

Limits and Dangers of *Shari'a* Arbitrage

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INTRODUCTION: THE MARKET FOR *SHARI'A* ARBITRAGE

“Islamic banking and other Islamic financial institutions are rapidly approaching a crossroads,” Sheikh Ahmad bin Mohammad Al Khalifa told the opening session of a conference on Islamic Banking and Finance in Manama [in late February, 2004]. “Islamic banks have grown primarily by providing services to a captive market, people who will only deal with a financial institution that strictly adheres to Islamic principles.”²

Islamic finance is fundamentally a prohibition-driven industry. Its beginnings can be traced to mid-twentieth-century literature on Islamic economics, which emphasized the presumed equity and stability consequences of adhering to Islamic legal and economic principles. However, the nature of this industry is best exemplified in the titles of some of the earliest and most influential writings on Islamic banking, for instance:

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² Opening speech by the governor of the Bahrain Monetary Agency, as reported in *Monday Morning*, February 25, 2004, cf. www.zawya.com/story.cfm?id=ZAWYA20040225134523. The issue of strict adherence to Islamic principles is normally reduced to approval by *shari'a* boards. Indeed, recent Islamic banking laws in a number of countries and jurisdictions explicitly list the need for appointment of a three-member *shari'a* board that is required to write periodic reports on adherence to the *shari'a*, which reports must be included in Islamic financial institutions' annual reports. See, for instance, the Islamic banking Law no. 30 of 2003, published (with corrections) by the official Kuwaiti government newspaper *Al-Kuwait Al-Yawm (Kuwait Today)* on June 8, 2003 (issue 619, 49th year), Article 93.

- Baqir al-Sadr, *The Riba-Based Bank in Islam: A treatise on replacement of Riba, and a study of the various activities of banks in light of Islamic Jurisprudence (fiqh)*.³
- Sami Humud, *Evolution of Banking Operations in a Manner that Agrees with Islamic Law (Shari`a)*.⁴

Most other writings on the subject started from a fundamental assumption that banking interest is the forbidden *riba*, and proceeded to propose means of operating “banks without interest.”⁵ Despite repeated questions regarding distinctions between interest and *riba*, jurists affiliated with or supportive of the Islamic financial industry have maintained that there is an irrefutable consensus as to what is forbidden and how to avoid it.⁶

While most Islamic economics writings suggested the evolution of a distinctive financial system under Islamic law,⁷ the titles of the two books by al-Sadr and Humud were better predictors of the Islamic finance industry to ensue. Both titles suggested that the starting point for Islamic finance is conventional financial practice. The authors reasoned that to the extent that standard banking operations were based on *riba*, that *riba* should be removed from the system. Otherwise, the goal and agenda was simple: find the closest approximation to conventional financial practice that can be deemed to avoid forbidden elements.⁸ Often, this approximation is form-based rather than substance-based.

Ever since the introduction of Western-style finance to the Islamic world in the late nineteenth century, large numbers of Muslims have felt uneasy about the new transactions, which they either believed or suspected to be forbidden under classical Islamic jurisprudence. In response, the twentieth century witnessed a vast literature on Islamic economics and

³ Al-Sadr 1969.

⁴ Humud 1976.

⁵ For instance, M. Uzair, *An Outline of Interestless Banking* (Karachi: Idaratul Ma`arif, 1955), and M. N. Siddiqi, *Banking without Interest* (Leicester, UK: The Islamic Foundation, 1983).

⁶ For a discussion of a recent heated debate, see M. El-Gamal, “Interest and the Paradox of Contemporary Islamic Law and Finance,” *Fordham International Law Review* (December 2003), 108-149.

⁷ For instance, see M. S. Khan and A. Mirakhor (eds.), *Theoretical Studies in Islamic Banking and Finance* (Houston: The Institute for Research and Islamic Studies, 1988).

⁸ Initially, the focus was on the prohibition of *riba*. More recently, avoiding forbidden *gharar* has also been important to the development of *takaful* as an alternative to conventional insurance, as well as the ongoing attempts to synthesize Islamic derivative securities to replace conventional options. For an economic explanation of the roots of this “closest permissible alternative” approach, see M. El-Gamal, “The Economics of 21st Century Islamic Financial Jurisprudence,” *Proceedings of the Fourth Harvard University Forum on Islamic Finance* (Cambridge: Center for Middle Eastern Studies, Harvard University, 2002), 7-12.

finance starting in mid-century, followed by the evolution of an Islamic finance industry later in the century. Many early practitioners of Islamic finance lamented the large gap between Islamic economic and finance rhetoric, which focused on the substance and spirit of Islamic jurisprudence, and the practice of Islamic finance, which focused on its medieval forms.⁹ However, the captive market, of which the governor of the BMA spoke in the opening quotation of this section, had already been established as follows: (1) conventional financial practice is certainly forbidden, (2) at least in theory, an Islamic financial alternative is available, and (3) even if the industry seems excessively to adhere to forms of Islamic jurisprudence rather than substance, it is now impermissible to use conventional finance based on the law of necessity.¹⁰

THE NATURE OF *SHARI'A* ARBITRAGE

Arbitrage opportunities occur when discrepancies exist between prices of the same product in different markets. Hence, the arbitrageur can buy the product in the market within which it is sold cheaply and sell it in the other, provided that the price difference exceeds transaction costs. A related type of arbitrage opportunity is called regulatory arbitrage, wherein the arbitrageur attempts to generate a profit based on certain financial practices being disallowed (at any price) within the legal system of one country or region (say, country A) but allowed in others (including, say, country B). In this case, financial professionals and lawyers cooperate to manufacture an analog of the financial product for country A. Often this is accomplished using the product in country B as a building block, and heavily relying on offshore special purpose entities to structure transactions in a manner

⁹ Al-Najjar 1993. See also, Sheikh Saleh Kamel's acceptance speech for the Islamic Development Bank's prize in Islamic finance in 1996 (quoted in El-Gamal, "Interest and the Paradox").

¹⁰ This focus on form rather than substance defies a famous Islamic juristic dictum: "What matters in contracts is substance (lit. meaning), and not wording and form" c.f. ibn Qayyim al-Jawziyyah, *ʿIlam al-Muwaqqiʿin ʿan Rabb al-ʿAlamin* (Bayrut, Dar al-Kutub al-ʿIlmiyyah, 1996), vol.3, pp.78-80. However, as distasteful as it may sound, surprisingly many Islamic finance practitioners defend legalistic formalism with the example of marriage contracts, wherein the contract form can distinguish between one of the best permissible practices (valid marriage), and one of the worst sins (adultery). Since this example has been repeated frequently, it is worthwhile to note that its tastelessness is surpassed only by its jurisprudential incoherence. A fundamental difference between this example and the case of financial transactions (which renders the analogy flagrantly invalid) is the default ruling of prohibition of sexual relations unless legalized through a marriage contract, as opposed to the default ruling of permissibility of all financial transactions, except for those including a prohibiting factor (e.g., *riba* or *gharar*).

acceptable to country A. This type of regulatory arbitrage played a pivotal role in giving rise to and sustaining the securitization industry in the 1980s and 1990s.

Shari'a arbitrage is a particular form of regulatory arbitrage, wherein a captive market of pious Muslims voluntarily chooses not to use certain financial products. Lawyers, in partnership with bankers and jurists, strive to provide them a reengineered version of those products. Conventional financial products are used as building blocks for the reengineered Islamic products approved by jurists. For instance, a special purpose vehicle may be created by a conventional bank. The SPV may receive a credit line from the mother bank (whether or not it is a wholly owned subsidiary thereof), but deal with its "Islamic finance" customers in terms of reengineered nominate contracts (e.g., under the name of *murabaha*-financing). Thus, the Islamic customer is separated from the interest-bearing loan by the SPV and juristic focus on the contract in which the customer is a party. This approach will become obvious in light of the example of HSBC's auto-financing *shari'a* board pronouncements cited in the following section.

Murabaha (cost-plus) financing is one of the oldest and most commonly used means of Islamic finance. The full technical name of this contract is "a credit sale with mark-up to one who ordered the initial purchase" (*al-murabaha lil-amir b-il-shira' ma'a bay'bi-thaman 'ajil*). Sami Humud envisioned one of the earliest manifestations of this transaction as a substitute for bank loans in his above-cited book (which was based on his Ph.D. dissertation). Over the years, a number of additional alterations have been added to make the contract as close to an interest-based loan as possible. For instance, a customer's promise to buy the property from the bank at the mark-up credit price was made binding by jurists, once the bank buys the property to finance its ultimate purchase by the customer.¹¹ Further pronouncements allowed the bank to appoint the customer as its buying agent – to negotiate the price and purchase the property on its behalf, and then as its selling agent – to sell the property to himself:

If in cases of genuine need, the financier appoints the client his agent to purchase the commodity on his behalf, his different capacities (i.e. as agent and as ultimate purchaser) should be clearly distinguished. As an agent, he is a trustee. . . .

After he purchases the commodity in his capacity as agent, he must inform the financier that, in fulfilling his obligation as his agent, he has taken delivery of the purchased commodity and now he extends his offer to purchase it from him. When, in response to this offer, the financier conveys his acceptance to

¹¹ See al-Qaradawi 1987. The binding promise *fatwa* was based on the opinion of the Maliki jurist ibn Shubruma, and adopted in the first international conference of Islamic banks in Dubai, 1978.

this offer, the sale will be deemed to be complete, and the risk of the property will be passed on to the client as purchaser. At this point he will become a debtor. . . .¹²

In the eyes of M. Taqi Usmani, a highly respected jurist who is frequently retained by Islamic financial institutions worldwide, the formalistic invocation of the buying agent's possessions of trust (*amana*), which keeps liability (*daman*) with the bank until the final sale, justifies the distinction between the bank's legitimate return on *murabaha* financing and the forbidden interest the bank would earn on a conventional secured lending operation. This distinction between possessions of trust and guarantee is indeed central to the formative classical jurisprudence. However, that classical distinction becomes obsolete in light of the contemporary conventional financial practice of secured lending, wherein the bank puts a lien on the financed property. Indeed, when the Office of the Comptroller of the Currency was asked to write an approving letter of understanding regarding *murabaha* financing in the United States, it reasoned as follows:

[OCC #867, 1999:] . . . lending takes many forms . . . *murabaha* financing proposals are functionally equivalent to, or a logical outgrowth of secured real estate lending and inventory and equipment financing, activities that are part of the business of banking.¹³

Thus, the task of *shari'a* arbitrage is accomplished: a conventional bank (in this case the United Bank of Kuwait, which later stopped its Manzil USA program but continued its similar Manzil UK program), can use its regular funds to finance the purchase of a home in an "Islamic" manner, through *murabaha* (or *ijara*) financing. Regulators are successfully convinced that this is an acceptable form of secured lending, while customers are convinced that it is done Islamically. Indeed, the *shari'a* boards of various Islamic home finance providers in the United States explicitly warn customers that due to state and federal regulations, their mortgage documents may include the terms "mortgage," "loan," "interest," "borrower," "note," etc. However, they are assured that such language is used only because regulators require it. Moreover, customers are told that they will receive form 1098 (mortgage interest statement), which they can use to deduct the "markup" or "rent" component that was listed as interest. As a consequence, most potential customers ignore the industry and –

¹² Usmani 2002: 67.

¹³ Available on the OCC website at www.occ.treas.gov/interp/nov99/int867.pdf. Similar language was used earlier for lease financing (under the Arabic term *ijara*), essentially accepting UBK's argument that "the economic substance" of *ijara* financing makes the transaction equivalent to secured lending, which is part of conventional banking practice; see www.occ.treas.gov/interp/dec97/int806.pdf.

depending on their initial preference and conviction – either continue to use conventional finance, or continue to avoid all forms of organized finance (of which they see Islamic finance as a thinly disguised variety). However, two groups of clients allow the industry to continue its *modus operandi*: (1) a critical mass of captive clients who attach sacred authority to the pronouncements of Islamic banks' *shari'a* boards, and (2) a group of clients who participate in the market hoping that it will eventually outgrow its current (*shari'a* arbitrage) mode of operation.

MECHANICS OF SHARI'A ARBITRAGE

Shari'a arbitrage relies on two main tools to achieve its objective: (1) dual characterization of a financial dealing, one for jurists and one for regulators, as discussed in the previous section, and (2) the addition of one or more degrees of separation between Islamic finance clients and the underlying conventional financial products. The latter is often achieved by inspecting each part of a complex transaction in isolation, rather than studying the entire transaction. The one degree of separation principle was – perhaps unwittingly – best described by HSBC when it launched its home finance program in the UAE. The following are excerpts from the Frequently Asked Questions (FAQ) circular that was published in the Islamic finance section of www.zawya.com on February 3, 2003:

Question: How can a conventional (interest-based) bank offer a *shari'a* compliant financial service?

Answer: Islamic law (*shari'a*) does not require that the seller of a product be Muslim, or that its other services be *shari'a* compliant as well. This is the considered opinion of our *Shari'a* Supervisory Committee. Conventional banks charge and pay interest, and the HSBC Group, of which we are a part, is a conventional bank. But we are also a customer-driven institution, and we provide *shari'a* compliant products to serve a genuine financial need among Muslims. Of course, our *shari'a* compliant products are available for Muslims and non-Muslims alike.

Question: Since HSBC is an interest-based bank, what would be an acceptable source of funding for HSBC MEFCO? Are you going to mix conventional and *shari'a* compliant funds?

Answer: The *shari'a* (Islamic law) does not require that the seller of a product be Muslim or that his/her own income be *halal* (permitted). We will therefore, initially use funds from conventional sources to finance Amana Vehicle Finance. Muslims may be understandably concerned about mixing conventional funds with *shari'a* compliant funds. It is important, however, to understand where the two can and cannot meet according to Islamic law

(*shari'a*). To open an account or invest money, funds must be segregated from interest-based funds so that returns are *halal* (permitted). To buy something or obtain financing, however, funds do not have to be from a *halal* source. The relationship with the seller must be in line with the *shari'a*—the seller's relationship with other parties, however, is not the purchaser's responsibility. This is the opinion of HSBC's *Shari'a* Supervisory Committee.

Question: How do you calculate the price of Amana Vehicle Finance? Are the payments similar to a conventional vehicle loan? If so, is this acceptable under the *shari'a* (Islamic law)?

Answer: HSBC MEFCO determines the rates on Amana Vehicle Finance using a fixed payment scheme that is competitive with conventional vehicle loans. According to the *shari'a*, the profit rate in a *Murabaha* transaction can be set at any value agreed between the buyer and seller. Also under *Murabaha* financing, HSBC MEFCO is acting as a vehicle seller and not a moneylender. There is no particular reason why a vehicle financed Islamically should be any more or less expensive than a vehicle financed using a conventional vehicle loan. The criterion for acceptability by the *shari'a* is that the transaction be compliant with *shari'a*, regardless of the price of the good or how that price is determined.

The idea of making an impermissible transaction permissible through degrees of separation is not new. In fact, it underlies many of the juristic stratagems (*hiyal*) for circumventing prohibitions. Consider for instance the progression of juristic opinions on various lending practices:

- A lends B \$100 today, with B to repay \$105 in one year. All jurists are unanimous that this practice is a form of the forbidden *riba*.
- B sells a stapler to A, for the cash price of \$100. A turns around and sells the stapler to B for a credit price of \$105 payable in one year. This practice is called “same item sale-resale” (*bay'al-'ina*). Some jurists (e.g., the Hanbalis) forbade it based on prophetic traditions, while others (e.g., the Malikis) forbade it based on the principle of “prevention of stratagems to achieve illegal ends through legal means” (*sadd al-dhara'i*). However, some others (e.g., the Hanafi jurist Abu Yusuf and al-Shafi'i) allowed the contract, ruling on each of the two separate valid sales separately. Provided that the second sale is not stipulated in the first, they reasoned, one cannot forbid the practice based on speculation about the contracting parties' unobservable intentions.¹⁴

¹⁴ For a comprehensive list of opinions and texts upon which they were based, see W. al-Zuhayli, *Financial Transactions in Islamic Jurisprudence* (trans. M. El-Gamal), (Damascus: Dar al-Fikr, 2003), 1:214-216.

- C sells a stapler to A, for the cash price of \$100. A sells the stapler to B for the credit price of \$105 payable in one year. B sells the stapler to C for the cash price of \$100. This practice is called *tawarruq* (literally, monetization – of the stapler in this example). Abu Hanifa contemplated this contract as a variation on the previous one, with a third party serving as an intermediary to avoid the prohibition (*muhallil*). While he forbade the simple '*ina* (without a third party), he was more accommodative of *tawarruq*. Most jurists considered *tawarruq* invalid, defective, or reprehensible. However, there were two reports on ibn Hanbal's opinion on this contract,¹⁵ thus allowing a faction of the Hanbali school to approve the contract, which is quickly replacing *murabaha* as the favorite mode of financing in GCC countries.
- C sells a stapler to A, for the cash price of \$100. A sells the stapler to B for the credit price of \$105 payable in one year. B sells the stapler to D for the cash price of \$100. D sells the stapler to C for the cash price of \$100. Now, we have added two intermediary entities (C and D) between lender (A, in all examples) and borrower (B). Contracts with larger numbers of intermediaries do not have explicit names in classical jurisprudence, and were not discussed in their writings.

It is easy to see how we can keep adding degrees of separation until eventually it would become impossible for any jurists, however strict, to prohibit the practice as merely a trick to subvert the substance of Islamic law (avoidance of interest-bearing loans from A to B) while adhering to its medieval juristic forms. When bankers wish to practice their standard lending practices, but cater to the captive clientele of Islamic finance, they need at least one degree of separation. Since multiple degrees of separation typically add transactional costs (legal fees, sales taxes, etc.), bankers prefer to keep the number of degrees of separation to a bare minimum. Often, one degree of separation is sufficient.

In this regard, it is worthwhile to examine the degrees of separation most recently utilized in Islamic finance:

- For issuances of bond-alternatives (usually called *sukuk*, which is an Arabic word for bonds or certificates, albeit different from the more conventional term for bonds, *sanadat*), governments and corporations have recently opted for a variation on '*ina*, which also incorporates lease-financing in a manner very reminiscent of the decade-old leveraged buy-out methodologies of conventional finance:

¹⁵ Ibid., 217.

- A special purpose vehicle (SPV) is created for the sole purpose of issuing the *sukuk*.
- SPV sells certificates/bonds (*sukuk*) and receives proceeds.
- SPV uses the proceeds to buy land, equipment, etc., from the government or a corporation wishing to issue bond-alternatives.
- SPV leases land, equipment, etc., back to the government or corporation, collecting interest-only or principal plus interest in the form of rent, which is passed through to *sukuk* holders.
- At lease-end, SPV sells the land, equipment, etc., back to the government (or as in one variation for Qatar *sukuk*, gives it back as gift, if the principal was fully paid along with interest as part of rental payments).

In this practice, there is one intermediary entity (SPV) and one intermediary property (land, equipment, etc.) to distinguish the *sukuk* from conventional bonds. The actual legal difference (e.g., how much real ownership *sukuk*-holders have through the SPV) may not be revealed until we observe the first round of lawsuits associated with those *sukuk* issuances. In the meantime, the “benchmark” argument discussed above is commonly invoked, to list the “rate of return” *sukuk* pay in terms of market interest rates (e.g., LIBOR) plus the appropriate risk spread (e.g., 45 basis points above LIBOR for the June 2004 issuance of \$250 million Bahrain *sukuk* rated A- by Standard and Poors).¹⁶

- For retail financing, GCC banks are increasingly moving toward *tawarruq* financing, which also employs one intermediary entity (C in our previous example) as well as some product (usually an easily tradeable commodity such as metals or grains) as degrees of separation for the interest-bearing loan.

DYNAMICS OF *SHARI'A* ARBITRAGE

It is interesting to note that many Islamic financial institutions could and may have in fact easily practiced *tawarruq* under the guise of *murabaha*. This is easy to understand: in the four cases considered in the previous section, it is easy to obtain *shari'a* board approval of part of the *tawarruq*

¹⁶ See *Bahrain Times*, July 13, 2004: “Bahrain: \$250 million BMA *Sukuk* listed on BSE.”

transaction as a *murabaha* one: “Islamic financial institution will buy commodity from C and sell it to A on credit and at a markup,” ignoring the fact that A will turn around and sell the commodity back to C for its cash price (less transaction fees). In fact, for the *shari’*a board regulating Islamic financial institution B, one may argue that the first two steps of *tawarruq* constitute the only part of the transaction that matters, since it is the only part in which B is involved (the third leg of the *tawarruq* transaction is between A and C).

Thus, since the preponderance of *murabaha* financing made it easy to gain *shari’*a board acceptability, and since *tawarruq* is not as widely accepted outside of a subset of the Hanbali school, it was easier for bankers to structure transactions (including ones with the intent of providing liquidity rather than actual trade financing) as *murabahas*. As more competition joined the market, including multinational financial behemoths such as Citibank, HSBC, etc., profit margins became narrower, and further innovations were introduced in *murabaha* practice to minimize costs (e.g. appointing the customer as agent, etc.). Finally, it became clear that *murabaha* transactions are more costly than *tawarruq*, especially if the customer’s intent was not in fact to purchase an automobile or a house, but merely to get liquidity for whatever purpose. In fact, it is sometimes cheaper to use *tawarruq* (in trading a commodity such as metals), even if the customer in fact wanted liquidity to finance the purchase of property such as real estate (given that the bank’s initial purchase of that property may result in additional sales taxes, registration fees, etc.).¹⁷

However, practicing *tawarruq* under the guise of *murabaha*, by keeping the three legs of the transaction separate, results in additional costs relative to treating the entire operation as a single transaction, especially one wherein the bank can serve as agent for the other two parties. Thus, as competition drove profit margins down, banks had to resort to *tawarruq* (despite its less than universal acceptability) for two economic reasons: (1) to gain better access to borrowers who simply need cash, student loans, etc., that do not easily lend themselves to *murabaha*, and (2) to provide more efficient credit facilities through *tawarruq* to others who would have previously obtained them through *murabahas*, the objects of which they would immediately sell for cash.

This illustrates a general feature of *shari’*a arbitrage. The existence of a captive market initially makes it possible to implement even the most inefficient replications of conventional financial products through degrees

¹⁷ At least one banker operating in the United States indicated to me that he would prefer financing auto purchases through *tawarruq*, since the transactions costs associated with *murabaha* (which requires two sales of the car) and *ijara* (which requires additional costs for title, insurance, etc.) are simply too high. In his view, *tawarruq* gives him a tool to offer auto loans at more competitive rates, using a method that is approved by the relevant jurists.

of separation. Profit margins in the early stages of *shari'a* arbitrage are sufficiently large to cover legal and jurist costs, as well as other transaction costs associated with the less efficient product. However, as competition increases, industry participants need to seek new markets and market segments, and also to enhance efficiency by cutting transactions costs wherever possible. In this manner, an industry built on *shari'a* arbitrage sows the seeds of its own downfall.

DANGERS OF SHARI'A ARBITRAGE

The dynamics of *shari'a* arbitrage, as analyzed in the previous section, identify two main dangers that are inherent in an industry built on that mode of operation. One of those dangers is religious, and the other is secular. The religious danger lies in the fact that the industry thus configured is destined to move away, rather than toward, strict adherence to Islamic jurisprudence.

Capitalization on arbitrage opportunities necessarily requires the payment of various transactions costs. In Islamic finance, those transactions costs are incurred due to conducting otherwise unnecessary transactions (e.g., in *tawarruq*, lending through three sales), as well as the additional legal and jurist fees required to structure a product and certify it. Although it is perhaps not sufficient, the profitability of *shari'a* arbitrage is certainly necessary to get bankers and lawyers involved in Islamic finance.

To the extent that classical Islamic jurisprudence is generally understood by contemporary jurists to forbid conventional financial practice, movement toward strict adherence to Islamic principles requires movement away from conventional finance. To the extent that profitability is tied to efficiency of the Islamized analogues of conventional financial practices, the profit motive dictates movement toward conventional financial practice, and thus away from strict adherence to Islamic principles as understood by contemporary jurists who are active in this industry.

Indeed, this is precisely the root of frustrations for early players in Islamic banking such as those cited in footnote 9. In the industry's earlier stages, minimal compromises (e.g., in making promises binding in *murabaha* financing) were deemed harmless temporary requirements until the industry matures. One could still make the distinction at this point between "asset-based" Islamic financing on the one hand, and conventional finance that operates based on "renting money" or "selling money for money." Of course, as competition in this sector increased, *murabahas* begat *tawarruq*, where the underlying asset may for all practical purposes be fictional, just like fiat money used in conventional finance.

If one believes (as I do) that much of conventional finance in fact does not clash with Islamic law (*shari'a*) and classical jurisprudence (*fiqh*), one may think that this profit-driven trend toward closer approximations of conventional finance is a good thing. However, if one also believes (as I do)

that some aspects of conventional finance do in fact contradict the substance of Islamic law, as well as the forms studied in classical jurisprudence, then one can see an impending danger of subversion of Islamic law. Indeed, by approving and eventually codifying (through AAOIFI, IFSB, OIC *Fiqh* Academy, etc.) legal stratagems to replicate conventional financial practices, jurists and bankers eventually drown the substance of Islamic law in their contemporary reconstructions of medieval forms of classical jurisprudence.¹⁸ Indeed, through Islamic financing, an individual can get excessively indebted (e.g., becoming “house poor,” as many Americans do by spending substantial portions of their incomes on their home mortgages, now “Islamized”), take excessive risks (e.g., by investing in shorting-based hedge funds that have recently surfaced), etc. By focusing on medieval juristic forms rather than eternal legal principles of Islam, the industry may in fact violate those principles and become less Islamic than prudent utilization of conventional financial products.

There is also a frightening worldly danger associated with current practices of *shari`a*-arbitrage-based Islamic finance. The three stages of development of an Islamic financial product bear a striking resemblance to methods used by money launderers and terrorist financiers. The degrees of separation often required for *shari`a*-arbitrage-based Islamic finance, as discussed in “Mechanics of *Shari`a* Arbitrage,” are often structured along the lines developed in the 1980s and 1990s for asset protection and minimization of tax burdens (a legal form of tax evasion). Separation is accomplished through the establishment of bankruptcy-remote special purpose vehicles (SPVs) or entities (SPEs), usually incorporated at offshore financial centers that act as tax havens for investments of high-net-worth individuals.

Some degrees of separation are introduced in Islamic financial products by virtue of being part of the conventional product being mimicked, while others are introduced merely to separate the conventional part of a financial transaction from its Islamic part. For instance, protected capital mutual funds marketed in Saudi Arabia tend to rely on non-Islamic partners or advisers to receive an option-like payment as management or advisory fees (e.g., by capping investor returns at some percentage, and giving the partner/adviser all excess returns above that level as fees, i.e., paying with a call option). Of course, those partners or advisers, European and American investment banks, can turn around and hedge that risk by trading in options markets. Thus, Islamic product providers can offer the payoff structures generated by derivative securities without themselves trading in those securities.

Degrees of separation help isolate sources of funds or financial products from their destinations. The multiple-case example described

¹⁸ Please see M. N. Siddiqi’s paper in this book, which discusses the issues of legal objectives (*maqasid al-shari`a*) much more extensively, and eloquently, than I do.

earlier showed how by going from a loan, to *'ina*, to *tawarruq*, and then adding more intermediaries, the degree of jurist acceptability increases with the number of intermediaries. Unfortunately, this is the same methodology used by money launderers and criminal financiers to separate the sources of funds from their destinations. In that criminal context, the process is called layering, and it is the pivotal middle-step in a three-step process. The other two steps are placement of the funds into the legitimate financial system, and integration which allows the funds to reach their final destination through that legitimate system. In the case of Islamic finance, the parallel to placement is identification of a captive clientele, organizing them into a market, and marketing the Islamized product therein. The analog of integration is the stage at which conventional financial providers finally collect their profits, interest payments, etc., that were generated from that captive market.

The similarity of methodologies is not coincidental, since *shari'a*-arbitrage Islamic financial practice strives to separate “Islamic” parts of a transaction from its conventional parts, whereas criminal financial activities aim to separate sources of funds from their destinations. In this regard, the highly celebrated “asset-based” or “trade-based” nature of Islamic finance is a liability rather than an asset. One of the classical criminal financing tricks is to convert money into a commodity (diamonds, gold, Swiss watches, etc.), which can be taken through a number of layers, and finally – through over-invoicing or under-invoicing – a sum of money is cleansed or transferred to its intended party. To the extent that *shari'a*-arbitrage Islamic financial practice utilizes the same tools as criminal finance, the industry may be vulnerable to abuse. For instance, if someone wished to get a large sum of money from one country to another, it would be difficult to do that through a loan with exorbitant interest. However, if the loan is structured as *tawarruq* through *murabaha*, diamonds may be bought in one place with under-invoicing, and sold elsewhere at a very large profit (equal to the desired transfer).

To the extent that everything carrying the “Islamic” label (e.g., charities, etc.) is particularly suspect in the aftermath of September 11, 2001, the effects of abuse of Islamic financial practice – even on a very limited scale – can be catastrophic for the industry. Indeed, much smaller events such as the failure of Islamic finance “fund mobilization companies” in Egypt, accused by the government and many analysts of running pyramid schemes,¹⁹ has made it virtually impossible for Islamic finance to flourish in Egypt, which could otherwise be a primary market. Of course, in light of this perceived danger, Islamic financial providers tend to exercise extreme care in “knowing their customers” and in using more reputable offshore financial centers, etc. However, as competition continues to drive profit margins down, the temptation to cut costs along those dimensions can be

¹⁹ Abdel-Fadil 1989.

expected to drive some market participants to take unnecessary risks. All industries suffer occasional scandalous collapses (e.g., Barings Bank, Enron, LTCM, BCCI) due to careless risk taking, driven by greed. However, an industry as young as Islamic finance, not to mention one that exists purely based on its “Islamic” brand-name which is (unjustifiably, but understandably) suspect at this time, cannot survive such a scandal. The current modus-operandi of *shari’a*-arbitrage Islamic financing is too dangerous.

CONCLUDING REMARKS

I opened this paper with a partial quotation of remarks by the BMA governor at a conference. The remainder of the governor’s remarks read as follows:

If the Islamic sector is to continue to grow and to become a powerful force in international financial markets, it must also be able to attract the business of those persons who might prefer to use Islamic banks, but are also prepared to deal with conventional banks and other financial institutions. Islamic banking must do this without in any way compromising its Islamic principles.²⁰

The real question is whether “Islamic principles” should continue to be judged purely on juristic grounds. If they are, then any contracts approved by jurists on Islamic financial institutions’ payrolls will continue to be deemed “Islamic.” This reading of the governor’s remarks implies that Islamic finance will simply continue along its current *shari’a*-arbitrage trend.

Alternatively, Islamic finance could strive to adhere to Islamic principles by considering the true spirit of Islamic law. That would require examining the evolution of classical Islamic jurisprudence by the standards of its own time, legal limitations, and economic understanding. If that is accomplished, perhaps the industry can transcend the governor’s vision of serving those who would prefer to use Islamic finance, but only if it is competitive. This group also constitutes a captive market, albeit not as captive as the group who refuse to deal with conventional financial providers. In that regard, while the governor’s vision is ambitious relative to the current industry’s mode of operation, it is quite timid compared to the industry’s true potential.

If we take the universal message of Islam seriously, we must believe that enshrined in the *shari’a* (divine law, as opposed to the human understanding – *fiqh* – of a given time and place), then we must believe that Islamic finance will be better finance. In fact, it should be so good as to

²⁰ *Monday Morning*, February 25, 2004.

attract those who are indifferent as to whether or not it is called Islamic, and whether or not professional financial jurists approve its contracts. It is popularly said that a cobbler complained to Martin Luther that he was just a cobbler, and wondered how he could act as a good Christian within his trade. Luther, the popular story says, instructed him: “make a good shoe and sell it at a fair price.”²¹ When Islamic finance is truly Islamic, rather than profit-driven *shari'a* arbitrage, it should be good finance at a fair price. At that point, the industry can proudly abandon the “Islamic” brand-name, to everyone’s benefit.

²¹ This popular saying (cited by everyone from evangelical preachers, to music bands, see, respectively, www.covchurch.org/cov/news/item3369.html and www.ocweekly.com/ink/02/47/music-kane.php) is likely an elaboration (possibly apocryphal, but illustrative nonetheless) on a passage in Luther’s “Address to the Nobility of the German Nation” in 1520, wherein he said: “A cobbler, a smith, a peasant, every man, has the office and function of his calling, and yet all alike are consecrated priests and bishops, and every man should by his office or function be useful and beneficial to the rest, so that various kinds of work may all be united for the furtherance of body and soul, just as the members of the body all serve one another,” c.f. Fordham University’s Modern History Sourcebook at www.fordham.edu/halsall/mod/luther-nobility.html. Banking, like all other professions, can be beneficial to society when practiced in an ethical and professional manner. In that regard, an Islamic banker does not need to market his craft as “Islamic banking,” just as religious practitioners of other trades do not need to use religious brand-names.