Islamic Finance Policies: Implications for Industry Stakeholders
Lecture by H.E. Emeritus Professor Dr. Ishrat Husain
Chairman, Centre for Excellence in Islamic Finance
Institute of Business Administration, Pakistan

Financial Policy and Stability: Islamic Finance Perspective
Lecture by Professor Dr. Monzer Kahf
Professor of Islamic Finance and Islamic Economics
Faculty of Islamic Studies
Hamad bin Khalifa University, Qatar
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The views expressed in this publication are those of the author(s) and not necessarily reflect the official Islamic Financial Services Board's views.

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ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital market and insurance sectors. The standards prepared by the IFSB follow a stringent due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which includes holding several Working Group meetings, issuing exposure drafts and organising public hearings/webinars and reviews by the IFSB’s Shari’ah Board and Technical Committee. The IFSB also conducts research and coordinates initiatives on industry-related issues as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

For more information about the IFSB, please visit www.ifsb.org.
About the Public Lecture on Financial Policy and Stability

In the Public Lecture on Financial Policy and Stability series, the IFSB invites eminent speakers with experience in the financial services industry to present papers on financial policy and stability. Although these papers are published by the IFSB, they do not necessarily represent the views of the IFSB.

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| 5th Public Lecture 2012 | Manama, Bahrain                | **Professor Dr. Vedat Akgiray**  
Chairman, Capital Markets Board of Turkey                                  | Building Resilient Islamic Financial Systems – Securities Market Regulations |
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Secretary-General, Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) | Building Resilient Islamic Financial Systems – Insurance/Takāful Regulations |
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| 8th Public Lecture 2016 | Cairo, Egypt                   | **Dr. Sami Al-Suwailem**  
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<td>Professor Dr. Monzer Kahf Professor of Islamic Finance and Islamic Economics, Faculty of Islamic Studies, Hamad bin Khalifa University, Qatar H.E. Emeritus Professor Dr. Ishrat Husain Chairman of the Centre for Excellence in Islamic Finance, Institute of Business Administration, Pakistan</td>
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Assalamu’alaikum and a very good morning to all of you.

It gives me a great pleasure to welcome all of you to the 10th IFSB’s Public Lecture on Financial Policy and Stability in Kuwait City. My special thanks to H.E. Dr. Mohammad Y. Al-Hashel, Governor of the Central Bank of Kuwait, and Chairman of the IFSB Council 2018 for hosting the IFSB’s Annual Meetings 2018 in Kuwait. This is certainly a testimony of Central Bank of Kuwait’s support to the IFSB and the development of the global Islamic financial services industry. I also want to take this opportunity to thank all the IFSB Council members and representatives of IFSB member organisations present here today.

Let me begin by reflecting on the IFSB mandate

The IFSB’s Mandate:

As you are all aware, the IFSB as an international standard setting body, develops prudential and regulatory standards for a robust and transparent Islamic financial services industry to enhance the stability and soundness of Islamic financial systems in member countries. The IFSB also supports the member jurisdictions in the implementation of its standards through a range of initiatives such as workshops, technical assistance, policy advice, capacity building through its e-learning platform and executive programmes as well as translating standards into multiple languages.

In order to achieve its mandate, the IFSB’s Strategic Performance Plan outlines “increasing awareness and knowledge sharing” as one of its Strategic Key Result Areas (SKRA) under which the IFSB coordinates initiatives to discuss and address industry related issues by organising conferences, roundtables and public lectures for the benefit Islamic financial services industry stakeholders.
Why we are here

Excellencies, Distinguished guests, Ladies and Gentlemen,

Please permit me to reflect on some past and recent developments in the global financial services industry and to share with you some rationale behind the IFSB Public Lecture series.

It is now ten years since the global financial crisis of 2007-08, after which substantial reforms have been undertaken led by the G20, and coordinated by international standard-setting bodies including Basel Committee on Banking Supervision (BCBS), International Organisation of Securities Commissions (IOSCO), International Association of Insurance Supervisors (IAIS), International Association of Deposit Insurers (IADI), and of course the IFSB. They all responded with a new generation of prudential standards, which include sound corporate governance practices, macroprudential tools, cross-sectoral and consolidated supervision, stress testing, as well as regulations on consumer protection, and anti-money laundering/combating the financing of terrorism (AML/CFT) issues.

However, while some industry experts are of the opinion that the financial services is over regulated, others are of the opinion that there is a need for stricter policies in so far as financial stability is to be sustained and future financial crises are to be avoided.

In fact, the whole response of the global financial community post-financial crisis was to achieve better financial stability and more effective regulation and supervision of financial institutions.

Now, new risks and structural changes such as FinTech, cryptocurrencies, blockchain technology, big data analytics, robotics, and artificial intelligence are appearing in the global financial services industry requiring a regulatory response. These developments have implications for both monetary policy and financial stability.

Even, green finance and socially responsible investments, which are continuing to grow their appeal can raise concerns in developing policies for financial stability.

All the aforementioned not only have relevance to the conventional industry but also have significant effect on the Islamic finance industry. In fact, the challenges for regulators are even more profound for Islamic finance since efforts and activities must comply with Shari‘ah. The cause is not helped when there is a disharmony between market and regulatory practices and differences on Shari‘ah opinions regarding permissible and impermissible activities between jurisdictions.
This is where the role of the international standard-setting bodies and regulatory authorities is increasingly crucial and highly dynamic in today’s world. In the case of FSB, they are currently placing an emphasis on evaluation of implementation of post-crisis reforms and identification of new risks. This is also where the IFSB is heading to, and I believe with the support of our members, we will surely get there.

**The main focus of the Public Lecture**

*Excellencies, Distinguished guests, Ladies and Gentlemen,*

As a part of our Annual Meetings, the IFSB public lecture series is published annually since 2007 and it is conducted by eminent speakers. It is aimed to promote the sharing of knowledge and experiences by acclaimed personalities such as industry practitioners, policymakers, and thought leaders, who have made significant contributions in their field.

It is through this platform that Islamic finance stakeholders exchange their valuable insights on financial stability issues at a global level.

This 10\textsuperscript{th} IFSB Public Lecture is being held at a time when the Islamic financial services industry has reached to significant level of growth of USD 2 trillion on the one hand, and on the other hand, the industry is facing considerable challenges due to macro-economic and geopolitical challenges especially in the context of liquidity risk management, slower growth due to volatility in oil price, financial disruption due to technological innovations.

These industry developments highlight the need for additional consideration in further developing and strengthening the financial architecture and enabling environment that could ensure soundness and stability of the Islamic financial services industry.

The current challenge is how to take the industry to its next stage of development and how to reinforce the robustness of the industry in a more challenging and dynamic socio-economic environment.

Of importance in this respect is the need to further build and advance the key strengths of Islamic finance as well as enhance institutional capacity in the industry. An important point to focus on is to have a holistic view of these developments such that integrated growth in various sectors in Islamic finance i.e. banking, insurance, capital markets, microfinance as well as social instruments such as zakat, waqf and sadaqah can be achieved.

The theme of today’s lecture is on how the development of Islamic finance and Islamic finance policies can meet the aspirations of industry stakeholders, while promoting the cause of a just, fair and transparent financial system that can promote growth and
address the “trust deficit” which financial sector is generally experiencing all over the world.

The IFSB’s core work on issuing prudential standards for Islamic financial services industry and facilitating their implementation contributes to the main objective of today’s public lecture in order to ensure soundness and robustness of the Islamic financial services industry in a more challenging and dynamic socio-economic environment.

Concluding remarks

Excellencies, Distinguished guests, Ladies and Gentlemen,

On that note, I wish you very productive deliberations and discussions that will allow us to generate new ideas on realising the objectives of today’s public lecture.

I am sure, our distinguished speakers will share their valuable experiences which will help the Islamic finance sector achieve greater heights and its true potential through the development of comprehensive applicable prudential policies.

Once again thank you all for your participation and I look forward to your contributions to this Public Lecture.

1 May 2018
Kuwait City
OPENING REMARKS TO THE 10TH IFSB PUBLIC LECTURE ON
FINANCIAL POLICY AND STABILITY

Waleed Al-Awadhi
Executive Director, Supervision Sector
Central Bank of Kuwait

Assalamu’alaikum and a very good morning.

It is a great pleasure and honour for the Central Bank of Kuwait (CBK) to host the ‘10th IFSB Public Lecture on Financial Policy and Stability’.

I wish to welcome all officials, central bank governors, heads of regulatory and supervisory authorities, financial institutions, and distinguished delegation of the IFSB members to the Annual Meetings and Side Events of the IFSB in 2018.

In particular, I would like to thank the IFSB, and it’s Secretary General Dr. Bello Lawal Danbatta for their support in organising this 10th IFSB Public Lecture on Financial Policy and Stability IFSB, in conjunction with the IFSB Annual Meeting. As a founding member, the CBK is pleased to be able to host such events and support the IFSB in its noble goals to promote the soundness and stability of the Islamic finance industry.

Let me also welcome the two distinguished speakers for the Public Lecture; H.E. Emeritus Professor Dr. Ishrat Husain and Professor Dr. Monzer Kahf.

In line with the agenda of the programme, my remarks will focus on the central theme of this event which is financial stability. In this respect, I will reflect upon the macro prudential policies required to safeguard financial stability and will then elaborate on some of the policies and practices in the Central Bank of Kuwait.

Let me start with macro prudential policies for financial stability.

Subsequent to the financial crisis, which struck the global markets and economies in 2008, policymakers and regulators have considered financial stability as an overriding policy objective. In this respect, the Basel Committee has indicated in its Core Principles for Effective Supervision the need for having a well-established framework for financial stability policy formation. A sound and stable financial system is a key prerequisite for economic growth. Financial stability is critical to a healthy, well-functioning economy. A stable financial system is one in which financial intermediaries, markets and infrastructure facilitate the smooth flow of funds between savers and investors and, by doing so, help promote economic activity.
Financial stability is, however, not an end in itself; it is an important precondition for balanced and sustainable economic growth. From this perspective, the safeguarding of financial stability can be seen as a forward-looking task — one that seeks to identify vulnerabilities within the financial system and, where possible, take mitigating actions. Central banks now place more importance and pay additional attention to the way that monetary policy and financial stability are linked.

To this end, the role of the macro-prudential policies to achieve financial stability has become critical for a stable financial and banking sector. Hence, there is an obvious need for macro prudential policies designed and directed to achieve the financial stability.

Now, let me reflect on financial stability in the context of the Kuwaiti financial system. Let me start by providing a brief overview of the financial system in Kuwait.

As a regulator, the CBK governs Kuwait’s domestic banks, foreign banks operating in the country, finance companies, and exchange companies. The Kuwaiti financial system is dominated by the banking sector, holding 83 percent market share, and is well diversified.

The domestic banking sector is composed of five Islamic banks, five conventional banks and one specialised bank.

The conventional banks hold more than 60 percent of the total banking system assets on a consolidated basis, this share remained broadly stable since 2007.

Kuwait has played a pioneering role in the global Islamic finance industry, with its first Islamic bank, Kuwait Finance House, established back in 1977. Kuwait is an important player in the Islamic finance industry, accounting for 6 percent of worldwide Islamic banking assets.

All developments pertaining to Islamic finance are documented in the ‘Islamic Finance in Kuwait: Broadening Horizons Report, which demonstrates Kuwait’s continued commitment to support the growth and development of the Islamic finance industry. This report, which I encourage you to read, provides an overview of the development of the industry in Kuwait, with analyses, insights, case studies and interviews with Islamic banks operating in the country.

For the promotion of Islamic finance, CBK works closely with the international institutions, including international Islamic finance bodies such as the IFSB, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Financial Market (IIFM), and the International Islamic Liquidity Management Corporation (IILM).
Now let me discuss some of our policies and practices for ensuring financial stability.

From the beginning, the CBK has been the lead regulator of Kuwait’s banking — centric financial system, and devotes considerable resources and attention to ensure a sound and stable financial system in the country.

In 2010, a separate Financial Stability Office (FSO) was set up with the mandate to regularly examine developments in the financial sector. The Financial Stability Report (FSR) is a flagship publication of the FSO, evaluating the performance of various components of the financial system and serving as a key surveillance tool for the CBK.

Moreover, the CBK has itself continued to adjust and, where necessary, improve its oversight and regulation by implementing, particularly, the regulatory standards issued by Basel Committee on Banking Supervision (BCBS) including the Basel III set of financial reforms.

In keeping with international best practices, CBK aims to strengthen the banking and financial sector’s ability to manage and be resilient to risk – thereby reinforcing the pillars of financial stability in the country and without lessening their ability to develop their businesses profitably and efficiently.

With the introduction of various regulatory measures, Kuwaiti banks also remain profitable; growth in the banks’ net income has remained healthy. Moreover, asset quality has also visibly improved despite a challenging domestic economic environment due to lower oil prices. Banks’ non-performing loan ratio has dropped to 1.95%, a historically low level.

In fact, the latest IMF Article IV also stated that the “The banking system is adequately regulated, and the CBK has been proactive in strengthening supervision. Banks are under Basel III regulations for capital, liquidity, and leverage. A comprehensive set of macro-prudential measures is being enforced to minimize systemic risks.”

Within this context I would like to briefly touch upon the elements of supervision that exemplify the Central Bank’s approach toward macro-prudential policies aimed at strengthening the financial stability of Kuwait.

1. We have enhanced our capital adequacy regime by setting out higher and better quality capital. As of December 2017, CAR of the banking industry stands at 18.45 percent, well above the Basel benchmark.
2. We have also put up additional capital requirements, up to 2 percent, for our systemically important banks. Furthermore, our additional capital conservation buffer and countercyclical capital buffer requirements aim to help banks to maintain additional cushion and limit the buildup of systemic risk.

3. We have also put in place a simple leverage ratio. Again, Kuwaiti banks stand at 10.2 percent, substantially higher than the 3 percent global benchmark.

4. We have introduced limits on the loan-to-value (LTV) ratio and the debt service-to-income (DSTI) ratio in November 2013 for financing extended by banks, investment companies and finance companies to individuals to purchase or develop residential property.

5. We have also been improving our macro prudential liquidity toolkit in order to mitigate liquidity risk. This includes:

   i. Liquidity ratio limits - local banks are required to maintain 18 percent of their Kuwaiti dinar customer deposit in form of balances with the CBK. Moreover, our banks are currently at a level of 31 percent;

   ii. Maturity Ladder limits.

   iii. Maximum Lending Limits – local banks are required to comply with limits on lending to available sources of fund, which should not exceed 90 percent. Moreover, our banks are currently at a level of 75 percent;

   iv. Liquidity Coverage Ratio — we have further strengthened banks’ capacity to withstand liquidity stress and to make their funding structure more stable by implementing Liquidity Coverage Ratio and Net Stable Funding Ratio. Our banks are already well above the minimum benchmark in both ratios;

   v. Banks are required to comply with the Basel III liquidity reforms for NSFR at a level of 100 percent. Kuwaiti banks are currently at a level of 112.9 percent.
Finally, let me say few words about the role of the IFSB in ensuring the financial stability. There are a few questions that come to my mind and I believe that it is important for us to ask ourselves these critical questions:

1. For managing financial stability in Islamic finance, it is equally important and challenging to identify and calibrate the tools and instruments suitable for Islamic banks. In this context, how should the macro-prudential policy framework be structured for measuring and monitoring systemic risk for Islamic banks, and which instruments should be used, how and under what conditions?

2. How can we develop and operationalise a rigorous analytical framework with clear criteria for systemic risk identification comprising a mix of quantitative and qualitative factors for Islamic finance?

In this respect, I hope that the speakers will provide us deeper insights into these questions, and I encourage all delegates to fully contribute by sharing their views during the programme. I am sure that collectively, we can go a long way towards addressing these issues.

I wish this programme a success and hope that today’s deliberations would help us find ways to further strengthen the soundness of our financial system.

Thank you for your attention.

1 May 2018
Kuwait City
INTRODUCTION

I submit that, after a decade, we have much better knowledge about the factors that precipitated the 2008 global financial crisis. We know that financial engineering—in which certain factors, such as complex derivatives, multiple Collateralised Debt Obligations and Credit Default Swaps, slice and dice securitised portfolio backed only by a trail of papers without the backing of real assets, and individual tranches rated by Credit Rating agencies, led to excessive risk-taking by the banking industry—played a large part. We also know that the theory of decoupling was proved wrong, and the contagion effect was quite strong and widespread. This interconnectedness was limited not only to the regulated financial institutions across borders but also between the regulated and shadow banking systems. The regulations and banking supervisions were not able to keep pace with either the rapidity or complexity of financial engineering perpetrated by the industry. Therefore, the capacity to appraise risk properly fell short. Risk mitigation strategies were ineffective as the source from which risk was arising could not be identified. These shortcomings and weaknesses of the conventional banking system should have naturally paved the way for the broader acceptance and spread of the Islamic banking system.

THE SALIENT FEATURES AND INFRASTRUCTURE OF THE ISLAMIC FINANCIAL SYSTEM

The main attributes of the Islamic banking system include the principle of equity, i.e. protecting the weaker contracting party in a financial transaction; principle of participation, i.e. risk sharing in economic transactions, the reward (profit) coming with risk-taking and not simply the passage of time; principle of ownership, i.e. asset-based financing linking finance with the real economy, providing solid pillars for maintaining financial stability.

There is no fixed, predetermined rate of return, i.e. the investors’ return is based on the performance of the underlying asset. Exotic, artificially contrived instruments do not find any place in the domain of Islamic finance.
It is an effective counterweight to the weaknesses and shortcomings of the conventional banking system, which became apparent in 2008 and caused so much harm and dislocation to the global financial architecture and economy.

Risk sharing rather than risk transfer, asset-based lending rather than paper-based engineering and prohibition of investment in non-social activities and gharār, i.e. uncertainty and speculation, provide an ideal answer to the problems we faced in the developments that led to the global financial crisis. By its inherent nature, Islamic banking reduces the incidence of risk and the amplification and magnification of risk through various contrived transactions without underlying real assets that circumscribe the limit.

An individual, an enterprise, or a group, when it borrows from the banks, is obliged to repay a fixed amount as interest at a given interval of time, whether the borrower’s underlying business is making profit or loss. The risk is concentrated solely in the borrower, and any exogenous shocks or endogenous derivations from the original goals of the borrowing do not matter. The origin of sub-prime mortgage loans in the U.S. can be traced to this particular characteristic of conventional banking. The banks had enormous liquidity that they wanted to deploy for profit earning. In a booming economy, the prices of houses were on an upward incline. Therefore, based on expected rise in the value of the houses, the banks attracted these borrowers who were not creditworthy at present but would become creditworthy as the loan-to-value ratio kept declining. The banking industry created many instruments for this purpose. When the housing prices started to fall, the borrowers were not in a position to pay the instalments due on time, and they had to lose their property through foreclosures. These were inequitable and one-sided transactions where the banks in their ‘irrational exuberance’ indulged in excesses as the risk was concentrated. The financial system was, as a result, completely destabilised. Under the Islamic financial system, there is in-built risk sharing and both parties suffer equally.

We have also created the infrastructure for the industry to take off. Standard-setting, guideline and development, regulatory institutions to guide the Islamic financial services industry, such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB), have all been established. The International Islamic Financial Market (IIFM) in Bahrain is mandated with the issuance of Islamic financial instruments and to encourage active secondary market trading. The
International Islamic Liquidity Management Corporation (IILM) has filled in a major gap by issuing short-term Sharī‘ah-compliant financial instruments to facilitate cross-border liquidity management. The Islamic Research and Training Institute (IRTI)—a part of the Islamic Development Bank Group—has been engaged in research and training of those engaged in the industry.

Malaysia has recognised the need for human resource development required by the industry and is very successfully operating the International Centre for Education in Islamic Finance (INCEIF). Similarly, the International Shari‘ah Research Academy for Islamic Finance (ISRA) is researching Shari‘ah issues. An Islamic Credit Rating agency has developed the criteria for evaluating creditworthiness of the entities offering Shari‘ah-compliant products. Islamic indices have emerged that now serve as more appropriate benchmarks for examining the performance of Islamic funds. Key index providers that offer Islamic indices include Dow Jones, S&P, FTSE and MSCI.

MAKING ISLAMIC FINANCE WORK FOR SUSTAINABLE DEVELOPMENT

These attributes of Islamic finance and the institutional infrastructure should have enabled the international financial community to understand that Islamic finance provides a credible alternative to the current global financial system for financial stability. Therefore, from a theoretical point of view, there is substantive justification for the adoption of Islamic finance.

At the same time, the impressive growth of impact financing, particularly environmental, social and growth funds, shows that there is huge demand for ethical and sustainable development financing. Why is it that, during the last decade, Islamic finance has not been mainstreamed into the current financial system or risen in volumes to match the Impact Investment Funding?

So I raise some questions for the consideration of the regulators, authorities, lawyers, Islamic finance industry professionals and support institutions. Why has the industry not been able to reach its potential and expectations? What are the impediments and constraints that have not allowed much progress? Even the pioneering countries which have been in the forefront of promoting Islamic finance in their countries have not made much headway. The share of Islamic banks in countries having parallel banking regimes has not reached even 50 percent. In Malaysia, for example, it is still in the mid-20s. In Pakistan,
it is only 14 percent.

I would then focus on one of the financing modes, which in my view exert a stabilising influence on the financial system, contributing towards sustainable development goals (SDG) and also meets the urgent needs of developing countries. I would refer to the finding of the latest Global Report on Islamic Finance by the Islamic Development Bank and the World Bank of which I happen to be a peer reviewer and commentator.

The United Nations estimates a gap of $2.5 trillion between the annual investment needs of the SDGs of $3.9 trillion and current annual investments of $1.4 trillion (UNCTAD 2014). The challenge posed by the scale of funding requirements is further aggravated by the need to commit funds for long-term horizons. Moreover, there is broad consensus that, to deal with the complex challenges of climate change, growing urbanisation, and social imbalances, the world needs to invest more in long-term sustainable projects.

Long-term finance plays a major role in sustainable economic development because it helps advance structural transformation of economies, stimulates development of infrastructure, and provides funds for fixed investments to enhance production capacity.\(^1\) The need for funding long-term investments is so huge that resources by governments, multilateral development banks, and other traditional development partners remain insufficient. The role of the private sector is critical in meeting the challenges of long-term financing needs. However, the existing financing patterns indicate the preference of investors for assets with short-term maturity despite their meagre returns. Thus, extending the maturity structure of finance is a key policy challenge for the development community. Market factors under existing conditions, together with systemic biases toward short-term debt and risk transfer mechanisms, substantially reduce the availability of funding for long-term financing, which creates deficiencies in resource allocation and a gap in long-term funding, despite the ample supply of global savings. While the gap exists globally, it is particularly critical in developing economies because it hampers the implementation of much-needed investment projects to enhance welfare. The latest edition of the Global Report on Islamic Finance presents a global perspective on the needs for and impediments to long-term financing. To deal with the ongoing underfunding problem in long-term investments, it proposes

\(^1\) Taken from Global Report on Islamic Finance, 2018, Executive Summary
the use of Islamic finance, which is based on risk-sharing rather than risk transfer, and thus offers many advantages. The main objectives of this Report are:

(i) To deepen the understanding of the significance of long-term financing by documenting why long-term financing is needed.

(ii) To provide a critique of the traditional financing model of transferring risk by presenting the theoretical rationales and discussing policy issues related to the financing of long-term investments from the perspective of Islamic economics and finance.

(iii) To formulate a theoretical framework that emphasises the central role of risk-sharing as a mechanism for acquiring long-term investment for sustainable economic development and provide some empirical evidence of widespread needs for long-term investments.

(iv) To review recent developments and trends in Islamic finance as a means of long-term financing and to discuss challenges that Islamic finance faces in mobilising long-term finance.

(v) To explore policy options to remove key barriers impeding the development of the Islamic financial industry for long-term financing.

RECOMMENDATIONS

The efficiency of Islamic banks and the pricing of assets should exceed that of conventional banks. At present there is not much difference.

1. The dynamic nature of financial sector developments calls for continuous enhancement of the portfolio of innovative Shari’ah-compliant products and services for different types of potential customers of IFSI.

2. Central banks / regulatory bodies need to address the dual challenge being faced by Islamic Shari’ah requirements concerning corporate governance, risk management, accounting and auditing, etc. Risk management is, therefore, unique.
3. There is a dire need to put in place a comprehensive set of prudential standards for all segments of the Islamic finance industry.

4. More focused research and development—there should be sharing of global data and success stories / experiences regarding various Islamic financial products/models in different parts of the world.

5. Steps should be taken to develop an international commercial Islamic law to facilitate structuring and uniformity of sovereign ṣukūk globally.

6. Strengthen the link between the real sector and the financial sector to obtain results in the form of equitable social development, profit and loss sharing and trade base modes.

7. Islamic financial institutions need to focus on nurturing and promoting Islamic financing for micro, small and medium enterprises (SMEs) as well as agriculture sectors, especially in the developing countries.

8. To achieve Maqasid al-Shari‘ah, Islamic finance industries’ infrastructure needs to be up to and compatible with global standards.

9. Regulators further need to work on consumer protection frameworks and arbitration centres (dispute resolution framework).

10. Regulators have to provide sovereign issuance of tradable ṣukūk that will help banks in the management of high-quality liquid asset (HQLA), so that banks can fulfil the Basel III liquidity coverage ratio (LCR).

11. Establishment of the Shari‘ah-complaint lender-of-last-resort facility to strengthen the financial stability of countries where the dual banking system is present is critical.

12. The regulator should provide incentives to increase access to finance for the SME sector by Islamic financial institutions.

13. The financial landscape changed drastically with the introduction of Fintech, Blockchain and distributed ledger technology (DLT). Cryptocurrencies, smart contracts, and crowd-funding have Shari‘ah issues, legal issues and regulatory implications.
14. Regulators and international standard setting bodies have to stop the complexity of products and replication of the conventional products.

15. Cooperation among the OIC countries and also between OIC and non-OIC countries is missing. Coordination and support among the countries that have made tremendous growth in Islamic finance and the ones that are new or struggling in the industry are important.

16. At the same time, the multilateral standard setting bodies must develop the synergy for the growth and promotion of Islamic finance.

CHALLENGES FOR ISLAMIC FINANCE

The exceptional growth of the Islamic finance industry in the last decade is a remarkable development, though it still constitutes a small fraction of global finance. The risk-sharing nature of Islamic finance has attracted attention in all financial sectors, including banking, capital markets, and insurance. Findings from various analyses show that despite its huge potential, Islamic finance is a small player in global financial markets and requires a concerted push for the necessary regulatory and legal changes to take root.

To reduce uncertainty and provide protection of property and investors’ rights, macroeconomic and political stability, institutional development, and an enabling legal and regulatory regime are necessary. At the micro level, the organisational framework of financial institutions and the diversity of financial instruments offered determine the extent to which long-term financing needs are met. Currently, Islamic financial institutions are subject to similar regulatory regimes as conventional institutions, thus forcing them to develop financial instruments similar to conventional instruments, even if those instruments are not Sharī‘ah-compliant. However, this structure limits the full benefits that could be obtained through the risk-sharing feature of Islamic finance.

Countries are at different levels of development concerning the key recommendations related to the developments in national plans and strategies, the legal and regulatory frameworks, the Sharī‘ah governance regime, liquidity infrastructure, and deposit insurance schemes. Some countries, such as Indonesia, Malaysia, Oman, and Pakistan, have adopted national action plans for the development of the Islamic financial sector, including separate
Islamic financial laws. In other member countries, adoption is still at the very early stages.
His Excellency Emeritus Professor Dr. Ishrat Husain is the Chairman of the Centre for Excellence in Islamic Finance at the Institute of Business Administration (IBA)—the oldest graduate business school in Karachi, Pakistan, established in 1955.

He previously served as Dean and Director at the Institute. During his term of office, he was actively engaged in the transformation of the Institute to become one of the ranking Global Business schools.

He also served as the Chairman, National Commission for Government Reforms, for two years from 2006 to 2008 with the status of Federal Minister reporting directly to the President and Prime Minister of Pakistan.

H.E. Dr. Husain was appointed as the Governor of the State Bank of Pakistan (SBP) Pakistan’s in December 1999. During his six years term, he implemented a major programme of restructuring in the SBP and steered the reforms in the banking sector. As a member of the economic management team of the Government, he also played a key role in the impressive economic turnaround of Pakistan. During his term, the SBP became a Founding Member of the IFSB.

H.E. Dr. Husain has also had a distinguished career at several institutions and held key positions at the World Bank and the international financial arena. Since his retirement, he has continued serving his country at both national and international levels, including in the International Monetary Fund (IMF), Islamic Development Bank (IDB), Asian Development Bank (ADB) and the United Nations Development Programme (UNDP).

H.E. Dr. Ishrat Husain obtained a Master degree in Development Economics from Williams College and a Doctorate in Economics from Boston University in 1978. He is a graduate of Executive Development Programme jointly sponsored by Harvard, Stanford and INSEAD.

In recognition of his meritorious services, he was conferred with the prestigious award of “Hilal-e-Imtiaz” by the President of Pakistan in 2003. The Banker magazine of London declared him as the Central Bank Governor of the year for Asia in 2005. He received the Asian Banker Lifetime Achievement Award in 2006.
CAUSES OF FINANCIAL INSTABILITY

When talking about the causes of financial instability, writers usually mention four important reasons or causes. These are increases in interest rate, changes (increases) in uncertainty, balance sheet weakness issues, and institutional and regulatory matters in the banking sector. A close look at these four causes indicates that they all go through the channel of information asymmetry, which is inherent in finance. Changes in any of these four causes or factors increase the moral hazard and the adverse selection as a result of worsening the information asymmetry between creditors (the finance institutions) and borrowers.

Looking at these four causes and performing stress tests on banks and other formal financial institutions, e.g., insurance companies, the Bank of England in its report on “Financial Stability 2017” declared satisfaction with the stability of the banking sector in the UK.\(^2\) It is well-known that satisfaction was similarly expressed in many reports on financial stability just before the crisis of 2008!

More sophisticated researchers try to go a little close to the edge of the box by saying that financial instability may also be caused by factors that are characteristic of financial capitalism, including excessive credit/indebtedness, excessive trading of expectations, short-term sources of funds, lapses of adequate financial regulatory and information systems and too much inter-bank connections that cause systemic domino effect.

Interest-based lending under the assumption of profit-maximisation creates a tendency for excessive financing and excessive credit creation. A financial institution with a high rating would be able to acquire loans at favourable rates of interest, and it can always reap the benefit of its advantageous rating by extending loans to other financial institutions at higher interest rates. Under the assumption of profit-maximisation, this may continue without a limit.

Expectations trading is undertaken through options and other derivatives.

When financial institutions trade expectations, they will definitely do that at the expense of provision of finance to the real sector. The more financial institutions involved in derivatives, the more they assign financial and human resources for trading expectations. Expectations are volatile by their nature. They can always be affected by economic and non-economic factors and incidences that cause instability in the financial system. The immediate implication is that a system that accommodates trading of expectations is a system that is open to a high level of instability.

The major source of funds in any intermediary finance system, whether conventional or Islamic, is other people’s savings, which means that deposit owners would be quick to engage in a rush on the bank when they expect any deterioration that endangers their interest. Although deposits may be taken for a fixed period in both Islamic and conventional banks, consumer protection as adopted by regulators always provides withdrawal choices even with forsaking any part or all return/interest. This is an intrinsic factor of instability, which accelerates and exaggerates the effects of any initial shock to the depository, conventional or Islamic, financial system.

Furthermore, regulatory infrastructure and information infrastructure always have a lag because they are set based on yesterday’s experience. This will affect transparency, disclosure and the extent of financial engineering, all of which are causes of instability.

The 2008 crisis and several regional financial crises that preceded it played the role of eye-opener and brought to our attention deeper issues that need to be discussed, including the role of virtual assets (which were described as financial weapons of mass destruction), the separation of finance transactions from real-world transactions, debt recycling, risk trading, and the failure of interest as an allocator of resources, as it allows huge resources to be allocated for speculation. The theory of upside-down pyramid came to life again after it has been dormant for more than two decades.

These deeper factors are fundamentally inherent to financial capitalism, which basically seeks economic enrichment through activities, manipulations and “games” in the finance sector instead of exercising real wealth creation in sectors that produce real goods and services. This made the Roosevelt Institute (Defining Financialization, 2015) argue that under this new form of
capitalism the whole society is reduced “to the realm of finance,” and the finance sector lost its objective “of providing needed capital to citizens and businesses … amid an explosion of toxic mortgage deals and the predatory pursuit of excessive fees. Beyond wasting financial resources, the [finance] sector also draws talent and energy away from more productive fields.”

Accordingly, we may have to resort to some fantasies entirely outside the box and re-examine the objectives of the financial policy itself and the role of the finance sector as well. Financial policy aims at helping secure the smooth and efficient flow of factors of production to the wealth-creating sectors/activities in the economy through the provision of finance by channelling savings from the surplus economic units to the deficit economic units (including consumers) without shying away from the leveraged function of credit creation, and without bumps that interrupt or distort this flow. In other words, financial policy aims at allowing the forces of supply and demand to play their roles and give their signals in the real market without being hindered by shortages of means of payment or by elements that misrepresent the real volumes of these forces or the depth of the supply and demand that leads to unsustainable misallocation of resources.

The immediate implication of this understanding of financial policy is twofold. 1) The financial sector should always be serving the real sector and channelling resources without disturbances and leakages, thus making financial stability the main issue in financial policy. 2) The financial sector itself does not produce wealth or create value; it rather helps the real sector in its function of value creation. Accordingly, any reward the finance providers may acquire should be apportioned by real sector allocation, not by exercises within the financial sector alone. This means that financial policy must maintain an approach which forces finance provision to be channelled through means that integrate finance into the real sector.

This allows us to argue that the stabilising effect of the Islamic finance system is a result of being asset-based and channelled through sale, lease and sharing rather than being equity-sharing-based. It also allows us to refuse the claim that lumps together debts in the economy without distinguishing between debt-creating financing, which is a necessary function for the prosperity of the real economy, and debt-based finance, which is a parasitic practice on the

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side of wealth creation activities and which rather pulls resources away from
the real sectors. Islamic finance is not sharing finance; it is rather finance for
the real economy.

Of course, we may always add a developmental objective to financial policy
through its enhancement of resource recruitment to the real sector. Although
this objective is usually put on the side in the industrialised economies, for
developing countries, it becomes important where improvement of financial
infrastructure has an important role in strongly pushing entrepreneurs to
create wealth-producing projects and sustain their progress.

FUNDAMENTAL ELEMENTS IN ISLAMIC FINANCE RELATING TO
FINANCIAL STABILITY

In this section we will deal with five main policy-related characteristics of
Islamic finance, which are realism, sticking to assets/goods, minimising
speculation in currency and other markets, developmentalist approach, and
inclusiveness.

REALISM

The principle of realism is well established in Islamic Sharī’ah in general, and
in Islamic economics and finance specifically (Kahf and Mohomed, 2016). It
has several implications, including the following. 1) Islamic finance deals with
things and issues as they are on the ground in real life. This means it does
not accept presumed, imaginary or untrue matters, assets, transactions and
issues. If an asset creates a return/utility/added value then it is a productive
asset; otherwise, no assumed return is accepted. 2) As debts do not generate
utilities or increments, no wealth creation could be attributed to them, and
consequently there should be no reason for making any economic gains from
exchanges of debts. This, of course, does not imply that debt transfers are not
convenient but their convenience is not market-valued. 3) Real assets that
produce increments/utilities create wealth, which may be shared or owned
by the asset owners or owner. 4) To cite the Prophet Muhammad ( ﷺ), no
transaction is tolerated on what does not exist in reality or is not owned by
the party that makes the deal. 5) Finance may be offered in either of two
ways: on benevolence basis with no return to the finance provider or on
return basis, where the finance provider must then own wealth-generating assets/goods in order to be entitled to any return. 6) The real play of the market forces determines the shares of contributors to wealth creation. This real play must be free from any artificial or implanted distortions; examples: rejection of monopolistic powers and abstention of government pricing except for countering monopolies. 7) For a finance provider to earn any return, it must be part of the chain of processing factors of production into a productive enterprise, a thing that can only be done through ownership. 8) Financial transactions that create debts are based on real wealth-producing assets while financial transactions that are based on debt are not acceptable because they do not produce any added value. This will also include some transactions adopted by many Islamic financial institutions (IFIs), especially tawarruq, debt sale and ‘inah.

STICKING TO ASSETS/GOODS

Islamic finance is repeatedly characterised as asset-based finance. Asset-based does not mean equity-based. It rather means that finance can only be provided on the bases of ownership of wealth-creating assets or goods so that the return of the finance provider would arise from sale at a higher price in the case of murābahah and its likes, value of utility generated in the case of leasing, or return from use of assets to create value-adding goods/services in the case of equity financing (mushārakah and muḍārabah) (Kahf, 2015). In Islamic finance, resources are channelled only through sale, leases or equity contributions with the immediate implication that all financial transactions shall always be backed by real market transactions in such a way that each finance transaction gives real market signal so that at no time do the financial layers of Maurice Allais’ ‘upside down pyramid’ become more than the real market transaction layers. It also means that there will be no finance/finance transactions as all financial operations become strictly real/finance or finance/real transactions. It also implies that there will be a ceiling on finance determined by the real market transactions. Furthermore, it connotes that for each financing transaction, there will be available collateral for its risk mitigation in the form of goods/assets that make the object of finance.
MINIMISING SPECULATION IN CURRENCY AND OTHER MARKETS

While every activity of production for the market is always based on expectations with the risk of failure, we can still distinguish between trade and speculation, whereby the latter is much more volatile and a lot less associated with any real-life activities or services.

In currencies and gold and silver, speculation is reduced by the requirement of full and immediate payment as mentioned by the Prophet,ﷺ. In quasi-currency markets such as the four commodities mentioned in the same sayings of the Prophet,ﷺ, similar conditions are also required which lead to reducing speculation too. In other commodity and capital markets, speculation is minimised by the requirement of ownership and possession before any further transactions as well as by elimination of tools and behaviours that are generally described as speculative, such as sale of warrants, indexes, contracts for the difference (CFDs), betting on goods and currencies, and day trading. All these are Shari’ah maxims developed by Fiqh scholars and academics on the basis of the Prophet’s traditions against the sale of what does not exist, is not owned or is not delivered, as well as other Sayings that do not tolerate vagueness, indetermination and lack of transparency in exchange transactions.

DEVELOPMENTALIST APPROACH

When finance is founded on realism and directly associated with wealth-producing assets/goods, it becomes developmental by its nature as each financial transaction necessarily gives a direct market signal, which enhances producers to re-generate the disposed-off assets/goods (Kahf, 2005). This is so regardless of whether we finance consumers’ goods/services or producers’ goods. Furthermore, because Islamic finance channels (sales, lease and equity contributions) are transparent, they are amenable to policy-maker developmental objectives of channelling financial resources and supported economic activities toward desired sectors of the economy.
**INCLUSIVENESS**

The nature of Islamic finance, being based on a set of commonly known and recognized rules of sale, lease and sharing, which are not vulnerable to any exclusiveness measures or discriminatory processes, makes it inclusive to all people on the basis of the positive criteria of risk/trust interaction. This is unlike interest-based finance, which is discriminatory against the moral and religious values of people who believe it has vices. Contrarily, the methodologies of Islamic finance of sale, lease and equity sharing are described, adopted and accepted by all persons regardless of faith, ethnicity, colour or geographical location, as they are detailed in all commercial laws, customary practices and religions (Kahf, 2015). It has been well-documented that interest-based banking is not able to accommodate masses of people in most Muslim majority countries; a matter that creates a real dilemma for financial policy and potential disturbances for financial and economic stability (Lagarde, 2015).

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4 We must add here that the whole idea of having a Shari’ah board, and even the use of the prefix ‘Islamic’, is circumstantial and temporal, not fundamental. It is only caused by a lack of adequate laws and regulations that provide detailed definitions and description of Islamic finance transactions.
OPERATIONALISATION OF ISLAMIC FINANCE-INSPIRED STABILITY POLICY

In this section I will discuss general ideas about proposals for short-run stabilisation policies and long-run proposal as well. Both are based on the fundamental ideas of Islamic finance. I will also discuss the challenges faced in the application of Islamic finance as practised by Islamic banks today. This is an issue that allows us to understand that the actual practice in Islamic banks falls short of the values and ideas of the theory itself.

SHORT-RUN POLICY

In the short run the objectives of a stabilisation policy and its tools in Islamic finance are not much different from what is known in general theories of finance and economics. The supervisory authorities would have to continuously monitor the maintenance of resilience and sustainability in the financial sector by using the tools that have become known in the literature. Such tools apply to Islamic banks and conventional banks, whether in a dual system or in systems of conventional with no Islamic financial institutions or Islamic with no conventional financial institutions (Khan, 2015).

These tools may have some variations in names while their substance is about the same. A fact that is not explainable by the claim that Islamic finance is only an image of conventional interest-based finance, with minor nominal changes. It is rather explainable by the fact that Shari‘ah prohibition is addressed to interest-lending as a mode of finance but neither to finance itself as a way of earning nor to the economic function of financial intermediation. When we understand Islamic finance through the eye of contractual relationships that recognise debt-creating, risk-reducing contracts of pre-fixed return, pre-determined schedule of payment and collateral-accommodating nature as its main methodology, the tools of controlling, monitoring, evaluating and supervising debts do not differentiate between debts created by sale/leasing and those created by interest-based loans.

Accordingly, supervisory authorities of Islamic financial institutions, whether in a system that operates fully according to Shari‘ah or in a dual system, can continuously monitor capital adequacy through requiring certain ratios of both Tier 1 and total equity to risk-weighted assets. The thorny issue of
whether investment deposits should be considered as a part of risk-bearing equity or not is easily solved by the IFSB-introduced alpha concept where the determination of the alpha (α) becomes a matter of circumstantial policy judgment.

They can also monitor liquidity ratios in 30 days or in 360 days to maintain financial institutions’ resilience. Those liquidity ratios apply to Islamic financial institutions as well as to interest-based institutions.

Other ratios are also important and apply to both Islamic and conventional banking. Such ratios include that of non-performing finance to total finance (loans for conventional), which indicates the quality of banking assets. Several ratios of profitability including return on asset, return on equity and cost-to-income ratio are also applicable to both kinds of finance.

Another important short-term ratio that applies to both Islamic finance and conventional finance is finance-to-deposits ratio, which is not different from loans-to-deposits in conventional banks. Maintaining this ratio at healthy levels enhances the ability of a financial institution to sustain resilience and face short-term shocks. This ratio at reasonable levels can assure taming the tendency to increase finance/loans at times of attractive returns, a desire that exists in both conventional and Islamic financial institutions.

Leveraging is another area that is important in the short run for sustained resilience. It may be measured either as assets-to-equity or as liabilities-to-equity, and both measures apply to Islamic financial institutions as much as they apply to conventional finance.

LONG-RUN POLICY

The recent-past experience showed that the strong and highly damaging financial destabilisers are not all the above. Rather the real destabilisers are fundamental and structural in financial capitalism and will remain there until we are convinced to address them by a fundamental and deep reform of laws and regulations. The real reform of the financial sector and financial policy lies in the hands of lawmakers and regulators. When the Obama administration finally adopted the highly-watered reform of 2010, House speaker Nancy Pelosi said that the law was aimed at liberating ‘Main Street’ from the crippling
authority of ‘Wall Street’ and making it more difficult for Wall Street players to overtake the real market.\textsuperscript{5} What is really needed is a more courageous reform that aims at preventing players in the financial sector from distorting or abusing the real economy. This can be done by taking back finance from the hands of speculators, doing away with the illusion that loans create value or that wealth can be produced by financial manipulations, and restoring the true role/function of finance and financial institutions, which is servicing, enhancing and supporting the wealth-producing sectors. This task can only be done by integrating finance into the process of wealth creation, i.e., making finance a part of the value-added operation so that its return is legitimised by an ownership similar to other value production ingredients.

The following lines of thinking present the main components of Islamic finance-inspired reform that must be embraced in order to generate a true and comprehensive financial stabilisation policy.

1) **GRADUAL ELIMINATION OF ALL ZERO-SUM AND OTHER SPECULATIVE CONTRACTS**

As zero-sum and other speculative contracts, such as the short sale of commodities, shares and currencies, do not produce any added value and only transfer wealth from losers to winners (Kahf, 2016), they are by their nature parasitic to the real sector. They also distort resource allocation by attracting human and financial resources that could otherwise be used in the real market. At times in the past, there was an argument that these kinds of contracts provide flexibility and lubrication to the market and help absorb risks, but these arguments do not hold after the tremendous improvement in communication to the extent that real players can reach each other at a much lower risk and without any need for additional lubrication or intermediaries.

Parasitic transactions include contracts for the difference (CFD), internet currency forums, internet forex trades, trading indices, betting on currency prices, short contracts in all commodities, currencies and equity markets and the likes. It is obvious that most of the emerging markets do not have many of

the above contracts in their systems; that is a very healthy sign. Some of the regulatory authorities in the Islamic countries either allow several zero-sum contracts or attempt to do so in a bid to cope with practices in industrialised markets. We believe that this is not at all a wise policy movement, especially at a time these industrialised markets are suffering from the destructive effects of these purely speculative transactions and trying to tame and restrict them.

It is also apparent that abrupt and sharp policy actions may have negative effect, a matter that emphasises the need for a gradual approach not only in this area but also in most other reform areas.

2) GRADUAL ELIMINATION OF CREDIT, INSURANCE AND OTHER DERIVATIVES

There is a need to tame placing funds in all derivatives, especially those that are used to facilitate intensive speculation and divert huge financial and human resources away from the real sector. Accordingly, financial stabilisation policy should increase restrictions on option trading to the extent of limiting options selling and buying to hedging objectives only by de-legalising options buy/sell for all those who do not have an existing real position in the market. In other words, except under the condition of having an outstanding market position that they like to hedge, market actors may not be permitted to buy/sell options.

Furthermore, there is need for abolition and de-legalisation of securitisation of all credit and/or insurance derivatives because they only add gas to the fire. Securitisation of insurance derivatives allow the insurer to get away with its fees and throw away the risk onto market speculators; this makes the market volatile. While insurance pools risks together and redistributes them in a way that smoothens potential ups and downs in market transactions and prices and makes their outcomes more predictable, securitisation of such insurances allows the insurer to get out of the risks completely and re-divert them back to the market and the hands of its most volatile players, the speculators.

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6 One of the blessed effects of the embargo against Qatar in 2017 was to divert resources from the stock market into the real wealth-producing sectors of agriculture, as well as agricultural and manufacturing industries, so that the country moved much closer to self-reliance in many food and manufactured consumer items.
3) **GRADUAL REMOVAL FROM THE MARKET OF SPECULATIVE PATTERNS OF BEHAVIOUR**

Arguments were presented in the past for the benefits of day traders, market-makers and other speculators in the financial markets, but two important elements not related to each other took place in the last two decades: 1) huge improvement of communication and internet connections, and 2) increased ability of trading in regulated markets across political borders. Both elements created a huge platform for suppliers to meet demanders in all markets, especially money, commodity and capital markets, in all corners of the world. Under these circumstances there is no more need for that ancient argument in favour of speculators and market makers. Day traders and market makers are today parasitic units that increase volatility and divert resources away from the real market. There should be legal restrictions on day trading and all kinds of market makers by reducing market accessibility and lengthening the regulated market’s processes in all trades.

4) **GENUINISING REGULATED MARKETS**

Economists in the past used to argue that trade creates value by incorporating real services to the traded items such as risk-taking, packaging, transporting, retaining, etc. These are known in the literature and there is no need to repeat them. Also, economists used to argue that investment means real capital formation that increases the real productive capacity at both macro and micro levels. Wall Street jargon changed that by considering sitting at night and kicking a few touches on keyboard ‘trading’ and ‘investment’ that add no valued services to the traded items or any machines to the stock of goods/services that produce other goods and services. It is like supplying farmers with little laptops and having them kick on their keyboards instead of ploughing soil and planting seeds! The expansion of regulated markets to redefine keyboard-kicking as investment and trade was not a step in the right direction! We need to regularise all financial markets by restricting currency and commodity futures to only hedging of outstanding real-market positions, restricting buy/sell activities in the equity market to make them reflect changes in capital needs of industry and limiting trades in currencies to financial institutions responding to real market demand/supply of foreign exchange.
5) RESTRICTIONS ON DEBT TRADING

There are times in which genuine needs exist for transferring debt from a debtor to another (or a creditor to another), especially as a means of debt collection; this can be normally done without profiteering from the transfer, i.e., at face value and for service fees. But the large amount of institutional debt trade allows banks that create debts to get away with their risks by passing the buck on to others while making their own return from the turnover volume. In other words, they create debts without bearing the liability and consequences of their own doing, repayment and settlement, and without limiting their ability to create more debts.

Prevention of debt trading in Islamic finance makes debt-creating institutions more consciously prudent to the liability burden and risk-taking of debt repayment at the very time of creating the debts because it eliminates the potential of passing the buck on to others.\(^7\)

Inter-financial-institution debt trade should be restricted to a minimum that barely allows liquidity adjustments, collateral liquidation and debt collection so that financial institutions that create debts should stand up to the risk they undertake in their activities and should recognise the restriction debt-creation imposes on their ability to create further debts.

6) RECHANNELING FINANCE TO GO STRICTLY THROUGH SALE, LEASE AND VENTURE CAPITAL

In Islamic finance, credit is only provided through sale, lease and equity sharing (venture capital). This has several important implications for stability policy where credit issuances cannot exceed the size of the real market needs so that there will be a natural ceiling on credit creation and expansion of financial assets. Furthermore, the rate of return signal would no more be transmitted from the financial sector to the real market sectors (effect of interest rate on allocation of resources). It rather will be transmitted from the real market (in the form of part of value added of the transaction that could be allocated to

\(^7\) Debts’ trading does not create value as it only transfers indebtedness between the economic units. Accordingly, claiming a value generated in the economy, i.e., at the macro level of national accounts, is neither ethical nor true. In other words, interest generated from such inter-personal transactions does not make added wealth and should not be counted into national income or gross/net domestic product.
finance provider) to the financial market. Additionally, the size of finance will be determined in the real market by the volume of real transactions, not by the credit creation capacity of the financial institutions. The credit creation signal shall then go in the opposite direction, from the real market to the financial market.

Channelling finance through sale, lease and equity sharing would also remove interbank debt transactions which do not add value or create wealth. It would also remove securitisation of debts and its resulting destabilising domino effect across the banking system and help prevent remote financial misjudgment and mismanagement from affecting the real market.

7) NEED FOR A FINANCIAL OMBUDSMAN

The 2008 financial crisis as well as previous several regional crises indicated that the law and regulations, as well as legal and supervisory authorities alone, are not sufficient to cope with the quick changes and borderline hazy financial products engineered in the financial market. Many things may be permissible in the letters of laws and regulations while they are in real and serious violation of their spirit, intent and ultimate objectives. This makes the creation of a financial ombudsman necessary to look after events, incidences and new products at their inception and to check the compliance of new products and transactions with the spirit of the law, not only with its letters.

Central banks in small and emerging markets may be undertaking this function and taking pre-emptive measures and requiring prior approval for any new moves by the institutional players in their relatively small financial markets, but this function is certainly necessary in big and influential markets like the US, Japan and other big players in the international spectrum.

We recommend that a financial ombudsman should be established in the big and influential markets, especially that the creation of the Basel committee, useful as it turned out to be, is not qualified to take pre-emptive measures in national markets. A national financial ombudsman may be created and consist of representatives of the domestic industry, the central bank, other stakeholders such as the Commission of Securities and Exchange, business

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8 In the sub-prime process of house financing in the US in the few years that preceded the 2008 financial crisis, the appraisal system of house valuation was intended to protect financial institutions, but the actual implementation of it was disastrous to that intention as it allowed sub-prime finance.
chambers, the academia, and concerned government departments. It should be competent to take action on individual players and suggest changes in regulation to implement the spirit and intent of laws and regulations.

8) CREATE A STANDBY LAST-RESORT FINANCE PROVIDER BODY

There is always a need to shield the real sector from any mishaps in the financial sector so that financial crises would not be extended to the real sector and would not affect production and employment. This calls for the creation of a government-supported standby organisation that should be able to offer finance to the real sector if the banking finance is cut off or drastically reduced in hard times. In other words, there is always a need to create a firewall to prevent the transmission of crises from financial institutions to real market organisations. Such a stand-by fund will be activated in bad times only.

The responses witnessed in the 2008 crisis allow us to say that most affected countries spent large sums from taxpayers’ money and other sources to uphold their failing financial institutions. Such funds could be used to directly finance the real economic institutions while letting failing banks fall apart. Such standby financial institutions could be set based on public/private partnership and financed from corporate social responsibility taxes or directly from the public sector.

APPLICATION CHALLENGES

Most writings on Islamic Finance are based explicitly or implicitly on the presumption of “two-tier muḍārabah” or “al-muḍārib yuḍārib” براضي براضملا. Thus, assuming that finance is provided to its users in the form of credit/money as risk-taking equity without any pre-determined amount, pre-known profit or pre-scheduled date of repayment, this makes Islamic financial institutions a form of mutual funds or investment agents that are based on 100 percent reserves.

A minority among writers on Islamic finance argue that Islamic financial intermediaries that have as their main source of funds deposits received from the public (both investment muḍārabah-based deposits and loan-based demand deposits) not only cannot but theoretically must not brush aside the issue of pre-determination of return, amounts of financial recovery and their dates.
Accordingly, this new version of Islamic finance theory focuses on depository institutions that provide finance mainly through sale and lease methodologies which assure not only pre-fixation of amounts and dates of recovery which assures the desired cash flow but also pre-fixation of return which assures the institution’s ability to distribute periodical profits to its depositors. Furthermore, by creating debts on the finance users, the methodologies of sale and lease grant the Islamic financial intermediary institutions the ability to collateralise their assets by requiring assurances and guarantees of payment both date-wise and amount-wise.

When dealing with depository financial institutions, this new version of Islamic finance theory emphasises that Islamic banks do not and should not provide money or liquidity to the finance users. They rather provide goods and services, which they purchase on request, against creating debts which are similar to the debts created by conventional loans. However, this new theory of Islamic finance maintains that its distinctive feature from conventional banking is bearing property risk, which is a necessary Shari‘ah requirement, while both price and liquidity risks are avoided.

The new theory of Islamic finance accommodates debt creating but does not go along with practices that became frequent in many Islamic banks over the last 20 years or so on the ground that these practices not only violate the minor details of contracting, such as contract objective/intent but they also violate the very objectives and characteristics of Islamic finance that was mentioned earlier in this paper, and by converging to conventional (interest-based/debt-based) finance they lead to the loss of any possibility of having an internally determined cap on the amount of finance as we discussed earlier in this paper.

The practices of tawarruq and ‘inah violate the fundamental principles and characteristics of Islamic finance by opening a Pandora’s box of repetitive finance transactions that are not matched by real market volume of transactions simply because of the artificiality involved in these two kinds of transactions.

The reputation of these two kinds of transactions, tawarruq and ‘inah, among Shari‘ah boards of Islamic banks constitutes a real challenge for the theory of Islamic finance as the dominance of their use converges Islamic financial institutions that depend highly on them into mimicries of conventional de facto interest-based banks.
A second challenge that arises from the skewed opinions of some Sharī’ah boards of Islamic banks is the permissibility of selling and trading “Islamic debts”. Some Sharī’ah boards of Islamic financial institutions distinguish in sale of debt between what they call “conventional debts” and “Islamic debts”, and argue that debts which result from Sharī’ah-compliant transactions are sellable and tradable at other than face value, while debts of conventional banks may not be sold or traded. While this opinion runs opposite to the stance of OIC Fiqh Academy, which is repeatedly expressed in several of its resolutions, and contradicts the known classical view in Islamic Fiqh, which talks about prohibition of sale of debt at other than its face value, this view results in the loss of the characteristics and intrinsic default-risk mitigators that are mentioned earlier and makes out of Islamic finance a mimicry and watered-down version of conventional finance.

A third challenge that results from the variation of opinions of Sharī’ah boards is the invention of a kind of ṣukūk based on endless recycling of assets. The original idea of ṣukūk, especially ijārah ṣukūk, was developmental and strictly tied to the real market whereby ijārah ṣukūk can be issued to acquire or construct a long-lasting value-creating asset. This idea was distorted by some Sharī’ah boards to become the recycling of existing assets in the hands of the borrower (ṣukūk issuer) to obtain cash from investors. Thus, the ijārah ṣukūk became only a vehicle for cash acquisition and the same assets can be recycled into liquidity again and again without limit.

All the above can be summed into challenges resulting from varying views of different Sharī’ah boards. In addition, other challenges are resulting from differences in transparency and in extending the activities of Islamic financial intermediaries into direct trading of goods and services which are also related, one way or the other, to the behaviour of Sharī’ah boards of different Islamic financial institutions (IFIs).

IFIs that work in dual systems are often faced with other challenges in the process of conducting their risk management and liquidity policies effectively. These challenges essentially emanate from the lag of adjustment of supervisory regulations with the nature of IFIs who accommodate partners in place of depositors and who are required to own in order to provide finance. In addition, supervisors did not adjust their services of short-term rescue funding, including overnight funding and liquidity instruments, to the new species which is called IFIs.

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9 Sale of debt at face value is redundant and not an economical transaction because it has no return.
CONCLUSIONS AND RECOMMENDATIONS

To sum up the lessons we obtain from Islamic finance in regard to financial stability policy, we need really to look into the real causes of long-term change in the functions and activities of the financial sector, as well as the short-term causes of instability. This is because even a riba-based system can be stable in the short run although it is unjust and contains the seeds of long-term problems.

In the short-term, both the Islamic and conventional financial institutions need to be monitored for maintaining the appropriate amount of capital in relation to risk exposure, appropriate liquidity ratios, appropriate leveraging, sustained profitability and adequate levels of asset quality. Differences between the Islamic and conventional systems are little in this regard simply because both are institutions that provide finance.

However, while some economists may claim “We warned of this earlier”, short-term stability policy does not mitigate the real causes of financial disorder and the disasters that hit our economies whether cyclically, surprisingly or expectedly. The real challenge is for lawmakers and regulators to take steps to remove the systemic causes of financial instability by strongly linking finance provision and credit creation to the real needs of the economy, and by admitting—in their real practices—the fact that pure financial transactions do not generate added wealth. Additionally, we need to realise that virtual assets and transactions are, in fact, imaginations and should not be allowed to attract resources that could otherwise enrich the potentialities of the real market.

Measures are necessary to take back finance, financial institutions and the whole financial sector from the hands of speculators, risk traders and expectation sellers, and put them all back in their appropriate place within the aggregate economic mapping and to have them play their proper role of supporting, helping and enhancing the real production of goods and services through limiting their financial activities to supporting the supply and demand of goods and services as well as factors that produce them. The only way to do that is by re-channelling the flow of finance to go through sale, lease and contributions to project equity instead of being channelled through lending and exchange of debts.

Additionally, Islamic finance realises that speculations are undoubtedly part of
real life; they are built in the nature of the human mind. They are necessary for every economic or non-economic decision as long as it relates to the future. However, like any other thing in real life, we are required to limit their exercise to be within rational constraints and at the same time mitigate their potential harm to the economy through laws and regulations. Accordingly, we need to avoid trading expectations, trading futures, options and other derivatives,\(^\text{10}\) and to make laws and regulations that tame speculation not only in the financial sector but also in the real sector.\(^\text{11}\)

\(^{10}\) Whereby laws must prevent options from being able to be tradable and limit them to being obtainable only by persons who have outstanding real positions, i.e. options may either be exercised or allowed to die. Similarly, commodity and currency futures can also be limited to hedge outstanding positions.

\(^{11}\) That is to remember that the 2008 crisis in the United States started in the housing market and was carried to finance because of the strong interlinks between them.
REFERENCES


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