

MOHD DAUD BAKAR

Author of Shariah Minds in Islamic Finance

THE HARD TRUTH OF ISLAMIC FINANCE



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The Hard Truth of Islamic Finance

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INTRODUCTION

This book is essentially a culmination of all my articles published in the Malaysian Business magazine from 2016 till 2018. They were published under the column of “Hard Truth about Islamic Finance”.

In this book, I have reproduced all of those articles following the same sequence, as they appeared in Malaysian Business. I have maintained the same content and presentation but with minor additional points and editing work, where relevant and necessary.

I envisage that this book would be able to strike a balance between expectations and objectives, as well as the idealistic and realistic approaches into looking at the desired behaviour and function of Islamic finance. Some of these expectations are not wrong but they could be out-of-context or out-of-proportion. Nevertheless, we need to be truthful to ourselves and all the stakeholders of Islamic finance. One thing for sure... the truth is intensely bitter but it definitely heals.

Thank you and do enjoy reading this book and I hope this book would prove to be stimulating and thought provoking. Of course, you may have your own personal assessment and perspective on the many issues that I have raised and articulated in this book, but while reading it, please hear me out and do keep an open mind. We may look at things differently but at the end of the day, all of us want Islamic finance to be at the pinnacle of excellence.





MONEY IS NOT A COMMODITY

This column is dedicated to Islamic banking and finance. This is meant to be a thought leadership article. I'll start off by saying that many good values and virtues of Islamic banking and finance has yet to be unlocked.

We have only seen the tip of the iceberg. Most of the values and virtues are either lost in the highly technical discussion of the mechanics of all Islamic financial products and services, or diluted by the utopian and idealist expectations of Islamic banking and finance.

As a person, I like to write about something which is human and real. After all, Islamic banking and finance have emerged to serve mankind. Thus, anything to do with Islamic banking and finance must be equally human and real, instead of being robotic and dogmatic.

By now, many would have understood that Islamic banking and finance denounces the practice of interest earning (and interest expense, of course). In Islamic technical term, interest has been associated with *riba*, which is a Quranic term.

***Riba* has been vehemently prohibited in Islam for more than 1,400 years. *Riba* is not only prohibited in the Quran, but it is also condemned in both the Bible and the New Testament. When interest-based banking was about to be imported from Europe to England**

in the late 18th century, it was negatively lamented upon and strongly resisted by great English authors, such as William Shakespeare and Charles Dickens.

Was there more about this doctrine of interest or *riba* in the history of humanity? Yes, there was more to it than this. Intriguingly speaking, in the modern definition of money, which secured the consensus of many great minds in the field of economics, money has been defined as a ‘medium of exchange, store of value and unit of measurement or accounting’.

Money is a medium of exchange in the sense that we all agree to accept it while making transactions. Merchants agree to accept money in exchange for their goods; employees agree to accept money in exchange for their labour.

As a unit of measurement or accounting, money provides a simple device for identifying and communicating value. How much is that bicycle? It’s RM200. This way, we can communicate the value of anything easier and faster. Otherwise, we need to say that bicycle is worth about 50 chickens or perhaps is equivalent to one pair of suit plus one ball. You may perform this value communication – with great difficulty – but to find someone else having this counter value ready to exchange for the bicycle is much harder. Impractical.

Money also serves as a store of value. What does this mean? Money can embed its value for future use. When we are paid RM2,000 for our salary or services, we can keep this money aside for our spending in the future. If we are paid in fruits or cattle, the value of these assets might disappear or evaporate. They simply cannot store the value.

I am very happy to find this definition of money in most, if not all economics books. This is exactly why *riba* or interest is prohibited in Islamic teachings. Money is and should not be a commodity. We need money after all to buy commodities and services. But money can’t be the commodity, and at the same time, serve as the medium of exchange, unit of measurement and store of value. Catch 22? You got that right!

In the Western world, just before the introduction of a new banking structure for taking deposits on interest and giving out loans for interest, many great minds were commissioned to find the academic and economic justifications as to why interest should be legalised.

Lured to make interest acceptable, many theories were later developed, such as 'preference theory', 'opportunity cost', etc., all of which were essentially based on (or biased towards) the whole notion that money is a commodity. Money was then transformed from a mere medium of exchange to become a commodity. As money is now a commodity, any money loaned out is entitled to a premium. It was then that money lost its function as a medium of exchange.

The introduction of the first interest-based bank in the world – in the city of Venice – gave birth to the practice of interest at the institutional level. Interest was then accepted as a good and functional element to manage humanity's economic affairs. History tells us that this created a bit of discomfort to the neighbouring Vatican City – which upheld the prohibition of premium over the loan – but that resistance didn't last long. Eventually, the idea and practice of interest were conveniently embraced by all.

Islamic banking and finance, thus far, still stood up by the very definition of money, as widely articulated by the economists of the world. Essentially, in the eyes of Islam, money has no intrinsic value. On the contrary, for money to grow, money needs the element of work and risk taking.

This is known as trading in Islamic nomenclature. It is for this reason that the grand design of Islamic banking and finance has been based on trading, in one form or another. Having said that, may I pose a question to everyone; should we now rewrite the definition of money in our economics books? Also, can we manage our economic affairs without the element of interest to provide the basis of measurement or accounting? This will be a good topic for another time. Till then!





TRANSPARENCY AND TRACEABILITY IN ISLAMIC FINANCE

By design, Islamic finance must pass the test of transparency, as well as traceability. These two requirements are beyond compromise. As a matter of fact, these two requirements not only satisfy the *Shariah* compliance requirements but also, more importantly, reinforce the best practices of doing banking.

The last thing we want to do is to enter into a dubious, unclear and unknown contract, which could strike against us from nowhere anytime. Then, it will be too little and too late to do anything about it.

In all honesty, transparency and traceability could also be part of the requirements in conventional finance, but not necessarily all the time. Indeed, this is quite logical and conceivable for conventional finance.

The main underlying subject matter of conventional finance is money or money lending. Aspects of transparency and traceability surrounding money lending are very limited.

What matters most is how the borrower would be able to repay the loan on time. In the case when there is a collateral attached to the loan transaction, the issue of transparency and traceability might be more relevant, as the subject matter – in the pledge contract - has moved away from money to other types of assets.

So, in a nutshell, what does Islamic finance do? Islamic finance purchases and sells, and sometimes leases an asset, be it tangible or

intangible. Occasionally, Islamic finance invests in certain projects or ventures, either through banking or *sukuk* products.

In order for Islamic finance to conscientiously document its rights and liabilities, Islamic finance needs to know exactly and precisely what kind of asset or service or venture it's going to put its hands on. Well, we do have to look both ways before we cross the road, right?

In the bigger scheme of things, the approximation of these underlying assets is not good enough. The knowledge needs to be exact and precise. This is important to ensure a bona fide and real transaction, though this can be a little harder to do.

If we issue a Letter of Credit (LC) or Letter of Guarantee (LG), the Islamic banks must see the whole value chain of this transaction, to the extent of knowing what is being stored in the warehouses at the ports and airports.

It goes without saying that Islamic finance would denounce any investment in highly speculative instruments, to the extent that the appreciation of the behaviour of the products is half measured. The matter escalates when some products have many wrappers. In Islamic finance, we need to unlock each slice of these wrappers.

Taking the example of mortgage-backed securities – which sent many banks to succumb to failure and bailout – these securities will not pass the test of the *Shariah*, since the underlying asset, amongst other things, was not certain. Although these securities were backed by Credit Default Swap (CDS) – which was a very famous (then became notorious) wrapper then, as a kind of insurance or protection - this will not take away the duty of *Shariah* due diligence to ascertain the very essence of these securities before they are wrapped by CDS.

Equally unhelpful is the behaviour of CDS. Many of those financial institutions were tempted to buy into CDS without knowing what they

were going into. When the mortgage-backed securities crashed, so did the CDS, which was linked to the mortgage-backed securities. It was the perfect storm that caused the house of cards to come crashing down.

Truly, both transparency and traceability have helped Islamic finance. Conventional finance has learned this lesson the hard way. It was also a costly lesson. Thus, many big financial institutions have disappeared from this planet. Conventional finance suffers from inattention to the basic rules of engagement; transparency and traceability. Islamic finance survived the whole affair not by default or chance, but by design.

This, however, does not mean that Islamic finance would not be vulnerable to other financial risks. It nevertheless offers a silver lining. Islamic finance, like conventional finance, is equally exposed to other risks, such as market risk, operational risk, single customer limit risk, quality of collateral risk, etc. That said, risk is of course an integral part of life. We can't avoid risk but we can manage risks the best we could. However, by adhering to transparency and traceability, the greatest risk of all has been avoided. This is my point.

In conclusion, we need to be able to trace the ownership of an asset or service, and how it is transferred from one party to another (with or without recourse) and most importantly, its real existence and its quality and quantity, where relevant.

Everything should be certain and traceable, or otherwise, it will likely trigger the *Shariah* alarm.

Intriguingly speaking, traceability is not required for money as a consideration in Islamic teachings. Money as a form of payment could come from any source - known or unknown; Shariah-compliant or Shariah non-compliant – of course, subject to relevant prevailing laws pertaining to Know Your Customer (KYC) and money laundering.

The final message; if you are doubtful about an asset or service or venture which you are going to deal with, ask for help and ask around.

THE HARD TRUTH OF ISLAMIC FINANCE

Don't go in blindly, and if you are still doubtful about it, don't proceed, as this may breach the fundamental *Shariah* requirements.

The cost of *Shariah* breach is high, as well as damaging, as far as the Islamic Financial Services Act 2013 is concerned. What can be more damaging than *Shariah* breach, while operating Islamic banking and finance?



THE POWER OF SHARIAH OVERSIGHT

Oversight is believed to be one of the cardinal principles (if not the most important principle) of good governance. “Oversight is more than trust” is a popular mantra in the space of governance. You can’t be too trusting.

I know this can sound a bit harsh but as far as good governance or disclosure is concerned, sometimes and perhaps on most occasions, you need to be sceptical to know what you need to know.

If you like, you can trust others but you need to validate what is presented to you. Failure to validate amounts to negligence and omission of the duty of corporate responsibility.

The above conduct is not an additional and an external thing that you need to do to ensure you don’t miss the compliance checklist. It’s not by design, however. It requires an external intelligence to “smell the whole affair”.

How does Islamic finance relate to the subject matter of oversight and compliance? It’s mind boggling to discover the fact that the *Shariah* compliance oversight is a necessary practice by design. *Shariah* compliance is a built-in element for good governance in Islamic finance. What a statement!

Let’s digest the above statement. It essentially goes back to the DNA of Islamic finance. Islamic finance doesn’t and shouldn’t deal with money as it is. That’s a given. Money is just a medium of exchange.

Agreed? On the contrary, it needs to deal with something else other

than money. What is this element?

The subject matter of Islamic finance could be assets - tangible or intangible - services or a venture or project, as necessitated by the nature of the contract that the parties to the contract have entered into. The first entrance into the Islamic finance space must be backed by this element of asset or service or venture. There are no two ways about it.

No arrangement or deal will pass the *Shariah* test if it doesn't embed this element clearly in the body of the contract or term sheet or prospectus, as the case may be.

Not only must this element be embedded in the contract, but the specifications of this element must be equally identified, described, vetted and checked. Anything that falls short would be doubtful if not rejected or disapproved.

This particular requirement is so powerful to avoid any fictitious contract that could lead to any undesired consequences. The moment we scrutinise this element - which is not necessarily the case in conventional finance - we are going to discover so many specifications; the quantity, the quality, the location, the supplier and vendor, the transportation mode and cost, the charges and expenses, the clauses on default, the risk matrix, etc.

What am I trying to impress on here? This necessary oversight on the specifications of asset or service or project as requested by the *Shariah* compliance test is a good prelude to validate many other aspects of compliance, in terms of parties to the contract (such as related party transactions or simply RPT), the method of payment, the quality of disclosure, the accounting treatment, as well as the risk factors.

If this is the case, we can then have another layer of oversight; this time, propelled by the *Shariah* compliance checklist. Without realising it, in the process, we would have multiple layers of oversight which

reinforce one another.

In one potential Islamic finance transaction, I was consulted on whether a general clause of the object to be constructed can be used as the underlying asset for the sukuk issuance. It was a highway project.

I was adamant that some relevant specifications of the highway project need to be identified to provide assurance that the project is real and *bona fide*. On another deal, I was asked to endorse an Islamic sukuk structure, where the utilisation of the proceeds was not clearly documented.

In these two cases, due to the lack of sufficient and material information to back up the *Shariah* endorsement (and ultimately to protect my back), I disapproved both structures. Well, if you need to do it, then you need to do it.

So, what is so special about this *Shariah* filtering? For an outsider, this filtering is basic oversight for *Shariah* compliance purpose. Every *Shariah* officer and *Shariah* board member would need to do this or ask relevant questions about this.

Again, without realising it, this inherent and simple exercise might lead to much relevant information that a wider oversight exercise will need to vet through. To put it differently, it may have started as a normal and simple *Shariah* checklist, but it may have ended with many discoveries and fact findings which are useful for a thorough validation later.

All in all, *Shariah* filtering provides another layer of oversight on top of the existing requirements for governance. At this stage, as Islamic finance must deal with real economic assets and activities, we might discover all kinds of worms, though they may be hiding behind financial formulas. Financial formulas – no matter how sophisticated it is – can't save the deal from strict and thorough *Shariah* filtering.

In one way, the *Shariah* board, while performing the normal *Shariah*

check-up, can be the early-warning board for any irregularities in any of the proposed financial deal or arrangement (provided the *Shariah* board members know where and what to look for).

Another problem is that we don't talk about it in the *Shariah* advisors fraternity. This mustn't go on. *Shariah* board members need to be trained or retrained on this aspect. That said, *Shariah* compliance oversight is still a good ground to smell any bad practices in the market. You just need to have the nose for it, so to speak.

I am not embarrassed to admit that I have learned a lot myself from my two decades of *Shariah* practice in Islamic finance, both local and abroad. As I progress and evolve, I can see how *Shariah* oversight is a natural fit for the modern definition and practice of oversight and governance. We just need to know where and how to look at the facts of the case.

Besides, as it deals with real variables, *Shariah* oversight is indeed a real oversight. Anything that is not real will be discounted entirely and the deal will be knocked-off dead. Gone with the wind.



GETTING REAL ABOUT ISLAMIC FINANCE

For reasons not exactly known to us, many believe that Islamic finance needs to serve a financial need differently from what conventional finance is expected to do.

This belief has led to many debates and on-going “behind the scenes’ clashes within the Islamic finance fraternity for decades. What say you? Is this really helpful for the industry and its stakeholders?

Does Islamic finance need to provide different economic benefits for its stakeholders?

What is the difference between a customer seeking to get a loan under a conventional set-up from a customer seeking *Shariah*-compliant means to buy a house or to hold and carry a credit card?

Personally speaking, I can’t see the difference between the two. In other words, a human is a human, irrespective of whether he is motivated to look for *Shariah*-compliant finance or otherwise.

In a nutshell, finance is all about creating a kind of financial intermediary, be it direct or indirect. Some segments of the society won’t deal with any form of financial intermediary if they don’t need this type of offering or if they find this new way of financial intermediary as irrelevant. However, most people need to deal with a

financial intermediary in one way or another.

As for the public or retail customers, they really need to deal with financial intermediaries, more so with regards to banking facilities. They look forward to have a safe place to deposit their cash and be able to withdraw their money at any time they like or need to.

They might also need credit assistance to buy their houses and cars, and to get access to a credit or charge card. This is the main reason why people go to the bank.

In this regard, in terms of motivation, there is no difference between a person seeking to have all of these objectives met using the *Shariah*-compliant way and a person who is not concerned about the means of securing these aims, as long as their goals are met.

The same motivation and expectation are equally true with regards to the corporate sector, as well as in direct financial intermediaries, such as shares and bond (*sukuk*) and other various funds. For instance, an importer would need a Letter of Credit or Letter of Guarantee for his international trading.

Likewise, an exporter would require the help of the bank (and to some extent, some dedicated funds) to liquidate their rights to the future payment by the importer. To ensure an effective business operation, everyone needs this kind of financial service.

If you are an investor having an excess of liquidity, you may want to directly invest in a private company or if you prefer better reporting and transparency, you may want to invest in a public listed company, as public listed companies are regulated by many agencies. You may also be motivated to invest via preference shares or bonds (or *sukuk*). Some of these investment activities are properly regulated and supervised.

Is there a tangible difference between an Islamic investor and a normal investor? I don't think there is a tangible financial difference, as everyone is mainly concerned about the bottom line, namely profitability. No one wants to be in the red.

In my 20-year journey in Islamic finance so far, I have yet to come across a financial objective that is unique to Islamic finance or perhaps

a financial objective that is very much attached to conventional finance. Even in the case of conventional derivatives – which have caused many financial crises – there is a ‘neutral’ financial objective behind this financial product, which is hedging.

The fact that the practice was contaminated by the speculators shouldn’t be a cause for us to regard the game of hedging as a cart of bad apples. In fact, Islamic finance also needs many hedging strategies to hedge against real risk, such as currency risk, asset and liability, and even profitability expectation.

What is more relevant to Islamic finance is to find alternatives or solutions to develop *Shariah*-compliant products to meet all of these financial objectives. There is a strong demand for the actualisation of these objectives, and Islamic finance is expected to fulfil this demand but this time, it will be done in consonance with the *Shariah*.

Islamic finance didn’t come to create new demand because the demand was normally created by humans. Islamic finance is not in a position to create new demand, as this will be detrimental to the shareholders. You can’t simply sell what you want. It’s the customers who decide on what to be on the shelves.

Referring to my opening remarks in this article, unfortunately, some Islamic finance stakeholders are convinced that Islamic finance, particularly Islamic banking, must be different in terms of its objectives and motivations.

According to them, Islamic banking, amongst others, must embrace equity financing, instead of debt financing. Not only are they convinced but they are also adamant that the current version of Islamic banking, which is seen as mimicking the same economic benefits and behaviour of conventional banking would ultimately mean that the current Islamic banking system is not fully *Shariah*-compliant.

They have also contended that being similar to conventional banking in terms of fulfilling the current needs of the customers has brought shame to Islamic banking.

Perhaps some even opine that the current version of Islamic finance does not fulfil the objectives of the *Shariah* (*maqasid al-Shariah*) and is merely an analgesic for the ‘ailments’ of the conventional financial system.

According to them, Islamic finance has become ugly and lacks of legitimacy. I guess this would be a matter of preference but some parties like to impose their will on others. Consequently, this would create a kind of arbitrage in the same financial market.

In the final analysis, we can go far but we can't go too far. We need to understand what the main task of any financial system is and how is that connected to the motivation of the shareholders and the grand design of a financial market.

Perhaps the idea of equity financing is a great idea but it would need a new type of shareholders (and depositors) and a new landscape altogether, which is different from a banking environment.

It's not wise to be different for the sake of being different. If it has to be different, then it must be for a valid cause!



OLD SHARIAH CONTRACTS FOR NEW FINANCIAL REALITIES

It is an open secret that the variables of life are always changing. Change is bound to happen regardless, and sometimes, life even throws you a curveball. This fact transcends all dimensions and styles of life, as well as times and geographies. The needs of humans are infinite, be it financial or otherwise.

Fortunately, the *Shariah* has never curtailed these changing needs, as long as it is useful and beneficial to humanity within a certain set of religious parameters. On the contrary, any attitude to limit the needs of humans will unnecessarily backfire upon humanity's wellbeing.

In the journey of modern Islamic finance for the last 40 years, it's rather intriguing to discover a certain principle of the *Shariah* which was not that relevant at the time it was first mooted, but it turned out to be of great relevance to our new realities of financial dealings.

Perhaps this is the only reason why the *Shariah*, which was revealed more than 1,400 years ago, has been able to impress humans across ages and centuries. It has the structured thinking algorithm to ensure it remains relevant and fashionable throughout the eons. I will provide some examples later for you to consider.

To be stagnant, fixed and conservative does not necessarily reflect an accurate and proper *Shariah* manifestation. Many people may get it wrong here. In order to progress in Islamic

finance (as well as in other areas, such as fashion, entertainment, sport, employment, lifestyle, education, etc.), there is no need to be more strict and conservative but to be more useful, relevant and impactful.

What do we call this approach? An inquisitive and solving mind.

Let us consider one or two examples to put this theory into practice. Undertaking or simply known in the technical *Shariah* term as “*wa’d*” was mooted in the past amongst the classical Muslim jurists.

While they are divided on the legal implication of undertaking (or promise under the English common law), a few schools of legal thought have made their stand firm, that is undertaking or promise, when given or spoken, will be binding on the promisor towards the promisee. Not only that it is binding, but his promise may implicate him to pay damages for any actual loss suffered by the promisee arising from his breach of his undertaking or promise.

The necessity to really pin down on the binding-ness of this promise may not be relevant in the past, as the market was relatively small and most of the transactions were conducted by physical meetings and conducts. Future expectations and deliveries were not the norm. Or perhaps, the urge to stand by one’s word was arguably embedded in the community’s nervous system then. No matter what the reasons were, we must acknowledge the fact that we are now living at a time when all forms of commitment and security are needed.

The trust element is shrinking. The time has come to ‘rediscover’ how the classical Islamic jurisprudence books had ever thought on protecting the legitimate expectations of the parties to a contract or a future contract. True enough that *wa’d* or undertaking has been one, if the not the most important vertical in contemporary Islamic finance. It has spread its wings in many areas and practices of Islamic finance across the board.

An old artifact has become the most needed item. Awesome.

This is quite normal in the study of the *Shariah*. What used to be

less important at one era could be the most important principle at another time and vice versa. This is an open secret why the *Shariah* has and will always be relevant and evergreen. The biology and chemistry of the *Shariah* are made of flexible features.

In a literary study, a student will be tasked to identify the different themes and topics in a novel or book. While many students would be able to easily identify as many topics as possible as they read the novel, only a few - and sometimes only under strict coaching and mentoring by their learned and experience teachers - could unearth the theme or themes of a particular novel.

The same goes for the Quran and the Sunnah of the Prophet Muhammad (PBUH). There are themes, as well as topics inside them. Similar but not the same.

On the issue of fulfilling one's promise as mentioned a few times in these two sources of the *Shariah*, some scholars would have looked at the issue from a legal perspective, namely the topical issue of legal ruling. Others have, however, compiled all the relevant Divine texts to underscore the grand theme of these texts. Using this methodology of trying to understand the real message of the *Shariah*, they would have likely arrived at a theme which is more superior and far reaching.

What is this theme then? Any promise would have necessarily created some expectation on the part of the promisee. That's a given.

An expectation may, however, lead to some commercial eventualities, which may be detrimental to the promisee if the promisor were allowed to walk away from his undertaking. It appears that the Divine theme is the obligation to satisfy the expectation and to remove any pain or loss caused by any breach.

By scanning the entire landscape of modern Islamic finance, we could see how many old contracts in the body of the *Shariah* - which are thought to be obsolete - are now being revived once again to meet the new requirements. This is an amazing journey of

rediscovery.

Examples include forward lease (to finance asset under construction via leasing), the permutation of classical *murabahah* to modern or financial *murabahah*, which is based on a firm order by the customer, the sale of intangible assets, the conclusion of the contracts via modern techniques of communication instead of physical meetings, the instruments to liquidate assets for liquidity purposes, etc.

A more interesting takeaway of this rediscovery is that human intellectual and practical experience in the past – either in the Islamic civilisation or other civilisations – are always useful for our wellbeing.

At one point in time, these old artefacts might be invaluable for us to solve our delicate humanity issues. So, what does it mean for you and me? Well, it would be wise for us to not be obsessed with our current stock of knowledge and experience. The journey of finding the right solutions and remedies for humanity in all dimensions of life is a long one; a journey that transcends our biological age.

Respect every source of knowledge and wisdom - both new and old ones (and of course the past generations).



RISK AND GOVERNANCE IN ISLAMIC FINANCE

Islamic finance, though inspired and guided by the teachings of Islam, is overwhelmingly human in character. This is an understatement. Islamic finance is essentially motivated and influenced, as well as implicated by both human preference and conduct.

It's unconceivable to come across such a statement that Islamic finance, by design or default, is not exposed to any financial crisis or any financial failure. It's a naive statement.

Why am I saying this? Islamic finance is based on a certain set of principles to avoid certain prohibitive elements in financial dealings, such as *riba* (interest), *gharar* (uncertainty), *maysir* (gambling or game of chance) and other practices which are not in consonance with some maxims of Islamic commercial law, e.g. capital guarantee.

This is within the Divine guidance and intervention, so to speak.

However, it doesn't necessarily imply that if we avoid these practices, our Islamic financial industry will be immune to credit risk, market risk, operational risk, fraud and manipulation. The latter refers to human behaviour and human misconduct.

Realising this fact or hard truth about Islamic finance, then naturally, Islamic finance must be regulated and governed by the same prudential standards and strict governance on risk and governance.

Financial crisis will still have an impact on the Islamic finance industry if we fail to manage concentration risk of both assets and customers.

True enough, from 2008 to 2010, Islamic finance was hit by the big crisis, not because we played the Credit Default Swap (CDS) game or anything along that line – as was the case in the West - but because some of our Islamic banks were too exposed to the property sector at both the bridging and end financing stage, not to mention a noticeable concentration of property portfolio in the balance sheet of many Islamic banks.

When the property sector crashed globally, our Islamic house financing was equally squeezed.

Many cases of default occurred in the Islamic banking sector, as well as the *sukuk* market. Many landmark *sukuk* default and restructuring cases were making headlines around the globe. “Islamic Finance is Defaulting and Collapsing”, for example, is one of many highlights in mainstream media back then. Fair enough.

We need to face the hard truth and deal with it intelligently. Being pantophobic won't do us any good.

We shouldn't be intimidated about this state of affairs. It was the result of our own doing. We simply failed to follow the strict guideline on single customer limit, as well as asset concentration.

Be bold enough to shoulder the responsibility and don't blame others. Being *Shariah*-compliant will not save us from the fiasco caused by human failure to observe all the prudential standards and many other best practices, as laid down by the international community and the respective regulator. Worry not. Don't allow this to be a dead end but instead, this perceived dead end can lead to new paths.

What is the moral of the story then? Islamic finance stakeholders can't hide behind the veil of *Shariah* compliance to put aside and downplay the importance of the risk management discipline and governance standards. On the contrary, they should be more attentive and serious to follow the highest standards of compliance and

governance.

They may have a *Shariah*-compliant credit card that has been approved by their reputable *Shariah* committee and this product may have been embedded with the latest technology and features to make their credit card “the sought after” Islamic credit card in town.

However, if they fail to follow the proper marketing standards and ethics, leading them to sell this card to the public through misrepresentation, lack of disclosure, lack of customer background checks, to name a few, then they are as guilty as many other conventional credit card issuers in town which commit the same mistakes.

Yes, it’s true. The *Shariah* compliance process and oversight can provide another level of scrutiny to each Islamic financial product that is offered to the public. But the *Shariah* compliance value chain is only effective if it has been accorded with proper care and support by the management – at the fabrication stage.

However, when the product is rolled out to the market, the *Shariah* compliance aspect ceases to be functional. It now comes under the custodianship of the management, from credit assessment to execution to advertising and marketing.

Be mindful that at each layer of this supply chain, there is a written and embedded regulation and guideline – both *Shariah* and governance – to be adhered to. This is how a financial market should behave for the greatest interest of the community at large.

What does the *Shariah* fraternity need to do then? A lot, I must say. The *Shariah* fraternity, from the (external) *Shariah* committee members to the *Shariah* officers who are on the payroll of the Islamic financial institutions must oversee the whole transaction flow up to its completion.

If the *Shariah* fraternity has no locus standi or access to some facets of the process flow, such as risk assessment (covering credit, market and operational risks), then they need to articulate clearly what is the *Shariah* requirement and expectation on each of these aspects.

At the very least, they need to discharge their duties by providing

THE HARD TRUTH OF ISLAMIC FINANCE

The Author

Datuk Dr Mohd Daud Bakar is the Chairman of Amanie Group and is one of the leading global Shariah advisors of recent times. Currently, he is the Chairman of the Shariah Advisory Council at the Central Bank of Malaysia, the Securities Commission of Malaysia and the Shariah Supervisory Board of First Abu Dhabi Bank. He also sits on the board of directors for Sime Darby Property Berhad, and a member of Permodalan Nasional Berhad's Investment Committee. In addition, he is the owner and Editor in Chief of Malaysian Business Magazine, Malaysia's oldest business magazine.

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Gear up as Datuk Dr. Mohd Daud Bakar knocks the hard truth of Islamic Finance. In this Malaysian Business compilation, the industry specialist aims to strike a balance between expectations and objectives, as well as the idealistic and realistic approaches into looking at the desired behavior and function of Islamic finance.



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