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Islamic Banking and the Politics of International Financial Harmonization[1]

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INTRODUCTION

In the mid-1970s, the Arab Gulf made a dramatic entrance onto world financial markets. In one year, oil prices quadrupled, precipitating the fastest transfer of wealth in the twentieth century. Many Gulfis who previously had no dealings with financial institutions had their first introduction to banking. It quickly became apparent, however, that there was a tension between the institutions and norms underlying Western finance and the prevailing belief among many Gulfis that earning interest is forbidden by Islam. Throughout the Gulf, and particularly in Saudi Arabia, religiously observant individuals chose to leave their money in non-interest-bearing accounts rather than contravene Islamic law.

This cultural difference opened up the space for entrepreneurs to mediate between the global system and local beliefs and customs. The result was the creation of Islamic banks: financial intermediaries that offer services similar to those of conventional banks, but through financial instruments legally structured to comply with Islamic religious law *(shari'a)*. The entrepreneurs behind this institutional innovation have been able to create a profitable niche for themselves among the religiously conservative populations of the Gulf. Beyond their marketing advantage, they have likewise used demands for parity with conventional banks to receive government contracts, and the desire of foreign investors to present a "local" face on their business to market themselves for joint ventures. Their advantages are not strictly economic, however, as my research into the Islamic finance industry in Kuwait, Bahrain, and the UAE has shown.[3]

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[1] This paper is based on field research made possible by the Fulbright Commission and the Social Science Research Council.

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[3] See Smith 2004: 168-190.

Politically, the banks have been instrumental in creating synergistic relationships between Islamist businessmen, Islamist political candidates, and the Islamist political movements more generally. And socioculturally, the Islamic movements have been adept at using the public position of the banks within the economy to demonstrate the applicability of Islamic law to modern life, and to proselytize for Islamic values and lifestyle.

All of these advantages certainly make the cultural and structural difference of Islamic finance worth defending. This is not always easy, however, especially as the Islamic banks operate within a broader global economy completely oriented toward interest banking. In this setting "difference" can also be a liability, especially since the Asian financial crisis, as harmonization of business practices and regulations has been placed at the top of the agenda of international financial institutions (IFIs) and global policymakers. With the emphasis on standards and global norms, a premium is set on uniformity, putting Islamic banks at a disadvantage.

Clearly then there exists a tension for Islamic banks between their commitment to keeping their distinctive character and their desire to expand business through deeper integration into global markets. Their response has been to attempt an Islamic integration into the international financial system, which entails working with the existing international financial institutions to improve internal practices and to upgrade supervision of Islamic banks while simultaneously insisting on the distinctive nature of Islamic finance and therefore its need for separate regulation. To accomplish this, Islamic banks have adopted the surprising strategy of lobbying over the heads of their own state regulators, appealing directly to those international financial institutions that set the agenda for standardization and regulation, in the hope of winning their support in persuading their own central banks of the need for distinct regulations for Islamic finance. This has resulted in the realization of new transnational Islamic institutions for accounting standards, financial prudentials, the rating of individual banks and products, and the management of liquidity that mirror conventional ones and are meant to regulate and facilitate the functioning of Islamic finance internationally.

This outcome is remarkable. It runs counter to a decade-long trend of the growing irrelevance of regional standard-setting bodies that have come under intense pressure from IFIs and global businesses, which increasingly demand the adoption of uniform international standards as the cost of doing business. More surprising is the fact that these same IFIs appear to be granting their support and imprimatur to these Islamic standard-setting bodies, giving an enormous boost to Islamic finance in its search for international recognition and legitimacy.

Furthermore, the challenge of achieving international recognition on their own terms has pushed Islamic banks to greater levels of self-awareness and organization. The individual Islamic banks were forced to confront substantial obstacles to collective action and interest representation in order to pull together as an industry to create transnational institutions able to defend and speak for Islamic finance internationally. The outcome is nothing short of a new global market for Islamic finance, underpinned by distinct regulation and expanded through improved industry-government cooperation in the creation of new products.

In this paper I will recount this bold act of market creation and examine its impact. How did the new institutions of the Islamic market come about in the face of resistance from world policymakers and hostility from the majority of the Islamic countries' central banks? Now that a separate institutional framework for Islamic finance exists on a global level, what will be its relationship to the existing international financial architecture? Do these institutions simply facilitate the integration of Islamic finance into global finance, or can they be instrumentalized economically and politically to (1) negotiate favorable concessions in regulations, (2) promote regional markets and divert capital flows from the West toward Muslim countries, and (3) nurture Islamic unity and promote an Islamic worldview?

My underlying argument is that Islamic banks have sought to use their difference strategically to negotiate to their advantage while working *within* the global economic system. Yet at the same time, in constructing their difference institutionally on the global level, Islamic finance has now created a separate financial architecture distinct from conventional finance. Thus far the focus of Islamic financial institutions on the global stage has been on expanding commercial opportunities through international integration. However, there exists the potential that in the increasingly polarized political environment of the war on terrorism, these institutions may become instruments of those waving the banner of Islam in an attempt to mobilize political loyalities with the intent of shifting business patterns away from the West. I will examine this possibility in the conclusion of this paper.

THE NATURE OF INTERNATIONAL INTEGRATION

In the past two decades world financial markets have undergone dramatic changes. A wave of deregulation in the 1980s allowed for an unprecedented autonomization and internationalization of markets. Capital flows increased dramatically, as did the global reach of these financial markets, leaving few regions of the world untouched. This expansion of world capital markets has worked to the advantage of Islamic finance, allowing the industry to broaden its sights beyond domestic markets to Islamic communities throughout the Islamic world and in the West. Some leading institutions have grasped the potential of this expansion and are working to create transnational enterprises capable of providing a full range of Islamic banking and investment services globally.[4]

While the greater openness of international finance is favorable to the industry, some of its new regulatory expressions pose particular challenges. In response to a series of financial crises that sent shockwaves through the global financial system, the United States in coordination with IFIs has been leading a campaign to strengthen the infrastructure of the global financial architecture. This has involved a new wave of global regulatory initiatives aimed at harmonizing financial practices and enforcing global standards on issues such as capital adequacy and accounting and auditing standards. Thus Islamic financial institutions have found themselves under pressure to comply with these regulations and standards that are inattentive to their special characteristics and often detrimental to their interests. In this section, I examine their strategic options in approaching the challenge of preserving difference in the face of international financial standardization.

When faced with the obligation to comply with increased regulation, the economic literature suggests that firms—especially smaller ones—may choose to avoid the extra costs of regulation and retreat into the informal sector.[5] At first glance, informality may seem to be an attractive option for Islamic finance. Many of the Gulf Islamic banks have special status within their national regulatory environments which gives them some leeway in negotiating compliance with national banking laws. Also, Islamic firms already have considerable resources for self-regulation—specifically, a shared set of norms to guide them and internal supervisory committees (in the form of *shari'a* boards) to ensure that these norms are adhered to. Also, interviews conducted in the Gulf suggest that Islamic understandings of contracts already form a basis of understanding for many informal business arrangements carried out between small importers and traders.[6]

Despite these assets, informality has not been an option for most Islamic banks. Although Islamic banks are often small by global standards, they are usually too large to escape the notice of domestic regulators. Even

[4] The original transnational Islamic banks were the Saudi-owned Al-Baraka and Faisal Islamic Bank, but other domestically-oriented banks are now expanding. For example, Kuwait Finance House is now established in Turkey and Bahrain, has been granted a license to establish a bank in Malaysia, and has applied for one in Lebanon.

[5] For a discussion of the potential costs of implementing international standards, especially by small firms in the developing world, see the *2001-2 World Development Report* (WDR), "Institutions for Markets," the World Bank, section 1.71-1.75.

[6] Interview with Paul Kennedy, author of *Doing Business with Kuwait* (London: Kogan Page Ltd, 1997), December 1999. An example of a traditional Islamic transaction used in informal trade in Saudi Arabia is the "10-14," where a suq merchant could get an Islamically acceptable loan by paying 14 riyals on a old bag of rice worth only 10 riyals.

more importantly, Islamic banks are highly dependent on the financial markets of the West—although rather unusually for emerging markets, Gulf banks depend on global capital markets more as investment outlets, not as sources of capital. For example, a recent survey of Islamic mutual funds found that 70 percent of their holdings were directed toward the North American and European markets. The restricted size of stock markets in Muslim countries and the higher level of country risk both limit investment opportunities in the Islamic world.[7] Islamic banks also rely on partnerships with Western financial institutions for their financial expertise and international reach, and to manage their short-term liquidity. Thus, most Islamic financial institutions are globally integrated *in fact*, and must deal head-on with the reality of global harmonization and standard setting. In short, while the smaller, more autarkic banks may wish to "go it alone" through a combination of self-regulation and negotiation with national governments, this is simply not an option for the larger, more globally integrated Islamic banks. These banks depend on international partnerships to grow, and thus require the legitimacy conferred by regulatory approval to function in the global marketplace.

Given this need for international legitimacy, and more immediately the obligation to comply with state regulators, Islamic banks appeared to be left with no alternative but to apply the international standards set for conventional banks; indeed, most Islamic banks report to their central banks using the templates laid down by international bodies such as the International Accounting Board (IAB) and the Basel Committee of the Bank for International Settlements (BIS). But this arrangement has problems as well. As the framework used by conventional banking regulators is not specifically tailored to Islamic finance, there is considerable leeway in how Islamic banks choose to report their balance sheets. This "cherry-picking" in the application of international standards has led to the non-comparability of balance sheets among Islamic banks—a situation that is troubling even to international regulators. Furthermore, although individual Islamic banks may profit from the resulting loopholes, the industry as a whole feels disadvantaged by the inattention to the differences inherent in Islamic banking, especially as regulators and rating agencies appear to emphasize the risks of Islamic finance, without fully appreciating the mechanisms for alleviating those risks.

This has prompted the largest, most globally present Islamic banks to negotiate a "third way" between rejection and full integration by attempting an Islamic integration into global markets. This entails a vigorous defense of the need for distinctive standards for Islamic finance, while conceding the need for harmonization and improved governance and transparency within the Islamic banking industry. To carry out both tasks—the formation

[7] Wilson 2002. In December 2001 there existed 105 Islamic mutual funds, and only twelve of them were directed at emerging markets.

of new standards for Islamic banks, and the promotion of their adoption—an interlocking set of new transnational institutions is taking shape. The key institution leading this charge has been AAOIFI, the Accounting and Auditing Organization for Islamic Financial Institutions. In the next section, I will look at the creation of this remarkable institution and its role in establishing separate standards for Islamic finance.

ISLAMIC INTEGRATION: THE CREATION OF AAOIFI

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is a private self-regulatory body created to promulgate accounting and auditing standards for Islamic banks. AAOIFI was initiated by an alliance of the largest domestic and transnational Islamic banks and a supranational body, the Islamic Development Bank (IDB). The idea to fashion an alternative set of accounting standards different from those laid out by the International Accounting Board (IAB) was first taken up at the annual meetings of Islamic banks organized under the auspices of the IDB in 1987. After extensive discussions that included at various times Islamic bank officials, Islamic legal scholars, academics, accountants, and regulators, the idea of a standard-setting body for Islamic financial institutions was endorsed in the IDB Islamic bank meeting two years later in 1989. The Financial Accounting Organization for Islamic Banks and Financial Institutions (FAOIBFI)—which later became AAOIFI when auditing standards were added to its agenda—was finally registered in Bahrain in 1991.

The push for specific standards tailored to Islamic finance, then, came not from state regulators but from the banks themselves. The fact that private sector institutions took the lead in their own regulation is unusual; although some private sector actors have pushed for greater regulation (most notably the Mexican financial sector), this is relatively rare, and exceedingly so in the Middle East.[8] The alternative faced by these banks, however, was not to be left unregulated, but rather to be forced to adhere to conventional banking regulations as interpreted by their central banks.

It is difficult to understand the creation of AAOIFI without first appreciating the attitude of state regulators toward Islamic finance. In my own research I found those charged with regulating banks to be very conformist in their beliefs and eager to enforce international norms and standards. They were mostly educated in Western institutions and took seriously their role in enforcing economic orthodoxy. In many cases they viewed Islamic finance as an aberration and an embarrassment. They also resented the special treatment of Islamic financial institutions that often left

[8] The unusual nature of the enterprise is noted by Abdel Karim 1995b.

the latter outside of their full control; as one bank official in the United Arab Emirates stated to me, "Why should a bank having the word 'Islamic' in its name mean we treat it any differently?"[9] Even in states that were supportive of Islamic finance, such as Kuwait, the central bank was unaccommodating. And in those states that did not recognize Islamic finance, such as Saudi Arabia, separate consideration was impossible. At best, then, state regulators were ignorant and indifferent to the special needs of Islamic finance; at worst they were openly hostile to its claims of cultural exception.

The first secretary general of AAOIFI has stated directly that the motivation behind the creation of AAOIFI was the anxiety individual Islamic banks felt about the actions of their respective governments; specifically they feared that central banks and stock exchanges would force the Islamic banks to implement the standards set down for conventional banks by international regulatory bodies such as the IAS and Basel Committee in a way detrimental to their interests.[10] In a pre-emptive measure to avoid this regulation by conventional bodies, they agreed to form their own standard-setting organization charged with adapting regulations specifically for Islamic finance. This gave the banks an independent transnational institutional base from which they could—in the words of the secretary general—"mobilize more power to resist pressures from their environments"[11] and win special consideration for the industry.

In doing this, however, the individual Islamic banks faced considerable obstacles to collective action. The Islamic banking industry up until this time had a poor record in organizing, primarily due to the immaturity of the industry, the reality of business competition, and personal rivalries among its leading members. The banks also operate in a number of different countries and could not rely on national authorities to help in organizing. Furthermore, no banks like to be regulated, and some of the smaller, locally-oriented Islamic banks were enjoying the ambiguity of regulation in the current situation. It was the banking groups such as al-Baraka, which are present in several different countries, that suffer from the lack of uniform regulation most acutely. Therefore, it was up to these large globally-present Islamic banks to overcome their differences and take the initiative in organizing.[12] Indeed, the budget for the standard-setting

[9] Interviews with Farooq A. Ashraf, Banking Supervision and Examination Department, UAE Central Bank, January 2001; Salah Kohli, assistant manager, Supervision Department, Kuwait Central Bank, November 1999; discussion with Abdel Razaq Abdul Khalik Abdulla, internal audit manager, Bahrain Islamic Bank, January 2001, on its early dealings with the Bahrain Monetary Authority.
[10] Abdel Karim 1990: 302.
[11] Ibid., 303.
[12] This outcome is consistent with collective action theory, which suggests that market makers are willing to take on the added costs of organizing. See Olsen 1965: 29-31.

organization was paid through contributions from the IDB and the four largest institutions in the industry: the Faisal Group of Islamic Banks, the Al-Baraka Group of Islamic Banks, Al-Rajhi Banking and Investment Corporation, and Kuwait Finance House.[13]

From its inception, AAOIFI has been fighting on two fronts: (1) with its own constituents, to force an improvement in transparency and compliance with its regulations, and (2) with global institutions and central banks, to obtain recognition of Islamic finance's unique attributes and need for appropriately tailored regulations. As suggested above, the efforts to bring cohesion and consensus within the industry are challenging. Islamic finance incorporates companies from some thirty-seven countries, many with very different practices. Differences are particularly pronounced between the two axes of the industry; the Gulf being more conservative, and Malaysia more liberal in its Islamic legal *(shari'a)* interpretations. Due process procedures for drafting standards are thus both lengthy and complex. The initial committees argue for a long time to get a base set of proposals that are then sent to AAOIFI's *shari'a* committee and to the Acting Board before being issued as an exposure draft which goes out to about three hundred institutions. After receiving comments and review at a public hearing, the draft has to go back to the board for the amendments and to pass again through the *shari'a* committee.[14] This lengthy due process procedure guarantees broad input from the industry and prevents any individual or clique from controlling the process. The committees themselves are chosen strategically to bring in individuals with widespread influence and respect, and to incorporate views from across the industry (both ideologically and geographically). Although working slowly, AAOIFI has now succeeded in issuing fifty standards in the areas of accounting, auditing, governance, ethics, and *shari'a* rulings.[15]

Ultimately, of course, the standards will only be effective to the degree that the institutions adopt them, or at least look to them as a base. Here AAOIFI has faced the same difficulties as other standard-setting bodies that rely on voluntary adoption. Thus far only three states (Bahrain, Sudan, and Qatar) have adopted AAOIFI's standards in full, although others (Saudi Arabia, Malaysia, Jordan) are studying them or are looking to adapt them, and some individual banks turn to them on their own.[16] Clearly then, AAOIFI faces a fundamental dilemma. Its very existence is attributable to the conviction that Islamic banks will not get a fair hearing from their central banks. Yet because these banks operate in government-driven

[13] Abdel Karim 1995a: 121.
[14] Related in an interview with Rifaat Ahmed Abdel Karim, secretary general of AAOIFI, Bahrain, December 11, 2000.
[15] AAOIFI 2004.
[16] Malaysia's current debate over accounting standards for Islamic banks was recently discussed on an Islamic investors' website. *See* Hafizah 2001.

economies, the only way to get AAOIFI standards fully implemented by recalcitrant banks is through the directives of these same government institutions![17] It is for this reason that the sympathy and support of the IFIs is so important to AAOIFI's success. The IFIs yield enormous influence over central banks in the region, and support from them would have the effect of legitimizing the enterprise of Islamic finance. AAOIFI's strategy, then, has been to lobby over the heads of the national governments in the hope that they can bring the IFIs to their cause and through them the central banks**.** A flow chart of this dynamic is displayed below:

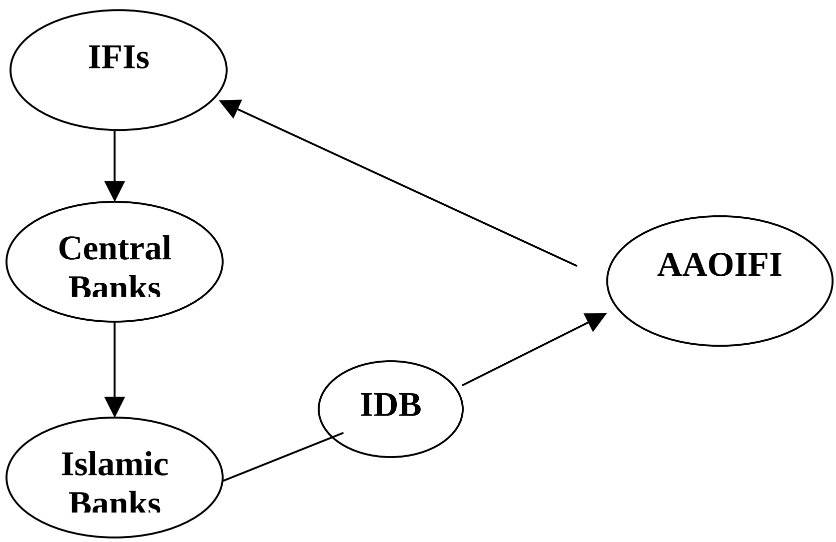

FIGURE 1.

Once constituted, then, AAOIFI began an all-out campaign to gain the recognition and backing of IFIs such as the International Accounting Board (IAB) and the Bank for International Settlements (BIS) which issues standards on capital adequacy through its Basel Committee. To gain the sympathy of these IFIs, AAOIFI lobbied them directly, but also began an assiduous courting of a most important mediator, the International Monetary Fund (IMF).

The IMF had become aware of Islamic finance through its member countries, particularly those that were attempting to implement from the top down a fully Islamic financial system. Its first operational involvement was with Iran, which was seeking to issue Islamically acceptable treasury bills. Later, the IMF also assisted the Sudan in developing an Islamic financial

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[17] The need for the central bank support is duly noted by Abdel Karim 1990: 304-305.

instrument for absorbing liquidity from the market. These initial forays into Islamic finance were complemented by some studies through the IMF research department into the effects of Islamic finance on government and monetary policies.[18] Yet another working paper was commissioned in 1998 to look at issues of prudential regulations and supervision in Islamic finance.[19] Still these engagements could be characterized as ad-hoc and did not constitute a significant visible engagement with the industry.

This more substantial interaction came through the persistence of AAOIFI, which succeeded in convincing the IMF to cosponsor a conference on the regulation of Islamic financial institutions held in Bahrain in February 2000. This conference received heavy participation from IMF officials, who presented papers on a wide variety of regulatory issues. A review of the papers, however, reveals that there was still not much intellectual engagement with the specific needs of Islamic finance; most of them merely reviewed the standing international regulations and urged Islamic banks to come into compliance with these conventional regulations—a point that was coldly received by the participating Islamic bankers.

Nonetheless, this conference did mark a gathering momentum in the interest and full engagement of IFIs in Islamic finance. It is fair to say that the IMF did not fully appreciate the consequences of its participation; as David Marston, the IMF Division Chief of Banking Supervision and Regulation, noted (tongue in cheek) he was "conned" into participation by AAOIFI Secretary General Rifaat Abdel Kareem, and was drawn into even deeper involvement in negotiations over the regulation of the Islamic finance industry after that. In these initiatives, he characterized the IMF as a "facilitator" and freely credited AAOIFI as being the "prime mover." The following September at the annual meetings in Prague, the IMF issued invitations to the central bank governors of eighteen countries to set up a working group to consider specific regulations for Islamic banks. The outcome of these negotiations was the establishment of the Islamic Financial Services Board (IFSB) in April 2002, with AAOIFI Secretary General Rifaat Abdel Karim as director. The goal is for the IFSB, which now has fifty-two members including fifteen regulatory bodies, is to have responsibility for the regulation and supervision of the Islamic financial services industry, with duties including (1) setting and disseminating standards and core principles for supervision and regulation; (2) cooperating with other standard-setters in the areas of monetary and financial stability; and (3) promoting good practices in risk management through research, training, and technical assistance.

The creation of the IFSB backed by the credibility of the IMF is the crowning achievement of AAOIFI and a testament to its success in defying

[18] Khan and Mirakhor 1991; Ul Haque and Mirakhor 1998.
[19] Errico and Farahbaksh 1998.

the trend toward the elimination of separate standards. AAOIFI's alliance with the IMF also gave it added clout in approaching other IFIs, and AAOIFI scored an impressive string of successes in gaining acknowledgment for Islamic finance. Rifaat Abdel Karim got the IAS to recognize Islamic accounting, and scored a seat on the Standards Advisory Council (SAC) of the International Accounting Standards Board (IASB) which provides advice to the IASB on priorities in setting standards and informs the board of the implications of proposed standards for both users and producers of financial accounts. Even more significantly, the establishment of the IFSB, which secured the influence of large state monetary authorities such as Saudi Arabia and Malaysia, finally persuaded the notoriously reluctant Basel Committee to support AAOIFI's initiatives on the grounds of making "more robust" its stated goal of adapting standards to local conditions.

The acceptance of AAOIFI and the IFSB are concrete manifestations of the success of the Islamic finance industry in gaining international acceptance of Islamic finance and acknowledgment of the need for separate consideration of its regulation. In gaining this recognition, however, the industry has had to pay the cost of relinquishing some of its authority in standard setting back to governmental bodies, both state and international. This serves the goal of achieving greater standardization within the industry. However, Islamic banks also have an interest in negotiating standards to their best interests and in seeing that their particular interpretation of international standards predominates. The question still remains: Can these new transnational Islamic institutions—and the argument for cultural exception more generally—be instrumentalized to yield concrete gains for the industry? The outcome of the negotiation between central bank governors, the IFIs, and the Islamic banks themselves can only become apparent by delving into the arcane minutiae of financial prudentials. To better understand the economic stakes in the battle taking shape, I will look in more detail at the arguments surrounding one such area: capital adequacy standards for Islamic banks.

THE POLITICS OF STANDARD SETTING: THE CASE OF CAPITAL ADEQUACY REGULATIONS

In the previous section I focused on "how" the Islamic finance industry is seeking to maintain its distinction and represent its interests on the global level through the creation of institutions like AAOIFI. In this section, I will focus on the "why": more specifically, why is it in the interest of Islamic finance to lobby for its own standards? Standard setting is a rather technocratic area of study. My goal here is not to give an exhaustive account of these procedures, but simply to provide enough background to show why having separate Islamic standards may work to the benefit of the Islamic financial industry, and thus why it may want to use the argument of cultural exception in its negotiations with the IFIs.

One of the key new components of international banking regulation aimed at increasing the strength and stability of the international financial system has been in the area of capital regulation. The main idea behind this regulation is to ensure adequate capitalization, given a bank's risk portfolio, to protect a bank from collapse. This area has received a lot of attention from IFIs as adequate capitalization is seen as a first line of defense in preventing banking failure and insulating the overall financial system from contagion. Enforcing minimal capital adequacy requirements is likewise a means to diminish a source of competitive inequality between international banks. Increasing capital reserves makes a bank more stable, but also diminishes its profitability; thus the existence of differing regulations results in an uneven playing field.

The agreed framework for measuring capital adequacy and the minimum standards to be achieved were laid out by the Basel Committee on Banking Supervision in the Basel Accords that were implemented in 1992. The Basel Committee is formed under the auspices of the Bank of International Settlements, which serves as a "central bank for central bankers" and is dominated by the G-10 countries. The accord sets a minimum ratio of a bank's capital to its risk weighted assets of 8 percent. Capital is further differentiated into two categories: Tier 1 and Tier 2, with restrictions placed on their relative size and relations to assets. Assets are assigned different risk-weightings based on a risk grid that weights more heavily for bank business with the private sector (vs. central government) and for non-OECD countries (vs. OECD):

Table 5. Basel Capital Adequacy Ratio and Risk Grid

Basel Capital Adequacy Requirement (CAR): $\frac{\text{Banks Capital (Tier 1+Tier 2)}}{\text{Risk-weighted Assets}} \geq 8\%$

Sample Risk Grid (showing risk-weightings):

	Central Govt	**Public Sector**	**Bank**	**Non-Bank**
OECD	0%	20%	50%	100%
Non-OECD	20%	40%	70%	120%

Thus for example a bank doing a lot of business with the private sector of a developing country would have a higher risk portfolio of assets than one working predominately with European governments, and would consequently be required by the Basel capital adequacy requirement (CAR) to hold more capital reserves. The basic concept, then, is to rate the riskiness of a bank's assets and to ensure an adequate amount of capital to cover that risk.

Islamic banks have been slow to warm to this system, and have questioned its applicability to Islamic financial institutions. In a 1988 interview, one of the leading Islamic banks, Kuwait Finance House, forcefully pointed out the "irrelevance" of what it called the "traditional" capital-adequacy ratio of commercial banks. The secretary general of AAOIFI shared this view in nearly identical language nearly a decade later.[20] Still, with regulators keen to push for these ratios—and the private sector turning to them as an important criterion as well—the industry and its standard-setting body felt it necessary to engage the CAR and make their case on their own terms. Their argument is based on the need to "adjust the framework to cater to the unique characteristics of Islamic banks."[21] The main difficulties in adapting the framework are twofold and are basd on both the asset and capital mobilization sides of the accounts.

As reviewed earlier, the most prominent distinction of Islamic banking is that it does not rely on interest-based instruments, and it does not deal in debt. This effectively shuts Islamic banks out of one class of assets that figures significantly in many banks, especially in developing countries: government bonds. Because these instruments are interest-based, Islamic banks are not in the business of lending money to the public or borrowing from it. At the same time, the most important set of assets for Islamic banks—namely *murabaha* facilities—are directed almost exclusively at the private sector. According to the Basel framework, these kinds of investments show a higher risk-weighting—100 percent or more—which means that under the Basel Accord, Islamic banks would be required to maintain higher capital reserves to offset these risks. This trend is exacerbated by the higher risk weighting for dealing in non-OECD businesses, which comprise a notable portion of Islamic bank asset portfolios.

Thus an initial reading of the Basel CAR would assign a higher risk to Islamic banks' assets and this would require them to set aside a larger portion of the banks' capital, cutting into bank profits.[22] This poses a grave problem for many Islamic banks because in their mobilization of funds, many are pursuing a strategy of aggressively pursuing profit-sharing investment accounts and keeping equity capital to a minimum.[23] Thus far,

[20] Quoted in Abdel Karim 1996: 32.
[21] Ibid., 33.
[22] The IMF report studying the application of prudential regulations to Islamic banks even suggests *increasing* the recommended Basel CAR to above 8 percent.
[23] KFH Annual Report 2001; or see graph in Abdel Karim 1996: 39.

then, the interaction between the prevailing norms on capital adequacy regulation and the different instruments used on the asset side of the balance sheet in Islamic banks works to the disadvantage of Islamic financiers. It is then to the liability side of the balance sheet that the Islamic finance industry turns to argue for special treatment and turn the difference of Islamic finance to its advantage.

The primary means Islamic banks use for mobilizing funds is through profit-sharing investment accounts (PSIA). PSIAs are uniquely structured to reward depositors if the bank profits, but to show losses if the bank's investments do not pay off. In practical terms, however, competitive pressures push the Islamic banks to reward PSIA account holders at rates nearly equal to prevailing conventional deposit interest rates. Islamic banks are also loath to lose depositors' money, and cases of this in the history of the industry are extremely rare. Still, the Islamic finance industry—through AAOIFI—has argued that PSIAs are fundamentally different from normal deposit accounts, and that this difference must be integrated into the CAR.[24]

The basic argument put forth by the industry is that since PSIAs bear risk in ways similar to equity capital, allowing the banks to absorb operating losses while staying in business, they should be used to augment the bank's capital calculations. The secretary general of AAOIFI suggests remedying this situation by allowing Islamic banks to deduct PSIAs from their risk-weighted assets. This would allow the Islamic banks to satisfy the core capital requirements stipulated by the Basel framework, while continuing to pursue a low-equity capital strategy that allows bank shareholders to maximize profits at no extra risk.[25] Therefore, this acknowledgment of the unique attributes of Islamic finance capital mobilization on the part of regulators would yield real financial benefits to Islamic financiers, and would offset the negative impact of CAR rules on risky assets.

AAOIFI has aggressively pursued its interpretation of capital adequacy standards on behalf of the industry, despite the fact that this is outside of its original mandate of adapting accounting and auditing standards. And it has had some success in arguing for the risk-bearing nature of Islamic deposits. In 2001, the Bahrain Monetary Authority (BMA) accepted AAOIFI's argument at least in part, allowing Islamic banks in Bahrain in calculating the CAR to subtract 50 percent of their PSIA deposits from their risk-weighted assets. This has the effect of freeing up bank capital for investment, thereby increasing potential profits for Islamic banks. Furthermore, there is no question that AAOIFI's bold entry into the area of capital adequacy standards forced state regulators to take up the issue; the concerns of state regulators about the industry writing its own regulations were one of the motivating factors behind the establishment of the IFSB. The IFSB has yet to issue its regulations on capital adequacy

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[24] This argument is laid out in Abdel Karim 1996: 32-44.
[25] Ibid., 39.

standards, but since former AAOIFI secretary general Rifaat Abdel Karim is now heading the IFSB, he is in a prime position to argue the industry's case, and early indications are that his argument will be accepted, at least in part.

These significant successes have been tempered by resistance from another set of international decision makers that have been less receptive to the Islamic finance industry's arguments: the ratings agencies. In June 2004, a revised framework for the international convergence of capital measurement and capital standards—known as Basel II—was published. Basel II gives much more authority to ratings agencies in determining the riskiness of banks and their assets. Thus a quick look at the relationship between Islamic banks and ratings agencies is in order; especially as it is revealing of the broad range of actors one must convince in gaining market acceptance and of some of the pitfalls in pursuing difference. The recent creation of an *Islamic* ratings agency also provides a window to exploring the rationale for and consequences of the expansion of a separate financial architecture for Islamic finance.

THE PROBLEM OF RATINGS AGENCIES AND THE CREATION OF THE IIRA

The case of capital adequacy standards shows clearly how the Islamic finance industry can use its difference strategically to negotiate to its advantage within the conventional financial architecture. Sustaining this advantage proves difficult, however, as such claims require acceptance by a wide array of actors and agencies. One class of actors that has been particularly bothersome to the Islamic finance industry is the ratings agencies. This is of concern due to the important market position of these institutions; the ratings agencies essentially signal to the market the credibility/riskiness of countries and institutions, and poor ratings can therefore limit one's access to international capital and global business.[26] The lower ratings consistently given to Islamic banks by the large ratings houses leave these banks paying higher spreads to raise money abroad; for example, KFH would currently pay higher rates in borrowing from Citibank (through Islamic instruments, of course) than would a Jamaican bank. And as stated above, ratings are to gain even more importance as the new Basel regulations come into force; then poor ratings will affect the capital adequacy requirements of these banks as well.

[26] In some sense Islamic banks are less vulnerable to ratings agencies because they are not on the bond market (ratings affect the bond prices for a bank). Still, the ratings affect their business in letters of credit and trade facilities, and there are general reputational costs as some banks are unwilling to accept dealings with lower rated banks.

The poor relationship with ratings agencies also deprives Islamic banks of a powerful market force for industry-wide standardization and acceptance. For example, one of the smaller ratings agencies sanctioned the Faisal Islamic Bank for not using AAOIFI accounting standards;[27] if such support for AAOIFI standards were widespread among ratings agencies they could become a powerful force for promoting AAOIFI and the unification of the industry. Unfortunately, however, the relations with the larger ratings agencies are more contentious, with the prevailing attitude toward the Islamic banks being "meet conventional standards or suffer the consequences."[28]

The ratings agencies claim simply that the Islamic banks have weaker internal controls and so earn lower ratings.[29] Yet they privately acknowledge that higher ratings tend to come to those banks that are at the heart of global finance. The professionalism looked for by the ratings agencies derives from dealing with Western banks, and becoming socialized in the same milieu; insular banks always tend to attract lower ratings. One agent confessed to me that although objective criteria are paramount, dealing with the raters is in some sense a confidence game where presentation and socialization count for a lot.[30] It is not surprising then that Islamic banks that aim for a separate and distinctive socialization of their own would be easily dismissed by these global arbiters. And it is understandable to see why the Islamic banks are now searching for a way to be judged by an institution closer to their worldview.

To this end, the International Islamic Ratings Agency (IIRA) was established in October 2002, and became operational in 2003. The IIRA is intended to be an independent body charged with rating Islamic banks and products by a uniform set of standards tailored to the requirements of Islamic finance. Still, from its inception there have been concerns about its independence and objectivity. The original conception of the IIRA called for strong participation from existing regional and international ratings agencies, which were to supply 50 percent of its financing while the Islamic banks would fund 35 percent and the IDB the remaining 15 percent of capital. Yet at the time of its launch, the IIRA received the bulk of its paid up capital—over 80 percent—from the IDB and the Islamic banks themselves. This lends greater credence to questions about its independence and objectivity. Although acknowledging a problem with the conventional ratings agencies, David Marston of the IMF expressed concerns about the

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[27] Capital Intelligence rating of Faisal Islamic Bank-Egypt, 1998.

[28] Interview with David Marston, IMF Division Chief of Banking Supervision and Regulation, May 2002.

[29] Interview with Andrew Cunningham, Moody's Ratings Agency, London, September 14, 2002.

[30] Interview with Andrew Cunningham, September 14, 2002.

moral hazard inherent in IIRA's link to industry in saying: "There is a risk in me telling myself I am handsome."[31]

More broadly, the creation of the IIRA reflects another danger with the whole strategy of creating an alternative financial architecture for Islamic finance. Although these institutions are necessary for the healthy functioning of Islamic finance on a global level, they can easily lead to its marginalization from global finance. The Moody's rater for the Middle East, Andrew Cunningham, stressed that this danger will become more pronounced with the shift from Basel I to Basel II. The new structure will encourage market players to employ a much more quantitative approach to judging banks, which will leave even less room for difference and explanation. He contends:

> One may argue for exceptions, but will anyone take the time to listen? This seems likely only for those organizations large enough and important enough to demand exception, and Islamic banks are still a small industry in the general scheme of global finance. The problem goes beyond convincing the IMF or the Central Banks; the market itself will ignore you.[32]

Stated another way, the creation of a separate market framed by distinct regulation and supervision will be in vain if there are not sufficient players to enter that market; as one trenchant observer of the Islamic finance industry noted, "You need products before you can have a market."[33] The Islamic finance industry—and its new state allies—have been attempting to address this problem by moving beyond building the regulatory framework of Islamic finance to addressing the dearth of products. This effort is epitomized in two new institutions based in Bahrain—the International Islamic Financial Market (IIFM) and the affiliated Liquidity Marketing Center (LMC).

MAKING A MARKET: THE INTERNATIONAL ISLAMIC FINANCIAL MARKET (IIFM) AND LIQUIDITY MANAGEMENT CENTER (LMC)

AAOIFI, the IFSB, and the IIRA mark concrete achievements in improving the regulation and supervision of Islamic finance. But making a market requires more than a regulatory framework. There is a need for a standardization of the contracts underlying the financial products, which in

[31] Interview with David Marston, May 2002.
[32] Interview with Andrew Cunningham, September 14, 2002.
[33] Interview with Taha Al-Tayeb, director of the Islamic Banking Program, Bahrain Institute of Banking and Finance (BIBF), June 23, 2002.

turn requires consistency in *shari'a* rulings. There is a need for greater openness and cooperation between companies and with government authorities. And there is a distinct need for more engagement from government authorities in helping banks to manage their liquidity. With this greater standardization and participation, a deepening and maturing of the market becomes possible through the creation of secondary markets.

The expansion and growing credibility of the Islamic marketplace has indeed attracted the attention of state authorities in the Gulf. This has given the industry an opportunity to enhance its product offerings by convincing monetary authorities to develop Islamically-acceptable treasury products. The fruits of these efforts are the new International Islamic Financial Market (IIFM) and the related Liquidity Management Center (LMC), both based in Bahrain.

The agreement to establish the IIFM was signed in November 2001 in Paris by Malaysia, Indonesia, Bahrain, Sudan, and the IDB. All of these states have a financial interest in seeing the growth of the Islamic financial industry. Their cooperation in achieving this growth, however, is complicated due to the competition between the two leading state proponents of Islamic finance: Bahrain and Malaysia. Both states have invested heavily in their offshore financial markets, and both have ambitions to be the center of the Islamic finance industry. It is a favorable sign, however, that they were able to compromise and clear the way for the establishment of the IIFM; Bahrain was selected as the headquarters of the venture, but the first chief executive officer selected, Abdel Rais Abdel Majid, is a Malaysian banker. The geographical distance between the two hubs is actually an asset, as both believe they can contribute to generating a twenty-four hour market for the industry.

The IIFM is set up as a company with the five country central bank governors and the IDB on board as shareholders. It is often advertised in ambitious terms as the new Islamic bond market, where governmental and non-governmental Islamic bonds can be issued, and a secondary market can be generated through the trading of these bonds. In reality its initial tasks are much more modest; the real goal of the IIFM is not to develop a competitive market to the existing one, but rather to ride on the existing infrastructure while providing the necessary incentives and support for bringing more Islamic products on the global market.[34]

As mentioned earlier, Islamic finance suffers from its inability to access the interest-denominated interbank market and likewise the market for government bonds.[35] This leaves the banks with few options for managing their short-term liquidity. The solution has been to turn to

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[34] Interview with Abdel Rais Abdul Majid, chief executive officer of the International Islamic Financial Market, Manama, Bahrain, June 23, 2002.

[35] The exception to this has been Malaysia, which issues Islamic government bonds, but the legal basis for this is contested in the more conservative Gulf.

contracts with conventional banks for short term commodity purchases—a device known in the industry as a commodity *murabaha*—but these vehicles give very little profit, leaving Islamic banks at a disadvantage against their conventional competitors. They are also disliked by *shari'a* scholars who have approved them only reluctantly with the expectation that the industry will eventually develop a more Islamically sound liquidity management vehicle.

Islamic and conventional financial institutions are working to do just that, but there is little cooperation and coordination between them. Instead each institution incurs expenses in developing the specialized contracts to pass through *shari'a* regulations, and thus sees these contracts/products as proprietary. Thus the relationship between the banks is still very competitive, as each bank guards its specific *shari'a* approved products as company secrets, and competing *shari'a* boards often refuse to accept the rulings of competitors. This has left the market extremely fragmented, as each contract is designed on an ad hoc basis, with little standardization and information sharing.

The IIFM is addressing this problem primarily through the creation of a *shari'a* supervisory committee (SSC) that will monitor the products being issued on the market. The hope is that this global committee, drawn from a geographically diverse and universally respected set of *shari'a* scholars, will help to bring about more transparency and standardization of *shari'a* rulings. It is also hoped that the new IIRA will bring more openness and consistency to the industry. There are also plans to open an Arbitration and Reconciliation Center for Islamic Financial Institutions (ARCIFI) to curb the more damaging side effects of competition between Islamic banks.

At present, however, the IIFM is hindered by the lack of commitment from the industry. The initiating governments that have a financial stake in seeing Islamic finance develop have contributed to the start-up costs of the IIFM, but the competing banks and financial institutions have not yet done so. This has left the IIFM with very modest resources; reportedly the IIFM began its work with a mere $100,000, barely enough to make it through its first year. Unless things change, with such minimal financial commitment, the CEO of the IIFM is reduced to the role of fundraiser, promoter, and agitator; having no resources on his own for product development, he can only persuade industry players of the importance of their development and encourage information sharing between them.

Due to the IIFM's limited resources, the initiative for product development has been taken up in earnest by its sister institution in Bahrain, the Liquidity Management Center (LMC), whose stated goal is to develop an active secondary market for short-term *shari'a* compliant treasury products. As an initial step in this process, the Bahrain Monetary Authority in June 2002 became the first state authority in the Gulf to issue Islamic government bills on a monthly basis. In August of the same year, the BMA announced the release of five-year Islamic leasing bonds to address the requirements of Islamic financial institutions for medium and long-term investment opportunities. On their own, these two releases are small—the Islamic government bill issue was only $25 million, and the Islamic leasing bonds issue was $100 million—but they marked a first step toward adding tradeable investment products for the Islamic market.

The actions taken by BMA have led more government authorities to experiment in asset-backed Islamic government bonds that are known in the industry as *sukuk*. Since the initiative taken by Bahrain, the IDB, Malaysia, Qatar, and the German state of Saxony-Anhalt have all issued international *sukuk*, and they are currently under consideration by the Central Bank of Kuwait as well. The IIFM and LMC are betting that financial institutions, conventional and Islamic, will likewise be attracted to the capital mobilization potential of Islamic finance, and will see the opportunity in creating a wider array of Islamic investments and products. In any case, the entrance into the Islamic market of many governments that were once ignorant of or hostile to Islamic finance is a further reflection of the growing acceptance of Islamic finance in the Islamic world.

ISLAM IN THE CONVENTIONAL GLOBAL MARKETS: A “FINANCIAL CLASH OF CIVILIZATIONS”?

This paper has provided an overview and analysis of the underlying institutions of the newly emerging global Islamic financial market. It is worth reflecting on the political implications of this incipient act of market creation. Although initiated for the express purpose of further integrating Islamic finance into global financial markets, these uniquely Islamic institutions clearly represent an alternative financial vision underpinned by its own norms and standards. Taken together with the growing mistrust and distance generated between the West and the Islamic world by the September 11 tragedy and its aftermath, one might ask if this signals a growing divide: a financial clash of civilizations? More specifically, can these newly established institutions be instrumentalized economically and politically to promote market divisions and create a regional market for capital mobilization and investment nurtured by an Islamic worldview?

Most Islamic bankers support using claims of cultural exception to negotiate to their advantage in the application of regulations; we have already seen this done successfully to alleviate the burden of capital adequacy on Islamic banks. Still others would like to wave the banner of cultural authenticity more broadly in an attempt to mobilize political loyalities with the intent of shifting business patterns. The CEO of the IIFM, Abdel Majid, speaks in ambitious terms of drawing Islamic money from the capital rich region of the Gulf to the product rich areas of Asia. The goal is to use Islamic solidarity as expressed through the IIFM to shift capital flow from the West to the East.[36] He sees an ideal opportunity for such an historic shift in the tension-filled atmosphere of post – September 11th West-Islamic relations.

There are clear signs that the poisonous atmosphere of the war on terrorism has strengthened the desire among many Muslims for Islamic solidarity in the financial realm. The director of the Islamic Banking Department at the State Bank of Pakistan noted that the current international situation has prompted a strong response, motivating many Muslims to shift to Islamic banking.[37] Also since September 11th there is growing unease over the arbitrary way in which regulatory authorities in the West have been acting against Islamic investment funds as well as conventional funds promoted by Arab banks. Some fund managers from the MENA (Middle-East North African) countries are considering relocating the domicile of their funds from Western jurisdictions such as Luxembourg to the growing Islamic financial centers of Bahrain and Labuan (Malaysia). Wealthy Arab investors have likewise been outraged by the freezing of Arab bank accounts, sometimes due to confusion over names, and many are looking to diversify their investments away from Western markets. There at least seems to be the potential to stem in part the capital flight from the Gulf and to generate a regional network for project finance and investment that would be small in global terms but quite significant for the region.

Such a shift still faces powerful economic impediments, however, in the form of small markets and political risk. Still, if political polarization with the West accelerates, then the political risk for Arab and Muslim investors may rise in the advanced industrial countries as well, making investment on the Islamic market more attractive.

The constitution of Islamic finance on the global level is the culmination of a strong desire on the part of many Muslims both to hold true to their religious principles and to express global Islamic solidarity. Whether this can be translated into greater financial independence and regional integration remains to be seen. But even in its incipient form, the evolving Islamic financial system has succeeded on a political level in constructing a concrete institutional manifestation of those aspirations.

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[36] Interview with Abdel Rais Abdel Majid, June 23, 2002.

[37] Mentioned in a talk by Pervez Said, director of the Islamic Banking Department, State Bank of Pakistan, before the Sixth Harvard University Forum on Islamic Finance, May 8-9, 2004.