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A critique of Islamic finance

Islamic finance signifies financial services, mechanisms, practices, transactions and instruments that comply with the provisions of the Quran and the Sunnah.

There are more than three hundred Islamic financial institutions (IFIs), with assets close to $1.9 trillion, in 50 economies across the globe. Islamic finance has experienced immense growth in Muslim as well as non-Muslim countries.

While there are similarities between Islamic and conventional financial systems, certain principles and restrictions are exclusive to Islam. For instance, Islam treats money as a medium of exchange, not a commodity; Islam requires the provider of capital to share the profit as well as the risk; and Islam prohibits Riba, Maysir, and Gharrar. In fact, these norms have rendered certain conventional financial practices and transactions void for Muslims.

The prohibition of Riba is one of the strongest restrictions. A majority of scholars believes that interest, usury and all other practices that result in unjustified gain constitute Riba. Maysir signifies gambling. Gharrar signifies uncertainty. Due to these restrictions, Muslims cannot deal in interest, futures, options, derivatives, lotteries, etc. Also, Muslims cannot deal in prohibited goods and services, such as alcohol, casinos, pornography, etc.

Some Muslims have absolute faith in Islamic finance, but others question various aspects of present-day Islamic financial products and services

The prevalent Islamic financial transactions can be classified as: deposit products, equity-based financing products, debt-based financing products, fee-based services and miscellaneous products and services.

The main deposit products are current deposit, savings deposit and investment deposit. The main equity-based financing products are Musharaka and Mudaraba. The main debt-based financing products are Murabaha, Ijara, Salam and Istisna. The main fee-based services are Wakala and Kafala. Miscellaneous products and services include Sukuk and Takaful.

While some Muslims have absolute faith in Islamic finance, many others question various aspects of the present-day Islamic financial products and services. These Muslims are not against the concept of Islamic finance. However, they refuse to accept Islamic finance in its current form.

It is often alleged that the theory and practice of Islamic finance are not consonant with each other. While the pioneers of Islamic finance called for using participatory modes — Musharaka and Mudaraba — the debt-creating modes are also being frequently used.

IFIs routinely conduct business on the basis of fixed rates and earn fixed returns. Even in participatory modes, IFIs charge market-based rates on their investments. They routinely use interest-based benchmarks, such as the London Inter-bank Offered Rate, to price their products and services.

IFIs routinely take collaterals while conducting business. They do not facilitate people who are unable to offer collaterals. As IFI's are always secured because of the collaterals, they actually never share the risks with their clients. Also, IFIs are never lenient towards genuine defaulters.

While striving to provide Islamic alternatives to conventional financial products and transactions, IFIs often simply replicate, in substance, conventional financial products and transactions. Consequently, Islamic financial products and transactions are similar, in substance, to conventional financial products and transactions.

Islamic financial products and transactions, compared to their conventional counterparts, are often inefficient. For instance, instead of a single contract with a one-time government fee or stamp duty, they usually involve two or more contracts, government fees or stamp duties.

Islamic financial products and services are not standardised. One can easily notice the variations not only between different countries, but also between different IFIs. This is due to the diverse approaches within Islam because of the different schools of Islamic thought. For instance, scholars in Malaysia are more flexible than those in Saudi Arabia. This lack of standardisation has given rise to a number of inefficiencies.

In most countries, IFIs work in the same regulatory environment as conventional financial institutions (CFIs). The standards set for the regulation of CFIs are not always appropriate for IFIs.

While setting up Islamic windows or Islamic branches, CFIs often allocate Riba-tainted funds as the base capital. How can the products and services offered by these windows and branches be deemed Islamic?

IFIs are competing with each other as well as with CFIs and their Islamic windows or Islamic branches. Therefore, in order to stay competitive, IFIs are not only offering a large number of products and services that are similar to the ones offered by CFIs, but also constantly trying to come up with new ideas. However, while trying to prove Islamic finance a viable option, Islamic financial experts must ensure that it remains Islamic in substance.

By truly implementing the principles of fairness and justice, as prescribed in the Quran and the Sunnah, IFIs can attract a large number of investors and depositors irrespective of their religious beliefs. For instance, in Europe and North America, there are a growing number of people who are in favour of ethical finance.

As the real Islamic financial principles have much in common with ethical finance, it should not be difficult for IFIs to appeal to the proponents of ethical finance by sincerely adhering to the true Islamic financial norms.

Islamic finance has had tremendous growth over the past decades. It has further potential for growth. However, there are certain Islamic financial practices that need to be either amended or discontinued.

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