Discussions /Dialogues – Islamic Economic Forum

Topic: Profit and Loss Sharing (PLS) - Dr. Daud Bakar's Thesis

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Summary of the Discussions on

Profit and Loss Sharing (PLS) with Dr. Daud Bakar's Thesis:

Five (5) Reasons Why Profit and Loss Sharing (PLS) Financing Does Not Fit Islamic Banks

&

5 Reasons Why Islamic Banking Can't Do Real Trading Bearing All The Risks

held in **Islamic Economic Forum**

Started on 24 March, 2017

Brief Introduction to Islamic Economic Forum:

The Group with the title of "Islamic Economic Forum" is for Islamic Economic Professionals – Sharia Scholars, Economists, Professors/Researchers and IF Practitioners for the purpose of positive discussions on various issues and challenges, facing the Islamic Economic Industry in order to explore ideas and solutions, pertaining to Islamic Economic from an economic as well as Sharia perspective. Since there are already various forums devoted to Islamic Economic, this forum is expected to have more emphasis on critical analysis as well as up to date information with the latest market movements, analysis, and research. The ideas generated will be for the benefit of the Islamic Economic Industry globally.

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Islamic Economics Forum Dialogue:

The discussion was initiated by **Sheikh Khalid Hasani** posting on behalf of Dr. Mohd Daud Bakar the following:

Dr. Mohd Daud Bakar at Oxford Centre of Islamic Studies (OXCIS):

In my conversation and engagement session, I articulated why profit and loss sharing is not suiltable for Islamic banks and why Islamic banks, while doing Islamic trading, must uphold the main function of financial intermediary so as not to compete with real economic players. Fiduciary functions and trust cannot be compromised no matter what.

I have also mooted that the time has come for big data analytics in our study of Islamic finance and even for Shariah studies. The result of big data analytics exercise should also be made available to the public at affordable cost....towards democratisation of data.

- **Dr. Humayon Dar**

I am writing a book to be entitled "Problem With Interest-free Banking", which takes a diagonal view to respected Sheikh Dr. Daud Bakar on the matter of Islamic banks and their functions of financial intermediary. If Islamic banks do not do "real" trading but rather are involved in "financing" of trade activities in such a way that they use an interest rate mechanism (LIBOR, KIBOR etc.), then the proponents of Islamic banking and finance, including Shari'a community, admit that interest rate mechanism is the best/efficient process for price finding and its determination.

The use of an interest-based benchmark along with "non-competition" with the "real" economic players is also a soft way of saying that Islamic banking and finance has nothing (or very little) to do with the real economy.

If that is the case, then all those (including me) who have been writing about superiority of Islamic banking and finance on the basis of its possible contribution to the real economy and hence it being more stable than conventional banking and finance, have been faking.

The pure fiduciary role based banking model has all the hallmarks of an interest-based financial system, and I am sure this is not what the early advocates of Islamic banking and finance intended to see.

wa Allah a'alam bi al-sawab

- **Almir Colan**:

Interesting. Perhaps the time has come to discuss the role of banks and financial institutions in society.

- **Dr. Mohd Daud Bakar**:

Noted my dear Dr Humayon. I will articulate later the necessary foundation of my thesis: [Five (5) Reasons Why Profit and Loss Sharing (PLS) Financing Does Not Fit Islamic Banks]

- **Wafa Nasr**:

This is the start point of thinking out of the box and finding the right means for right ends.

- **Dr. Ugurlu Solyo**:

That's actually a good argument, you cannot ignore.

But as you know you have to differentiate between market or price mechanism and *riba*.

As far as I understand our prophet stressed the exchange of different goods as to distinguish between ribs and trade, but not the price mechanism. On several occasions he pronounced the importance of it and its freely occurring.

Thus there is no wonder that also for the riba system and its surrogate markets (riba free) the price mechanism is the most efficient system. That should not surprise.

The question is whether the real economy could act independently from the financial system. When this is given, the question would be how riba free Banking could contribute to that.

Presently it contributes hardly to the arise of that any alternative systems.

- **Dr. Tariqullah Khan**:

The question raised by Dr Dar is pertinent in my view. However, the financial intermediary role is dominant. I think financial intermediaries can play a key role in developing the real economy if of scholars can reduce their differences. How can a typical financial contract be halal to some and haramr to others! If the scholars can agree that tawaruq etc are either halal or haram, we can progress a lot. In the early nineties the question of Dr Dar was very much debated but the dichotomy of halal/haram was not so serious. I wrote my humble PhD in Dr Dar's Loughborough university on the same question and the thesis can be downloaded here. https://dspace.lboro.ac.uk/dspace-jspui/handle/2134/6960

- **Dr. Manelle bin Sultan**:

Very good point to be raised at this time in light of the market status, however interest-free is not the end objective of Islamic banking and finance, the limitation of riba is a mean not an end. I do agree with Dr Humayon, we need to get out of the dominating views and create the needed change that enabled the compliance with the teachings of Islam and realise its objectives, which is possible.

- **Dr. Sahar Ata**:

I agree with you Dr. Manelle bin Sultan and of course Dr Dar it is time to create that change but we have to change as well, it is a change of mind set and behaviours nothing will happen till we believe in this. If we continue doing the same thing we contain getting the same result . Hopefully this won't be in discussion in 10 years .

- **Dr. Hurriyah El Islamy**:

Masha Allah, I have the highest respect to Dato' Dr Daud Bakar being my former lecturer when I studied in UIA. Nonetheless I beg to differ in this respect. I am championing for Islamic/Syariah compliant banks to be true to the values and spirits that Syariah meant to serve, to participate in real value creations, to be given the regulatory supports to allow it to conduct business including by using profit-loss sharing kind of arrangement. if islamic banks have to behave differently than its conventional counterparts then be it and the regulatory framework should be laid down to support rather than oppose that.

- **Maharlika Kristal Alonto**:

I Agree.

- **Dr. Ugurlu Solyo:**

In Turkey the regulator differentiates and requires lower equity for PLS-accounts as the Participating Banks could shift some of the risks to the customer.

- **Dr. Sahar Ata** (Response to Dr. Hurriyah)**:**

Yes if they change, regulation will have to adopt and change but because they confirm there no need for change . Regulation come after the demand or this what is been happening . We have many examples green bond is one of the Islamic finance industry is another one . So let them start the application or the demand for these applications or the frame work. Then the demand for regulation to adopt for change will take place. The question here is there is a will to have a real change !!!

- **Muhammad Wail** (Response to Dr. Ugurlu Solyo)**:**

IFSB standard 15 goes also in this direction (standard formula) *[Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services Excluding Islamic Insurance (Takāful) Institutions and Islamic Collective Investment Schemes]*

- **Dr Mohd Daud Bakar**:

Five (5) Reasons Why Profit and Loss Sharing (PLS) Financing Does Not Fit Islamic Banks

As much as we would like to see PLS operational in our current Islamic banks, there is a structural problem that hinders this vision and dream of many to become a reality of life. PLS, generally speaking, is very functional in other areas however such as stock market, venture capital, private equity, partnership and companies not to mention series A and series B investors before VC and PE come into play. We need to do more PLS in this area.

Why a bank, Islamic and conventional, must avoid PLS in the asset side or financing? There are at least 5 reasons as far as I am concerned.

First: The very essence of any bank set up is to provide financial intermediary that is taking deposit and providing financing. An Islamic bank cannot be the trade operator nor equity partner in any venture. If they were to do that, they are going to compete with real traders and venture operators. A bank cannot be both deposit taking and business owner. To combine two functions in one entity will create advantage to bank over another entity; thus not healthy. In this world of governance and best practices, any combination of two conflicting functions (e.g. legislative and executive, investigation and judiciary, deposit taking and business owner and business operator) is a recipe of failure and disaster. If we were to allow an Islamic bank to have an equity stake, we have to allow all business owners and operators to take deposit at a cheaper cost of fund to create a level playing field. Can we do that?

Second: Arising from the above, the act of equity ownerhsip by an Islamic bank in any business with his selected partners and business operators will trigger the fiduciary relationship and duty between this bank and his other potential clients and partners. Surely, this bank could potentially benefit from the business proposal from others (asking for either debt or equity financing) to his own benefit and advantage as it has also its own interest in the same business line. Being a financial intermediary, this Islamic bank will have no business interest other than financing and taking the profit from the spread and just managing the credit risk. However, being a business owner, they are tempted and motivated to take advantage from their other clients that could breach the fiduciary duty. Above all, no client will approach this bank anymore as the trust has disappeared. Rightly so. Honestly speaking, do you want to share your IP, business plan, marketing and distribution strategies with your potential competitor? I for one don't want to do that. It's harakiri. Plain and simple.

Third: The administration cost will escalate because the Islamic bankers need now to be involved in real business. If the shareholders are happy to do that, then I will rest my case. Why should the shareholders be keen to do this kind of business through a licensed bank? They can simply achieve this objective through other vehicles which are more cost effective.

Fourth: The moment the Islamic deposit being used for PLS financing, the Capital Adequacy Ratio (CAR) under Basel III will increase. Meaning the Islamic bank(s), need to increase equity capital or tier 1 or tier 2 capital through sukuk. Technically speaking, Islamic banks need to have a higher capital compared to its conventional counterpart. If the shareholders are fine with this, I will denounce this particular argument.

Fifth: New accounting standard under IFRS of marked to market. If Islamic banks have real exposure as the equity owner, all assets and liabilities must be subject to marked to market. If Islamic banks are keen and willing to do this, well and fine. Islamic banks have become a real business company by definition.

This is my thesis why I don't think that PLS fit modern Islamic banks. Don't take me wrong. I am not against PLS. PLS is a valid Shariah contract. Just that it does not jive well with the intended function of an Islamic bank unless we are all happy to make our Islamic banks competitors and rivals to real economic players amongst the contractors, builders, logistic and warehouse operators, manufacturers, etc. Under this regime, Islamic banks would become big companies controlling the whole value chain of business from deposit taking to financing to equity ownership to owning and operating hospital and power plant.

As for me, I don't subscribe to this notion as I believe in separation of functions. Every organ or entity has a function to play. Conflict of interest and trust deficit must be avoided.

Hope this is useful. I have however my own version of how to make our Islamic banks more effective in financing real economy. Perhaps this can be articulated in the next session.

Please share this post and feel free to comment and disagree. Engagement is healthy and productive.

Dear Brothers and Sisters, this is my respond to the issue that I have raised yesterday.

- **Dr Muhammad Iman Sastra**:

Thank you very much Dr Daud Bakar for the sharing of your valuable thoughts.

- **Mujtaba Khalid**:

Regarding the 2nd point, don't business owners already share information with venture capital firms and angel investors etc? They don't seem to have any issue sharing with them, why would they have an issue sharing with a PLS based bank?

Regarding 4th, I think it will be the opposite ie no buffer requirement at all! If the bank and it's customer are willing to share both profits and losses, why the need for a buffer? Maybe a PER just to help smoothen returns.

- **Dr Muhammad Iman Sastra**:

I don't know whether you understand or not with the above statements of Dr Daud Bakar. Since your question is not reflected what is stated by him. I believe who are in the industry will understand with his statements.

- **Ahmad Ali Siddique** (Response to Dr. Mohd Daud bakar):

Assalam o Alaikum Dear Respected Members,

I would respectfully differ from the above and take an alternative model for Islamic bank. We see Islamic banks as a trading house and Investment company that needs to involve in real trade and business. Having its own warehouses, showrooms, trading arms, real estate and car rental fleets and so on.

As we are taking on real trade and business so we need PLS deposits to grow our business on a partnership based mode that is working under proper rules and regulations. So a common customer has more trust on an Islamic bank as their business partner then any joint stock company where the business is controlled by few majority share holders and most of the time their commitment to Shariah is almost zero or near.

Luckily our Central Bank in Pakistan is also thinking on these lines and they are thinking to allow Direct Trading and Investments to Islamic banks so they can earn real trade profits and could share these returns with the PLS deposit holders.

- **Dr Muhammad Iman Sastra**:

I will explain you first point only:

Dr Daud Bakar states that since the Islamic bank is the financial intermediary, not business operator, off course the customer will share the information because he is not the competitor not interest with that business. If the Islamic bank you ask to be a real business operator (to do partnership and PLS), the customer will not share the bank his data.

Your question: you talk about venture capital and angel investor. Then issue of sharing with the PLS bank.

- **Dr. Hurriyah El Islamy** (Response to Dr. Mohd Daud Bakar):

More reasons why we should not view Islamic finance from conventional eyes.

This is in response to Dr Daud's write up why Islamic banks should stay as intermediary. He gave five reasons to support that. The hypotheses, I would say, were correct if we view Islamic banks from conventional eyes, if we continue trying to place Islamic banks within conventional mould. But is that how it should be?

Let's take a few steps back; let's evaluate the purpose of having Islamic banks. Is it just to provide banking free of riba? Or we want to actually create true Islamic institutions serving the public's need for banking services (including financing) in a manner blessed by Shariah?

Forcing Islamic banks to fit in conventional mould will result in only one thing: Islamic banks will be forced to behave like conventional banks and that will result in overuse of tawarruq, eliminating creativity and 'killing' the spirit Islamic muamalah seeks to serve (including serving the maqasid shariah as well as creation of values).

We have a real example of that: Malaysia post IFSA. banks can no longer take deposit unless it is capital guaranteed. The industry is racing as to who can first introduce the system sophisticated enough to allow very 'organised' and fast tawarruq so eventually they can offer tawarruq as the basis for deposit. Why? Because right now wadiah is the only commercially viable option and yet the industry feels something is not right about continuously giving hibah while taking deposit as shariah compliant (but not giving it run the risk of depositors shifting to competitors).

Let's view the matters from the eye we should, from shariah view point rather than regulatory or otherwise.

First ground, if bankers become traders create uneven level playing field between bankers and traders. Any data to support that? I have seen quite the opposite. In Bahrain, there's an institution where they have a mall, selling cars and providing financing for any customers buying car from them (ie, paying by instalment). To achieve economic value is not about having more money at lesser cost of funding. One can offer better price by understanding the market demand and having good supply for the products. That something traders can do but not bankers. Bankers are not traders from regulatory point of view. Even when bankers trade, they do this to serve financing objective rather than anything else. I have witnessed an Islamic bank continued making profit from this activity even during financial crisis, when banks mostly experienced loss and many conventional banks went bankrupt. Banks won't be a threat to local trades. On the contrary, banks will become their trading partners because banks won't go to the source to get the supply, instead, they will partner with local traders who will provide the supply as the needs arises. In fact, I am now mooting for one institution to come out with another type of mall (the idea is still confidential to protect the business interest, hence, I cannot make full disclosure yet) where the bank will have MOUs with local traders, have items available for sale (while putting risk mitigation approaches in place) and provide financing to the public who would like to purchase those items. This will be a win-win kind of arrangement. Traders can now have access to wider market and bankers can now provide financing in a more shariah compliant manner.

Second – fiduciary duty that may create conflict of interest. Will it? I don't think so. On the contrary, ethical business, ie, caring about where the money goes, how it is being invested is something that should differentiate Islamic banks from conventional ones. To say that Islamic bank should not have business interests other than financing is a standard set by (whom? Conventional banks? Regulators? Whoever sets it, definitely not shariah). Now, we do istishna' in acquiring the house for our client. Isn't that good if the bank, as the owner, will have fiduciary duty, will exercise better diligence in ensuring that the house will be finished and delivered to the customer. Even if the bank will not go to the extent making sure that the developer will perform, at the very least, the bank will do proper DD as to the ability of the developer to deliver before providing financing to the customer and in some country, the banks even enter into agreement with developers to ensure contractual performance by developers and to mitigate the risk of non performance. Having interest in the project is not always a negative thing. Now it is interesting when it's said 'business owner would be tempted and motivated to take advantage from their other clients that could breach fiduciary duty" – how so? Taking advantage from any clients (competitor or otherwise) is not something Shariah will allow. Islamic banks cannot operate their business in such manner. They cannot even depose their money without the sanction from the Shariah board, I wonder if there will be any shariah board that will allow Islamic banks to behave in such manner. If the threat is not real, shall we deprive Islamic banks from its prospect to serve Shariah in better way due to such fear? Sharing IP, business plan, marketing and distribution strategy, aren't these assumption went too far? I have seen Islamic banks went to equity based investment, partnership, etc. We did share our plan and view as well as strategy as to what we intended to do with the object (investee) but not that of the banks, we invest in them, not they invest in us. Plain and simple.

Third – administration cost will escalate. How? Banks will not transform themselves into pure traders just because they can do PLS. They do PLS because they want to provide financing in manner consistent with Shariah (not merely avoiding riba). The objective remains the same, ie, to provide financing, not to change the institutions to trading entities nor to undertake business in other areas. One with clear comprehension of the AOA and the nature of license will easily see that. trading is not their main objective (hence the license). the reason why they 'trade' while providing financing is because the objective is to provide financing and at the same time recognise the importance as to the method and manner how it's done – not to trade per se. To say otherwise is like saying the only way to minimise cost is to continue just taking fee (seldom fixed, most of the time its factor to the capital and hence, to me, it's a back door to riba) or to do tawarruq (which could be the option of lesser evil but should not be resorted too when other principles of shariah can serve the objective of financing).

Fourth and fifth are true but this what I have been arguing over and over, why 'judge' Islamic banks from conventional standards? Why do we have to force Islamic business from conventional mould? It is easier for the conventional banks to do that because they mainly operate on riba generating/paying loan (either taking or giving) while that is the very substance we, islamic banks, must avoid. We acknowledge the increase of burden (in CAR requirement, etc) on islamic banks for doing business in a more shariah acceptable manner because the Shariah requirements were not taken into consideration when those standards were set. The question is, should we strive to have man-made rules corrected to suit or to adapt to Shariah or should we 'alter' or 'lower' the Shariah standards to suit the man-made rules? I am a strong believer that so long what we do is in line with Shariah, it cannot go wrong (may be some hiccups but Allah knows best including the reasons why Shariah principles set in certain manner). The professionals, however smart or experienced they may be, are still humans and they as we all do can err. Thus, I suggest that Islamic finance stakeholders should strive towards having those standards improved to accommodate shariah and not the other way around.

My humble submission is this, Allah did not reveal Shariah just to suit one generation time. It is meant to be relevant eternally. Therefore, don't use human standard as the standard not especially when we try to do business according to the law set by God AlMighty. We should avoid saying doing Islamic banking the shariah way does no longer fit the modern Islamic banks. What are modern Islamic banks? What standard are we using when calling them as such?

Not jive with the function of an Islamic bank? Let's evaluate what the real function. Is it to provide financing the way conventional banks do? If so, then the statement is true. But if the main purpose is to provide financing in the manner acceptable to and in line with Shariah, there is nothing wrong, not even at the slightest, about PLS. In fact, I am all for PLS for we should serve the objectives of Shariah, that even in doing banking we should strive to create values.

All the fears that Islamic banks may transform into something else is not with substance. If the fear is real, there would have been such institutions by now for islamic banking industry has been around for over 60 years now. Banking is one of most heavily regulated industry. Regulators will not keep quiet when banks have undertaken its business beyond its license (stakeholders won't either) and shariah board members won't allow Islamic banks to behave in any way in breach of its fiduciary duty, taking advantage on others, etc. I do believe each has its own function too, but allowing islamic banks to trade as means to provide financing will not make banks into traders. Rather, they have to work and collaborate with suppliers/traders to achieve this. I see no potential of conflict when each entity remains within their domain and as per the AOA and license and I see no ground for trust deficit either. On the other hand restricting the function of Islamic banks just to mere intermediaries is the same as forcing them to make profit out of fix fees for such services (because linking it to the capital = backdoor to riba) or tawarruq (being the closest option if they want profit out of capital without "trade" or "PLS"). To me, that's what I term as 'conventionalising islamic banks" and that should not be what we should propagate.

Wallahu'alam bisshawab

- **Ali Raza Nemati**:

A new paradigm opened

- **Ahmad Ali Siddique**:

Good arguments Dr Hurriyah!

- **Humayon Dar**:

@Dr Mohd Daud Bakar . Sheikh, thank you very much for your kind input.

I don't think there is any room for disagreement with you on the issue of non-compatibility of PLS with the current conventional banking model and the contemporary practice of Islamic banking, which is embedded within the conventional banking regulatory framework.

The regulators (both in the Muslim and non-Muslim world) first did not allow or wholeheartedly accepted Investment Accounts proposed by Islamic banks. Rather they insisted on making Islamic banks deposit-taking institutions. In the UK, the regulators didn't allow Investment Accounts and insisted on offering only deposits (which are by default capital protected).

In the Muslim countries, Islamic banks were advised to devise practices and mechanisms like Profit Equalisation Reserves (PER) and Investment Risk Reserves (IRR) to ensure that Investment Accounts were like deposits for all practical purposes.

Given the lack of true PLS-based Investment Accounts on the liabilities side, there is no scope for PLS on the assets side of the Islamic banks. It goes against the risk regimes of Islamic banks to offer PLS-based products on the assets side when they have fixed-return liabilities on the other side of the balance sheet.

Given this reality, no one should disagree with you, as I mentioned earlier. This is the classical Glass-Steagall Act.

What the proponents of the use of PLS in Islamic banking argue is that the whole Islamic banking model has evolved into something that is a replica of conventional banking not only in products but also in its overall philosophy and objectives.

The purist Islamic banking model by its very nature is a capital intensive business. This means the cost of doing Islamic banking business is more than conventional banking. But this is not necessarily a bad thing for the wider stakeholders in the industry. As the base of capital providers in Islamic banking (I am referring to the purist model) is wider to cover

Investment Account Holders (IAHs) in addition to shareholders, this means that the return going to IAHs should be higher than what they receive in the presence of PER and IRR. Of course, this is something shareholders of Islamic banks don't like as it means return on the Shareholders' Equity will be less. This is in effect aversion to diffusion of ownership.

In a purist model of Islamic banking (perhaps a better term would be Islamic finance), the deposit taking should be for purely safe-keeping. In other words, an Islamic bank should practice what in the West has come to know as narrow money.

Once, we agree on the principal objectives and philosophy of an Islamic Bank, then other issues like competition with the real economy sector, capital adequacy and other related matters become less of a problem.

Wa Allah A'alam bi-Sawab

- **Dr. Abdullah Turkistani**:

I would rewrite Dr. Daud Bakr long statement of "5 reasons", if I may:

1. Practically there was one option possible for us: Commercial Banking, so either we reject it and live with pure usury and riba. Or accept it and live with less usury and riba from ugly "Islamic" products. Hoping for gradual change and finally converging to real Islamic Finance. This is almost similar to what Dr. Dar said it: "Forgive my language but tawarruq in the Islamic finance industry happens to be like a child born out of wedlock. If we like it, it shouldn't be because we love bastards but because it is a human being". OR:

2. We cannot convince Rich Muslims that we found commercial banking the wrong structure for our shariah principles, PLS. We cannot say it bluntly: Commercial banking cannot be "islamised", sorry. OR:

3. Brothers and sisters: this is the best we can do.

- **Dr. Hurriyah El Islamy**:

Eloquently written but I stand with what I wrote earlier for the contemporary "practise of Islamic banking" differ widely between countries and regions.

#1. the argument put by Dr Daud and Dr Humayon is true when viewed from certain countries where the regulator laid the framework for Islamic banks (its really Islamic banks in Malaysia, for example, for BNM does not legally have supervision nor regulatory power over financing companies whereas in Indonesia OJK has supervision and regulatory power on IFIs in its true meaning) and treated them in the same manner conventional banks do. Malaysia is one of them post IFSA (as opposed to pre IFSA/during the IBA period).

#2. However, and let me put emphasis that my statement is based on facts not just theory, the argument is NOT true in countries where regulators are striving to regulate the islamic finance services as a banking/financing system deserves recognition of its own.

I am not well-versed with the framework in Pakistan but if I understand the context shared by brother Ahmed Ali Siddiqui in his reply, it seems that Pakistan will fall in this category.

Indonesia, for sure, strives towards this.

Some GCC countries like Bahrain falls somewhere in between and UAE somewhat behaves towards this (albeit minimum extent of restrictions) and GCC will continue on this track because of its civil law (already in line with shariah) and as long as the regulators do not start imposing strict/rigid conditions or conventional standards on Islamic banks and/or finance companies. CBB, for example, has been willing to recognise the uniqueness of Islamic principles by extending 'deposit' protection scheme to URIAs. In Indonesia, 'urias' are automatically protected as deposits because the regulators do not limit 'bank deposits' by imposing conventional standards as BNM did not pre- IFSA.

Those who recognise and observe the above will have the choice - either to support the move already taken by some regulators (#1) i.e.,, to have Islamic banks treated, behaved and served functions strictly like conventional banks are (which to me is against the very nature of Islamic finance as Shariah forbids the very substance that makes conventional banks business 'profitable' and commercially viable) or (#2) to propagate and continue striving for the regulators to give or continue dealing with Islamic finance institutions in the manner blessed by Shariah.

It's a choice - because what's limiting the institutions in the #1 regime is man-made law/rules and system set by human that can change and have changed over time. we can change them or we can make them be changed.

Shariah while flexible especially in mu'amalah areas, contains rules and principles set by God. humans do not have the say in areas where the rules have been firmly laid down. instead we are ordered to follow them.

when we have regulators putting emphasis on the importance of shariah in Islamic finance industry, this should be applauded. we should support and propagate this and not the other way around.

we should not try to put to their minds, "look, there are standards made by humans and because these are more widely used standards (by and for conventional banks) you should use the same in dealing with your local islamic institutions too" - this is something we should avoid.

hence the title of my earlier message because PLS do not and will not seem fit when we viewed Islamic finance from conventional eyes.

for a moment, take off that conventional glasses and try to see Islamic finance industry - how they develop in many countries and the potentials that have been growing where regulators recognise the importance of shariah in regulating IF industry (as opposed to human standards first and shariah to suit that).

The reality is not the same as the perception gathered with bird eye.

when I was part of Islamic banks industry in Bahrain, I used to think Malaysian practise was more superior but that was because what I had until then of Malaysia was theory and some readings of Malaysian IF industry practise.

I was wrong.

It took me the experience holding responsibility to manage group Islamic governance and shariah legal of one of the largest Islamic bank in Malaysia to realise the reality is not as good as the perception and while we have the numbers = we have quantity, not quality.

After that I have the opportunity to see (and directly involved in) IF industry in Indonesia. Masha Allah, in term of numbers the country is far behind Malaysia (they started way late anyway) but look at the substance. Look at the essence of products the industry have to offer. look at how the institutions are growing. they may not catch fast on numbers but they are internally growing as the employees (starting from those directly involved) are growing their appreciation to shariah and have this appreciation reflected in their daily lives. when that happens, the desire to do business in manner blessed by shariah is growing too. still thinking commercially but it is no longer solely about 'chasing the profit'. I saw first-hand how Shariah is placed predominantly while BU is trying to achieve commercial targets. the industry is not perfect yet but the due diligence banks exercise coupled with the need to do PLS or other non tawarruq mode of transactions place the banks in the positions that they have to exercise higher level of fiduciary - they provide financing only when it is viable (not just a matter of securities). of course not every institution is behaving in such manner yet but many already have and that's due to the regime taking shape in the country.

Indonesia has beauty which is missing in other country, including the perceived leading country where everything is evolved around tawarruq (that's inevitable when IFIs are forced to behave like conventional ones).

I am not the opponent of tawarruq (although I am not for it absolutely either) but I am opposing the notion that Islamic banks have to behave and be regulated in the same exact manners their conventional counterparts are.

the argument that this and that do not fit IFIs only arises when we use and continue to use the conventional mould.

the issue and/or the argument will not arise when we stop wearing the conventional glasses and stop trying to impose the conventional standards on IF industry.

- **Dr Muhammad Iman Sastra**:

Another comment from Dr Daud Bakar from Facebook:

before I proceed to address each and every issue raised - to which i am grateful - i need to impress again that my thesis was based on PLS as financing (not deposit taking) which is clearly mentioned in the topic, the issue of equity ownership and not investment intermediary and i am not making a preference of debt over equity or even the other way around. My focus is on the structure of the currrent function of a bank...which is not meant to facilitate investment through real investment. Investors looking for real investment will opt for other markets. Banks are essentially structured to protect the capital and to provide cash management and sort term liquidity. I dont have the problem with this structure.it is Shariah neutral. if we want to add another new function, then this is open for opinions not only from the Shariah perspective but also best practices and governance and market efficiency.

- **Dr. Nida Davis**:

Is it possible to get a copy of Dr. Dawood's book to further examine his ideas? The PLS concept is a big issue in banking. It does change the role of the bank from a financial intermediary to a participant in the financial exchange. In a conventional bank the participation is limited to facilitation of the movement of capital without incurring the risk of the enterprise being funded by the capital. A bank hedged against the risk of loss of its capital by managing its risks and passes onto the borrower the full risk of the investment. PLS requires that the bank partaken in the business enterprise itself. This requires specialization on the part of the bank to become conversant in the market dynamics and the enterprise itself. The question is can a bank become specialized in the different fields in a PLs market? How will a bank manage the risks under PLS when there are few infrastructure available to help manage the risk of the enterprise? PLS versus intermediation is really an important topic.

- **Ibraheem Tijani**:

Interesting read and a core area of discussion in the Islamic finance industry. I don't see myself as the most suitable to analyze or give personal opinion, so I will share it from another source.

I have extracted below some aspect of what was mentioned from the Research Paper *Challenges in the Application of Mudarabah and Musharakah Concept in the Islamic Finance Industry in Malaysia* pg 19-22.

Which reads:

Suggestions for the Implementation of Mudarabah and Musharakah

Several authors have come up with a number of solutions in order to make PLS contracts more appealing to IFIs. Bacha (1997) suggested that the mudarib should ‘reimburse’ the rabb al-mal in the event of certain outcomes. Karim (2000) recommended that the mudarib contribute some capital or collateral to the project. Adnan and Muhammad (2008) argued that while cases of mudarib negligence leading to losses are taken care of in mudarabah, proper systems should evolve to establish such negligence and ascribe the losses to the mudarib. Khan (2003) suggested that banks guarantee investment deposits by tabarru' to minimize the agency problem. Orhan Astrom (2011) proposed a negative incentive scheme as a solution to reduce the problem of asymmetric information inherent in PLS contracts such as mudarabah and musharakah. Sundararajan and Errico (2002) state that the administration of the PLS modes is more complex than conventional financing. However, they accept that the structure and balance sheet of Islamic banks and the use of the PLS modes mean that Islamic banks are better placed than conventional banks to absorb external shocks. The authors add, "In the event of operational losses, unlike conventional banks, Islamic banks have the ability to reduce the nominal value of a portion of their liabilities.

As a result, solvency risks that may result from an asset–liability mismatch are typically lower in Islamic banks than in conventional banks" (Sundararajan & Errico, 2002, p.4).

Elgari [A member of the Islamic Economics Forum] (2003) also rebuts the assertion that Islamic banks face more risks than their conventional counterparts, since dealing in loans—as conventional banks do—does not lead to a reduction in banking risks. Therefore, the cause of a higher level of risk for Islamic banks is the result of relying on non-PLS modes of financing such as murabahah. The reason for this situation is that financial assets generated from murabahah assets resemble those which are generated by conventional bank loans. Chapra (1985) stressed that the non-PLS modes of financing such as bay' mu'ajjal and murabahah could degenerate into pure financing agreements with an agreed profit margin and would thus be no more than a mask for interest.

In his study, Nagaoka (2010) concluded that it is not realistic in Islamic finance to introduce profit-sharing instruments on a large scale as doing so would result in a liquidity crunch. He further states that it is feasible to develop community and ethical investment, focusing on financing of small and medium enterprises. He states that this financing sphere offers opportunities on a large scale suitable for introducing new partnership-based instruments on the reformulated economic wisdom of 'risk-sharing without risk-scattering'. Experiences based on Chinese businesses has proved that robust corporate entity is not a necessary condition for the economic development, as they have been conducted successfully using certain types of 'risk-sharing without risk-scattering' instruments (Nagaoka, 2010).

Challenges

- High Level of Risk
- Lack of Expertise
- Banking Landscape Geared more towards the Conventional System
- Complicated Documentation Process
- Asymmetric Information
- Inadequate Demand from the Market
- Other Issues

(Read the details of each challenge in the research paper)

Proposed Policies

Realising the challenges in the practices of the mudarabah and musharakah concepts, the interviewed IFIs suggested the following measures:

(1) Institutions that offer third-party guarantee services such as Syarikat Jaminan Kredit Perumahan and Credit Guarantee Corporation (CGC) should be created by the relevant authorities.

(2) IFIs should establish subsidiaries to implement mudarabah and musharakah concepts.

(3) The major IFIs should play a bigger role in initiating the implementation of mudarabah and musharakah concepts.

(4) IFIs should establish dedicated teams to supervise mudarabah and musharakah contracts.

(5) The government should introduce special regulations to govern Islamic partnership in Islamic banks.

(6) The government should provide special tax waiver and tax neutralization to IFIs that offer mudarabah - and musharakah -based products.

(7) The government should provide suitable parameters on the implementation of mudarabah and musharakah contracts.

(8) The IFIs should be allowed to use zakah portions to overcome genuine default cases.

(9) The government should continuously harmonize various acts related to mudarabah and musharakah contracts.

Challenges in the Application of Mudarabah and Musharakah Concepts in the Islamic Finance Industry in Malaysia - ISRA Research Paper 56

Access the full paper: http://ifikr.isra.my/publication/-/publication/getPublicationDetail/3206

- **Yau Isah**:

Thanks for sharing, quite incisive

- **Souheil Thabti**:

Thanks for sharing! I can't agree more and I share this thought completely. I don't believe that Islamic banking can be realized within the framework of banks.

- **Dr. Nida Davis** (Response to Dr. Mohd Daud Bakar):

The PLS products were a response to a religious problem. If the other non-PLS products come across to many in the industry as a work around RIBA that looks close to a Riba instrument. So it is very difficult to differentiate the non-PLS products from interest based products. If PLS products are not a good fit in a banking framework, what is the answer to the religious problem in banking? Murabaha is very similar to internet loans. What is the differentiation strategy in a form of banking that claims to be rooted in religious grounding that rejects RIBA if PLS is not the heart of its framework? Was there financial intermediation role in the times of Muhammad pbu that facilitated the buy-sell? How is the lender borrower relation in Islamic banking different from conventional? PLS as a framework may not require the bank to become an expert in the enterprise but it does require the bank to examine the risks of the enterprise and the credit worthiness of the parties involved in the enterprise. So it is a matter of credit and risk to the bank, not a matter of enterprise specialization. But there might be some building of such specialization for commercial banks finding real estate or funding industrial projects or finishing agriculture. And that is okay. That is not the issue. The issue is most of the Islamic world does not have credit management organizations that measure the credit worthiness of businesses and individuals. That makes it hard to measure the risk. Second, every enterprise must have a business case with rate of return as a measure of its worthiness for investment. So pls is an interesting frameworks in banking. It does solve the religious problem more effectively than other interest like products. But it does not have a mature set of institutions to manage credit risk and market risks in my humble opinion. Dr. Nida Davis

- **Souheil Thabti**:

By religious problem you mean interest?

Regarding the framework I believe when it comes to credits the Islamic alternative can be seen in merchants who sell their items on a spot price or credit price. Imagine an amazon online wholesale shop that offers a spot and a credit price.

Speaking from the German/European jurisdiction banks that claim to offer pls accounts/finance are bind to conventional ways (loans) by law.

For the time being Islamic banks could play a big role in terms of considering the environment and social dimension in their financing. What I unfortunately observed in my PhD and work as sharia compliance manager (speaking for Europe and Germany in particular) is that there is no consideration neither for real pls financing, nor for maqasid (environmental, social considerations)

- **Dr. Kaleem Alam (Response to Ibraheem Tijani)**:

The basic problem with the Islamic banks is in trying to Guarantee (risk free) issue, which I call GM (Genetically Modified) financial products. In order to provide those guarantees we enter into gray areas. Business by nature has risk of loss, so the Halal investors must b willing to take those risk.

The ethical values are challenge n trust deficit r high, diminishing partnership has better future.

We don't need credit worthiness formula as in west, but banks n financial institutions must share data of individual borrowers. Which is already in practice.

- **Dr. Ugurlu Solyo**:

For most of you this argument will be not new. But to use pls instruments as mean of Finance has besides regulatory aspects several other reasons:

Supply side:

-socialisation and habituation of the most of the managers within the conventional banking, framework and thinking

-lack of vision and will to go new ways

-lack of experience and experts

Demand side:

-expectation of secure return (profit and profit accounts instead of PLS)

-expectation of immediate returns

-expectations of constant returns

The demand side quasi determine and foster the supply side driving forces, which lead to the Current situation.

- **Dr. M. Burhan Arbouna**:

Dr. daud is among the forefront Islamic banking thinkers if not the most active one and an authority in fiqh almuamalat. he is our mentor. we should have keep quite had he did not give us a chance to voice our view. Dr. Hurriyah had done a good job to respond to some aspects of the post. i did not wanted to comment until I translate the thesis in Arabic and posted it which was done. by translating the thesis I have had the opportunity to analyse each sentence of the post. is the thesis in its totality valid and not subject to counter argument? no. the issue of whether or not Islamic banks are financial intermediaries in the strict sense of intermediation is debatable and was debated extensively since the advent of Islamic banking and financial services. Is this thesis relevant in the context of trade versus riba. Whether or not Islamic banks are traders for themselves or are trading on behalf of funds owners within the available in which they are allowed to operate. From the 5 reasons at least two of them are not much convincing which are related to capital adequacy requirement and marked to market issue. these are more of technical issues which the post is suggesting that the Islamic Banks should change to meet them instead of changing these technical rules to accommodate the practices of Islamic Banks. marked to market is not always leading to fair presentation of financial position of an institution. there are cases where using this approach will lead to unfavourable presentation.

- **Dr. Hurriyah El Islamy**:

For the link to PLS discussion, if we 'restrict' the role of Islamic banks (IBs) merely are intermediaries like the conventional banks are, the only two ways IBs can make money are through ujrah (fixed fee based - no linking to principal sun - otherwise backdoor to riba) or tawarruq to allow more optimal 'margin'.

- **Dr Mohd Daud Bakar**:

5 Reasons Why Islamic Banking Can't Do Real Trading Bearing All The Risks

Islam has prohibited riba but has allowed trading. Trading is the oldest profession in the world. Some of us maintain and contend that Islamic banks must be a real trader to really make them Shariah compliant at the highest level. They are not wrong but they are not contextually right.

Setting expectations is different than setting objectives. What is the objective and the very function of Islamic banks? Financial intermediary. All the five reasons hinge around this financial intermediary function and objective.

First: In order for Islamic banks to become real traders (manufacturer and operator), they have to own a trading company or to have an agency or SLA with another trading company. The issue arises whether banks are allowed to own a trading company.

Second: The biggest concern of all is that banks cant be allowed to compete with real traders. Why do we need traders in real economy if we allows our banks to become the real contractors and airline operators? If the banks are technically traders, why would a real trader come to get the financing from these banks for potential conflict of interest? The separation of functions is essential. Governance must prevail.

Third: The impact on the cost of financing. At the moment, Islamic banks simply charge the spread for their financing that is the differential between the cost of fund (deposit or liability) and the cost of the financing (asset) which is in the range of 5 to 8 percent. If Islamic banks were to bear the cost and risk of shipping, warehousing, distribution, volatality of commodities prices and currencies, etc., which a real trader would normally be exposed to after all, the profit margin for the financing for Islamic banks can no longer be in the range of 5 to 8 percent. It could go as high as 30 to 40% pending on the sector such as construction and manufacturing. Islamic banks must decide now : are they essentially financial intermediaries or real traders?

Fourth : Regulatory cost will escalate if the risks of real trading are kept with Islamic banks. The fact that Islamic banks have resorted to wa'd in murabahah financing, purchase undertaking under a financial lease (ijarah muntahiyah bi tamlik) and many more Shariah solutions, has reduced the regulatory cost under Basel III. Many may object to this notion of risk transfer in the Shariah. I will devote a special discussion on this aspect later to see the real picture in the body of the classical Shariah.

Fifth : If Islamic banks aspire to become real traders, the composition of Islamic bankers must comprise of both credit officers and business practitioners. This can be done but Islamic banks have transformed to become then a trading company doing EPC, maintenance, operation, etc.

What is the impact on the ground? Many Shariah standards have taken this fact into consideration that Islamic banks may not be able to take all risks of real trading. Whether you would agree or disagree to this treatment is beside the point. The point is that Islamic banks, under its current structure, are not fit to become real traders.

What is the way forward? Value chain financing in real economy transactions. This is the missing link that Islamic banks must do more away from retail or consumer or household debt financing. Islamic banks must support real economy instead of competing. I have elaborated on this aspect in details in my forthcoming book " Emirates Airline Sukuk : Pushing the Boundaries of Islamic Finance".

Hope this is useful and your comments and perspectives - both agreeing and dissenting - are always appreciated. Engagement is good and healthy but difficult. Disengagement is easy but destructive.

MDB

- **Dr Mohd Daud Bakar**:

This complements my thesis of the very essence and function of Islamic banks in 21st century. I am not pro tawarruq nor against PLS. I just try to put the right Islamic modalities in its right condition at the current without setting or working o aspirations. aspirations may come or may not come but the curreny structure of modern banking regulated by central banks and international standards have some limitations. Can we work within this framework to get the best out it? thanks for reading and sharing your comments.

- **Amjad Bangash**:

Excellent. Right indeed.

- **Dr. Nida Davis** :

Interesting discussion. The question at hand is that does PLS fit into the banking model? It seems that Dr. Daud does not think it does. I have not yet read his thesis but I plan to do so today. The banking system was developed at the turn of the century as a vehicle for financial intermediation and as a system through which central banks manage monetary policies. When we discuss the banking system, we must include its function today as a dual platform through which financial intermediation and monetary policy are executed. The modification of the banking system to transform financial intermediation into a trade system is not without its challenges. Trade requires managing new forms of risks. The banker role changes from an intermediary وسيط to merchant تاجر. The role transformation introduce new risks and expands the scope of requires skills to run a bank. It also requires modifications of the supervisory framework in the central banks to manage these newly formed risks. The interesting question Mr. Daud puts on the table is that is banking the best model to revive Islamic finance? Seems that he does not believe that to be the case. I will further read his argument to better understand why. If we assume this to be the case, there are two challenges in his thesis. The first, financial intermediation is a critical necessity for all Muslims and the Islamic world to ensure financial inclusion in the global financial system. Banking is an essential need in modern society and trade is not a good alternative to basic banking needs. Second, assuming other modalities of finance are used in lieu of banking to instrument PLs, what mechanisms of capital movement and intermediation would be used to fund such models? You still need banking to manage the financial intermediation for the purpose of finding PLS ventures. You still need the banking system to run the monetary policies. So, it is not a question of either or as there are symbiotic synergies between banking and trade in today's modern economy. One can not have trade without financial intermediation in today's economy. The conventional financial intermediation is built based on use of loans with interest. Can Islamic banking operate its financial intermediation based on a trade model? That is the crux of the matter here. Excellent question. Any takers?

- **Dr. M. Burhan Arbouna**:

I think I have given an answer. it is about which product the client prefers.

- **Khaled Ibrahim:**

The answer to your question Dr. Nida is NO taking into consideration that the Islamic concepts do not fit into the banking model. This is my view in brief irrespective of the existence of different forms of Islamic or participation banks. We need to decide whether to compromise Shariah rules to fit the banking model or to compromise the banking rules and concepts to match the Shariah requirements or to come up with a new business model that with new mind set to put the Shariah requirements into practice without tricks, abuses, or even fraud. We do not have a banking model that can serve as a reference for bankers or Supervisory authorities who want to understand Islamic banking practices. This is why lot of controversies are going on and are expected to continue about the existing Islamic products until the banking model or the Shariah requirements prevail.

- **Dr. Hurriyah El Islamy:**

and if I may sum up my stance with respect to trade, pls:

1- I believe regulators and stakeholders (including the governance functions within Islamic banks) wont allow the bank to be transformed to a trader

2. IBs should explore PLS and develop better framework for the same

3. 'trade' (and ijarah) for purpose of financing should be encouraged as it is better method to tawarruq.

4. trade for purpose of financing will contribute to real economy as banks will work with suppliers and traders to facilitate supply

5. tawarruq should be allowed but controlled and well regulated and supervised and its use is to be limited when other principles or combination of the same will create backdoor to riba. (tawarruq as the lesser evil option)

End....

List of IEF Group members that contributed in the Discussion (25 out of 256 Members):

Sheikh Khalid Hasani	**Ahmad Ali Siddique**
Ali Raza Nemati	**Almir Colan**
Amjad Bangash	**Dr. Muhammad Iman Sastra**
Dr. Abdullah Turkistani	**Dr. Humayon Dar**
Dr. Hurriyah El Islamy	**Dr. Kaleem Alam**
Dr. Manelle bin Sultan	**Dr. Mohd Daud Bakar**
Dr. Nida Davis	**Dr. Sahar Ata**
Dr. Tariqullah Khan	**Dr. Ugurlu Solyo**
Ibraheem Tijani	**Khaled Ibrahim**
Maharlika Kristal Alonto	**Muhammad Wail**
Mujtaba Khalid	**Shiekh Arbouna**
Souheil Thabti	**Wafa Nasr**
Yau Isah	