

Islamic Finance and the International System: Integration without Colonialism

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As Islamic financial institutions develop in strength and scope, they interact more frequently with governments, conventional financial structures, multinational enterprises, and international organizations. The emerging Islamic network and the international system are reshaping one another at the same time as they are transforming the world economy. Because both Islamic and conventional institutions are struggling to reinvent themselves in an uncertain global environment, the most likely future is not the simple “domestication” of burgeoning Islamic practices by Western-dominated structures, but an improvised series of reciprocal influences and mutual adaptations that could evolve into an intentional process of collective learning and cooperation. This essay explores the possibilities of integrating Islamic finance into a more open network of multicultural structures capable of promoting global growth and equity, highlighting what international lawyers and international relations theorists have described as the emergence of “international regimes” and “transnational civil society.”

The Kozlowski–Bin Laden Effect: from the Washington Consensus to Basel II and SOX

Efforts to integrate Islamic finance into the world economy coincide with a time of crisis and soul searching, when our most powerful business leaders are wondering if capitalism has lost its way and if they can save it from its own excesses. Regulation has been reborn—even if we prefer to call it “self-regulation”—and this incarnation promises to be truly universal, embracing nation-states and international organizations as well as global

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banks, conglomerates, and transnational associations of professionals, investors, and consumers on all continents.²

The new mindset is a stunning departure from the triumphant liberalism of the Washington Consensus that heralded the collapse of the Soviet Union with categorical endorsements of deregulation, privatization, and free trade. Today, the same power centers have fashioned an ambitious interventionism around the mantras of “capital adequacy,” “risk assessment,” “transparency,” and “corporate governance.” Instead of celebrating “market freedom,” they stress “market discipline.” Instead of relying on the “invisible hand,” they call for compliance with “core principles” and “codes of conduct” reinforced with the threat of sanctions and prosecution.³

The burgeoning ethos of re-regulation spearheaded by the Basel Capital Accords and the Sarbanes-Oxley Act follows two decades of financial failures and ethical abuses that have redrawn our cognitive map of global business, exposing the ubiquity of “managers’ capitalism,” “corporate kleptocracy,” and “offshore underworlds.” The line between banking and crime seems thinner than ever—not merely in the unfamiliar realms of Islamic finance and “Islamic” terrorism, but at the very heart of the most respectable business circles in Europe and North America.

Business Is Business and a Dollar Isn’t What It Used to Be

As conventional banking seeks to integrate Islamic finance into a more centrally regulated global economy, it is also adopting a business model that more closely resembles the ideals, if not the practices, of Muslim investors. International banks are moving away from their traditional reliance on lending money at interest, and instead moving toward a wide array of fee-based services geared at managing risks and earning returns on

² See John C. Bogel, *The Battle for the Soul of Capitalism* (New Haven: Yale University Press, 2005); Willam Brittain-Catlin, *Offshore: The Dark Side of the Global Economy* (New York: Farrar, Straus and Giroux, 2005); Richard J. Newman, “Corporate Kleptocracy: Why Conrad Black Has Hollinger Investors Seeing Red,” *USNews.com*, September 13, 2004,

<http://www.usnews.com/usnews/biztech/articles/040913/13black.htm>; and Ibrahim Warde, “Crony Capitalism: The Banking System in Turmoil,” *Le Monde Diplomatique* (English edition), November 1998, <http://mondediplo.com/1998/11/04warde1>.

³ For further details see Bank for International Settlements, Basel Committee on Banking Supervision, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, June 2004, <http://www.bis.org/publ/bcbs107.htm>; and *The Sarbanes-Oxley Act of 2002*, <http://news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf>.

assets.⁴ The rise of a more integrated financial services industry has lowered the old barriers between providers and consumers of capital, encouraging quasi-partnerships in which risks and returns are shared instead of compartmentalized. The greater prominence of investment banking and venture capital alliances brings conventional finance closer to the Islamic view that merchant banking is a higher calling than bankrolling merchants.

In fact, Western bankers and lawyers have proven to be some of the most astute innovators of Islamic finance.⁵ By engineering new *shari'a*-compliant products and orchestrating multinational mega-deals with important Islamic participation, they have spurred a broad interpenetration of Muslim and Western financial networks and set the stage for their eventual integration into a unitary international system. The nodes and building blocks of that system are already well established in close working relationships between technocrats, business people, and professionals that link Europe and North America with the Middle East and Asia.⁶ The upper echelons of the modern financial community comprise an increasingly distinct segment of transnational civil society—a universe of its own beyond nation and culture, based on common training and on socialization to professional norms that grow more explicit and binding each year.

Will Westerners Take Over Islamic Finance?

Islamic banking and investment has probably passed the point where the global economy can allow it to fail or to go its separate way. Regulators are on the rise, determined to pull in the reins on ever more unstable world markets, and the Islamic markets are no exception. Yet there is no more certain way to destroy the Islamic financial experiment than to subordinate it to non-Muslims. If foreigners try to control Islamic institutions too much or too directly, the entire sector can be stigmatized in the eyes of its own supporters, particularly those who are already skeptical about overblown marketing that appeals to religion for the sake of profit.

⁴ Ibrahim Warde, "The Prophet and the Profits: Islamic Finance," *Le Monde Diplomatique* (English edition), September 2001, <http://mondediplo.com/2001/09/09islamicbanking>.

⁵ Owen Matthews, "How the West Came to Run Islamic Banks," *Newsweek*, October 31, 2005.

⁶ See Benjamin C. Esty, "The Equate Project: An Introduction to Islamic Project Finance," *Journal of Project Finance* 5, no. 4 (Winter 2000): 7-20; and Michael J. T. McMillen, "A *Rahn-Adl* Collateral Security Structure for Project and Secured Financings," kslaw.com/library/pdf/mcmillencorporate.pdf.

Islamic finance can only be brought into a global regulatory net by Muslim regulators—not by anonymous agencies headquartered in Christian-majority countries, or by “*halal* windows” attached to mansions built by *riba*. The pivotal actors in this process are the central banks in the Islamic world. They alone possess the expertise, authority, and connections needed to fashion the alliances—nationally, regionally, and globally—that can pull Islamic finance together and negotiate its future in an increasingly volatile world economy.

The *‘ulama* (religious scholars) are an indispensable if often difficult partner in any coalition that financial technocrats seek to lead. Collectively, the *‘ulama* act as gatekeepers, ever mindful of their power—as well as their sacred duty—to quicken social innovation, to question it, or to kill it altogether. Regulators and bankers are eager to enlist the *‘ulama*’s legitimacy and expertise, but they are equally determined to prevent religious leaders from exercising an effective veto. Thus, most of the *shari‘a* advisory boards that review new financial products and contracts are ad hoc committees of handpicked *‘ulama* who frequently serve alongside academics, entrepreneurs, and politically connected bureaucrats.⁷

The *‘Ulama* and the Accounting Firms: Probity versus Sorcery

The growing and prospering cadre of “financial *‘ulama*” face the classic predicament of the would-be auditor who also tries to serve as an inside consultant. The inherent conflicts of interest are obvious and potentially fatal to clients and professionals alike. Indeed, it was precisely the implosion of the great accounting-houses-turned-consulting-firms and the big-banks-turned-brokers that helped to launch the current wave of regulatory zeal sweeping both conventional and Islamic finance. Ironically, some of today’s most illustrious financial *‘ulama* are building multifunctional professional practices just when the disgraced accounting and banking giants are severing such ties and trying to reclaim their shattered niches.

Although the *‘ulama* are under mounting criticism for their inconsistent rulings on several controversial issues, their decentralized case-by-case approach gives Islamic finance remarkable flexibility in developing multiple markets in widely separated regions and cultures. It is

⁷ See Bill Maurer, *Mutual Life, Limited: Islamic Banking Alternative Currencies, Lateral Reason* (Princeton: Princeton University Press, 2005); Clement M. Henry and Rodney Wilson, eds., *The Politics of Islamic Finance* (Edinburgh: Edinburgh University Press, 2004); and Timur Kuran, *Islam and Mammon: The Economic Predicaments of Islamism* (Princeton: Princeton University Press, 2004).

much too soon to restrict the spirited debate over proper forms of financial innovation, particularly when the conversation is sparking borrowing and cross-fertilization among Muslims worldwide. Islamic finance is still germinating in many countries and fields. Its institutions are constantly reinventing themselves, and most of its future client base has never seen a survey questionnaire or a focus group.

One of the most insightful commentators on Islamic finance opines that the *'ulama* opportunistically engage in "*shari'a* arbitrage."⁸ Mahmoud El-Gamal identifies the paradox of contemporary Islamic law and finance in the *'ulama's* willingness to denounce the interest-based operations of conventional banks while simultaneously blessing Muslim-run institutions that mimic their services in all but name.⁹ Professor El-Gamal correctly notes that the *'ulama* are very similar to arbitragers because they take advantage of disparities between separate markets—in this case legal as well as economic markets—that do not share common rules and information. Criticizing the inconsistencies and hypocrisy that threaten the credibility of the entire field, he urges that Islamic finance must achieve greater coherence and uniformity before it can expect broad support from Muslims, let alone acceptance under international standards.

On the same evidence, however, I would suggest the opposite conclusion—instead of eliminating *shari'a* arbitrage, let it proceed until it does its job. Let the *'ulama* continue to endorse an array of practices with variable claims to *shari'a* compliance, encourage entrepreneurs to offer competing baskets of services, and give citizens in the emerging markets a voice in the outcome. Instead of insisting that conformity with the *shari'a* is an all or nothing proposition, view it as a probability—and a risk—of being “more or less Islamic.” Let the *'ulama* lead the way in assessing those risks initially, but invite the entire *umma* to participate in an admittedly imperfect and open-ended process that is bound to change over time and adapt to local circumstances.

Shari'a arbitrage helps to segment the market for Islamic financial services by permitting individuals to choose among alternative practices depending on their preferences in balancing moral virtue and economic utility. Decision-makers can assess the probabilities and degrees of *shari'a* compliance for various solutions and choose according to their tolerance of the recognized risks—both spiritual and material. No one will expect consensus on the propriety of specific decisions, but everyone can

⁸ Mahmoud El-Gamal, “Interest and the Paradox of Contemporary Islamic Law and Finance,” *Fordham International Law Review* (2004): 108-149; and El-Gamal, “Mutuality as an Antidote to Rent-Seeking *Shari'a* Arbitrage in Islamic Finance,” <http://www.nubank.com/islamic/Mutuality.pdf>.

⁹ El-Gamal, “Interest and the Paradox of Contemporary Islamic Law and Finance.”

appreciate the need to respect personal differences in matters of conscience where sincere intention may be our only guide.

This sort of market segmentation is already quite advanced concerning the basic building blocks of Islamic financial practice. A common way to avoid the appearance of charging interest is to structure a loan as though it were another type of transaction—a sale (*murabaha*), a lease (*ijara*), or a partnership (*mudaraba*). However, there is widespread agreement that these three approaches are not equally satisfactory. Many authorities and practitioners believe that a sale is often a loan in disguise, that a partnership is distinct in form and superior in purpose, and that a lease is somewhere in between a sale and a partnership. Legally and morally, all three arrangements are permissible, yet the pecking order is clear—a lease is better than a sale, and partnership is the best of the lot.

This is essential information for Muslim rational actors. It gives them the freedom to mix and match an assortment of pre-approved contracts according to their self-defined preferences. It also allows businesses and consumers to “vote for” the competing Islamic approaches that best suit their changing needs, so that markets arise from popular demand instead of legal fiat.

This sort of market segmentation will inevitably erode the power of the *‘ulama* as their limited knowledge becomes just one of many factors influencing collective decisions. Globalization and the information revolution are probably diluting the authority of all experts, and it is hard to imagine how religious scholars could escape the trend.¹⁰ Many decision-making theorists claim that expert monopolies are already giving way to “smart crowds” and “qualified groups” with free access to current research and informed opinions on nearly every aspect of daily life.¹¹ In fact, the emerging orthodoxy assures us that a modern mass usually makes more accurate judgments than an old-fashioned specialist.¹² If so, then today’s *shari‘a* arbitragers may be digging their own graves by nurturing Islamic markets and electorates that can act as rival sources of consensus in the future.

¹⁰ James Surowiecki, *The Wisdom of Crowds: Why the Many Are Smarter Than the Few and How Collective Wisdom Shapes Business, Economics, Societies and Nations* (New York: Random House, 2004).

¹¹ Josh Chafetz, “It’s the Aggregation, Stupid!” *Yale Law & Policy Review* 23 (Spring 2005): 577-585, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=755785.

¹² Saul Levmore, “Ruling Majorities and Reasoning Pluralities,” *Theoretical Inquiries in Law* 3 (Online Edition, 2002), http://works.bepress.com/saul_levmore/2/.

When Is There Too Much Convergence and Harmonization?

These ruminations lead me to conclude that the current campaign to standardize Islamic finance is premature. The current patchwork of law and practice might seem chaotic at times, but is it any worse than the incoherence of the common law before the advent of the Uniform Commercial Code? Perhaps we should disaggregate our regulatory thinking about Islamic finance, and focus more on the “financial” than the “Islamic.” It is far more important for the industry to adopt internationally accepted standards of good business than to pursue a phantom of religious perfection. Islamic institutions that toe the universal ethical line today will have ample opportunity to agree on more specialized and idealistic norms tomorrow.

Building an international regime to manage Islamic finance will require a step-by-step strategy that puts global compliance ahead of *shari'a* compliance. Regulators should firmly push the industry toward adopting evolving rules of capital adequacy, disclosure, and corporate governance. However, they should also provide a neutral venue where industry leaders can continue their contentious debates over sensitive questions of religious law with no immediate pressure to produce binding decisions. Delay in adopting new world standards would make the regime irrelevant, but any effort to homogenize a pluralistic legal tradition would blow the regime apart. In *shari'a* matters, international regulators need to enmesh industry representatives from all countries and branches in an ongoing bargaining process that they can gradually embrace as a home of their own making and a symbol of their common fate.

International Regimes and Transnational Civil Societies

The core of the new Islamic financial regime is already up and running. The Organization of the Islamic Conference—the so-called United Nations of the Islamic world—launched the Islamic Financial Services Board in 2002 and the Accounting and Auditing Organization for Islamic Financial Institutions in 1991.¹³ These standard-setting bodies inherit both the authority and the political problems of the entire OIC framework. Like all successful regimes, this one will need to juggle multiple functions simultaneously—mediator and arbitrator, monitor and enforcer,

¹³ Islamic Financial Services Board, “Information on the Islamic Financial Services Board (IFSB),” <http://www.ifsb.org/index.php?ch=2&pg=1&ac=1>; and Accounting and Auditing Organization for Islamic Financial Institutions, “The Shari’a Board,” <http://www.aaofi.com>.

information broker and debate umpire. Above all, it must earn recognition from both members and global interlocutors as the interest aggregator extraordinaire for a sprawling and poorly understood economic powerhouse.

The vigorous beginning of the IFSB is encouraging, but we should be realistic in assessing the pervasive power struggles that will shape its agenda and hamper its effectiveness. Two examples, one national and the other international, are particularly worrisome: political infighting in the Central Bank of Malaysia, and regional rivalries shaking the OIC edifice as a whole.

The *Shari'a* Advisory Board of Malaysia's Central Bank is a classic study in balance of power politics that descended into factional infighting and sudden purge. In its early years, the Board reflected a professional and partisan coalition assembling *'ulama*, academics, and bureaucrats connected to rival wings of the ruling party that were led by former Prime Minister Mohammad Mahathir and his one-time lieutenant Anwar Ibrahim. Mahathir's campaign to disgrace and imprison Ibrahim influenced every corner of public life in Malaysia, and the *Shari'a* Board was no exception. Pro-Ibrahim members were dropped, and a rump assembly of Mahathir loyalists ran matters for several years until Abdullah Badawi became Prime Minister and filled the vacancies with his own nominees.¹⁴ Simultaneous scandals at Tabung Haji—a world pioneer in both Islamic banking and pilgrimage management—further tarnished the industry's reputation. If Malaysia expects to remain a pacesetter in Islamic finance instead of becoming a mere outlier, it can hardly afford exposing official *shari'a* bodies to political cronyism, especially when the “Islamic” opposition party is systematically shut out of the discussion. The Malaysian drama is far from unique; *shari'a* boards in all countries and institutions are susceptible to similar pressures, and they need to adopt more convincing safeguards of their independence and integrity.

The OIC reflects even deeper conflicts on a far grander scale. Mounting demands for OIC reform show that the uneasy balance between the Arab, Asian, and African blocks is giving way to an open battle for control, pitting the once dominant Gulf kingdoms against the most dynamic and ambitious non-Arab members led by Turkey, Pakistan, Malaysia, and Indonesia.¹⁵ This is a far-reaching power struggle likely to continue for decades. It is impossible to predict the implications for

¹⁴ Bank Negara Malaysia, *The National Shari'ah Advisory Council on Islamic Banking and Takaful*, <http://www.bnm.gov.my/index.php?ch=174&pg=467&ac=371>.

¹⁵ Abdulhadi Ahmed, “Malaysia Seeks Dramatic O.I.C. Reform,” *IslamOnline.net*, June 29, 2005, <http://www.turkishweekly.net/interview.php?id=87>; and Robert R. Bianchi, *Guests of God: Pilgrimage and Politics in the Islamic World* (New York: Oxford University Press, 2004).

Islamic finance, but the smart money will probably wager on growing influence for the eclectic experiments of Asia and Europe at the expense of the lingering attachment to formalism in the Gulf.

Most of the OIC reform proposals circulating these days strive for a stronger Islamic voice in the United Nations system. If adopted, they could also bolster the Islamic finance regime in negotiating with members and non-members alike. Nonetheless, one proposal stands out as a terrible idea: establishing a *shari'a* super-court to issue final and binding decisions in the name of Islam. Similar plans have been floated in the OIC for years, and each time they have had as much staying power as the Harriet Miers nomination to the US Supreme Court. There is no place for an Islamic Sanhedrin. We already have a World Court—the International Court of Justice associated with the United Nations. We should all be strengthening that tribunal instead of tinkering with knock-offs that have no future.