imitation of and convergence with the conventional finance that it was supposed to distinguish from. This led to a feeling of skepticism or disillusionment towards Islamic finance within the Islamic finance fraternity, even among the very scholars who had earlier approved the products.

Discourses were held and calls for self-introspection were made. Serious re-evaluation of the products were made with the aim of verifying Shariah compliance by re-looking the whole chain of transaction. Reassessments of rulings were made to ascertain their alignment with the objectives of Shariah. The approach was to look at the big picture and study the probable implication of any ruling made. This is admittedly a more insightful approach. Such an approach led to some prominent refinements to a number of past rulings, such as: the pronouncement by the Shariah Board of AAOIFI in February 2008 that sought to correct some of the "questionable" practices in *sukuk* transactions; the OIC Islamic Fiqh Academy's latest resolutions on *tawarruq* to accord "authenticity" to the transaction; and the Central Bank of Malaysia Shariah Advisory Council's latest resolutions on *bai' al-'inah* to rectify its flawed implementation in the market.

All of these efforts aim at reforming Islamic finance practices, avoiding the pitfalls and mistakes learned from yesteryears. The desire is go back to the root philosophy of Islamic finance as founded in the Shariah and manifested in its *maqasid*. With strong fundamentals built on principles of accountability, fairness, justice and inclusiveness; supported by clear focus on real transactions that are linked to the real economy; and strengthened by effective regulation and good governance, Islamic finance is bound to create distinction and in the long run, re-gain its authenticity and credibility.

ENDNOTE

1 IFSB (2005) defines the displaced commercial risk as *"the risk arising from assets managed on behalf of Investment Account Holders which is effectively transferred to the Islamic Financial Institutions own capital because the Institution forgoes part or all of its mudarib's share (profit) of on such fund, when it considers this necessary as a result of commercial pressure in order to increase the return that would otherwise be payable to Investment Account Holder's"* (Standard 76).

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