ISLAMIC FINANCE

INNOVATION *and* AUTHENTICITY

S. Nazim Ali
Editor

With an introduction by
Rodney J. A. Wilson

Islamic Finance Project
Islamic Legal Studies Program
Harvard Law School

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Preface

The Eighth Harvard University Forum on Islamic Finance, held in April 2008, with its blend of academic scholarship and business experience, was a unique venue for critical and objective examination of Islamic finance. Lawyers, regulators, academics, and practitioners alike analyzed the legal and regulatory challenges faced by the industry and discussed new developments in the field. The papers were selected from a pool of submissions based on the evaluations of the Forum's reviewers. More than forty papers and speeches were chosen for the Forum, including those presented at the pre-Forum workshop on microfinance. Each reflects on some of the key issues that affect the relationship between Islamic finance and the mainstream financial community, particularly the balance between innovation and authenticity.

This Forum occurred at a major junction in the history of Islamic finance. As the industry grows in popularity and breadth, the importance of analyzing what *shari'a*-compliant Islamic finance truly is has become a contentious issue for many in the industry. For that reason, we chose to focus the Forum's discussion around the themes of innovation and authenticity. This analysis addressed questions such as: How can we learn from modern economics and finance, while remaining true to an Islamic ethical core? Can we modernize Islamic banking? What are the limits of innovation in Islamic finance?

For the first time, the Forum hosted a Nobel Laureate to deliver the keynote address. Robert Merton, the recipient of the 1997 Nobel Prize in Economic Sciences, identified important areas for economic development and for the efficient management of risk. He commented on the potential of utilizing available conventional market innovations in accordance with *shari'a* standards and challenged the Islamic finance industry to further probe *shari'a*-compliant derivatives for risk-mitigating strategies. When reading his paper in the volume, one should keep in mind that it was delivered before the global financial crisis.

The Forum Address by Umer Chapra is also featured in the volume (Chapra's closing remarks have not been included). Returning to themes touched upon throughout the Forum, in his closing address Chapra analyzed the role of *maqasid al-shari'a* in financial systems. What exactly is Islamic about Islamic banking? How do we stay true to

shari'a objectives while accounting for modern financial needs that perhaps had no precedent in earlier times?

William A. Graham, Dean of Harvard Divinity School, John Lord O'Brian Professor of Divinity, and Murray A. Albertson Professor of Middle Eastern Studies, delivered the banquet address and spoke about misconceptions regarding politics and Islam in the United States and globally and their implications thereof. Graham provided the historical context of Islamist movements in the last three decades, stating that there have been only a few pre-modern attempts to found Islamic states. The idea of a theocratic state, he noted, never became a widespread reality in the Islamic world, much as it never became a popular reality in the Christian world. Indeed, there has often been a functional split between the state and *ulema*, which continues in modern times. He concluded that today's more extreme Islamist elements, which call for the creation of polities around Islamic ideals, are moved by nostalgia for an Islamic religio-political ideal that, in fact, never existed.

As mentioned above, more than forty papers were presented at the Forum and the workshop on microfinance, organized under specialized sessions devoted to *shari'a* scholars' perspectives on innovation and authenticity, international perspectives on governance and policy, debt and equity modes of financing, *shari'a* scholars' perspectives on debt and equity, microfinance in a sustainable Islamic finance model, and current academic research. As a new, unique feature to this Forum, we included video footage, produced by the Islamic Finance Project, of comments by four prominent *shari'a* scholars and two senior Islamic economists who were unable to attend in person. These video clips provided an interesting platform that developed into a thought-provoking discussion.

Since the Forum was held in April 2008, several events have affected the banking landscape, foremost among them the ongoing global economic crisis. At the time, it was commonly believed that Islamic financial institutions would be less affected by a crisis than conventional banks. However, the overall credit crisis decreased liquidity in the Islamic finance industry's capital markets, and some major default scenarios in Dubai, Saudi Arabia and the United States further undermined confidence. Additionally, the industry's heavy exposure to real estate caused significant devaluations in a majority of Islamic banks' balance sheets. Lastly, issuances of *sukuk* slowed dramatically during the crisis, with unfavorable market conditions commonly cited as a major factor. Islamic financial institutions have

also suffered a setback, as well as received a new opportunity, because of Justice M. Taqi Usmani's criticism of the practice of *sukuk* and the OIC Fiqh Academy's decision on *tawarruq*. These developments point to the ongoing need to organize forums for the critical examination of Islamic finance and its improvement as a field.

In response to these events, the Islamic Finance Project (IFP) has expanded its range of activities to complement Forum discussions. The Project has also started a new series of panel discussions. The first panel discussion focused on Aamir Rehman's paper on the response of the Islamic finance industry to the economic crisis, while the second centered on Mahmoud El-Gamal's paper on Islamic finance, petrodollar recycling, and economic development. Both panel discussions brought together scholars from varied backgrounds for a dialogue on specialized issues within Islamic finance. IFP continues to make efforts to hold joint workshops with the London School of Economics (LSE). The last workshop was held in 2009 on risk management, and the next one is scheduled for 2010 on ethical governance.

The other major area that IFP has been looking into is *shari'a*-compliant microfinance. A successful day-long symposium was held in 2007 to address how Islamic finance institutions and microfinance institutions can learn from each other's successes to better provide *shari'a*-compatible products to underprivileged communities. This was followed by a pre-Forum workshop on April 18, 2008, to discuss concepts and ideas about financing the poor within a sustainable Islamic finance methodology.

The Eighth Forum was a huge undertaking made possible by the support of many individuals and organizations. I wish to thank the sponsors of the Forum and of IFP: Abu Dhabi Islamic Bank, Arcapita Bank, HSBC Amanah, The International Investor, Kuwait Finance House, and Wellington Management Company. They have valued and encouraged our work in this field. I am also grateful to the faculty and staff at the Islamic Legal Studies Program (ILSP) from whom the IFP has drawn tremendous support, and the student volunteers at various Harvard schools whose impressive work allows us to be ambitious in planning such a Forum as this. Special thanks to Iqbal Khan, Chief Executive Officer of Fajr Capital Limited for his untiring efforts in gathering much needed support from the Islamic finance industry.

A number of individuals have supported the Project and worked together to enhance and increase its activities. Most notable among

them are Baber Johansen, Acting Director, ILSP and Affiliated Professor at Harvard Law School; Samuel L. Hayes, Professor Emeritus, Harvard Business School; Frank E. Vogel, Founding Director of the ILSP; Ibrahim Warde, Adjunct Professor, Tufts University; and Thomas D. Mullins, former Associate Director of the Center for Middle Eastern Studies. Finally, the untiring efforts in the transfer of IFP to Harvard Law School by Peri Bearman, Associate Director of the ILSP, who has recently retired, will not be forgotten.

We are especially proud of the level of involvement and commitment to the Project shown by students in the Harvard community. They have been a wonderful resource in compiling the research DataBank, organizing the Forum and seminars, and assisting with research and publications. Special mention goes to Yousra Fazili AM ’09, Zain Khalid AB ’08, Hisham Mabrook AB ’08, and Shaheer Rizvi AB ’08, for their work and contributions in the organization of the Eighth Forum. IFP is also fortunate to enjoy the advantages of a terrific network of alumni who continue to contribute their ideas and wisdom to the Project long after they have left us. For this in particular, we thank Taha Abdul-Basser AB ’96, PhD candidate, Saif I. Shah Mohammed AB ’02, Aamir Rehman AB/AM ’00, MBA ’04, M. S. Shaheen JD ’06, Mansoor Shakil LLM ’04, Abdur-Rahman Syed ’99, Nadiah Wan AB ’07, Munir Zilanawala AB ’01, and Farhan Abbasi of Ernst & Young, Boston, for their immeasurable support. I would also like to take this opportunity to thank Husam El-Khatib for his aid in organizing the joint Harvard-LSE annual workshop and public lecture at the LSE in London.

Last but not least, I would like to acknowledge Rodney Wilson, Professor of Economics and Director of Durham University’s Centre for Islamic Finance, Durham, United Kingdom, for writing the introduction, and Hebah Ismail AB ’06, JD ’10, Husam El-Khatib, and Muhammad Hassaan Yousuf AB ’12 for their assistance in compiling and editing this publication. Their contributions to this book were invaluable.

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Introduction

Rodney Wilson[1]

The Harvard University Forums provide an opportunity for *shari'a* scholars, Islamic economists, lawyers, regulators, and bankers to meet biennially and discuss the current state of the Islamic finance industry. Participants are encouraged to be reflective, to question and to view Islamic finance in its wider social context. The theoretical ideas discussed at these academic gatherings have played a major role in shaping contemporary Islamic financial contracts and in influencing practice. Of particular significance has been the debate between the often idealistic Islamic economists, the *shari'a* scholars concerned with the integrity of *fiqh*, the lawyers who draft the contracts, and the specialists who engineer new Islamic financial products.

The contributions to the Eighth Harvard University Forum are especially valuable, and cover a wide range of issues concerned with Islamic finance. The general theme of innovation and authenticity highlights the possible conflicts between the rapid emergence of new Islamic financial products and the need to ensure that the contracts are authentic from a *shari'a* perspective. While some welcome the advances made by the financial engineers in the design of new Islamic financial products and applaud the efforts by law firms to ensure the contracts are enforceable under English common law, others believe that the pace of product development is too rapid, and that *shari'a* boards are being encouraged to validate new financial products without having the time to reflect on all the implications which the process of *ijtihad* requires.

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[1] Professor of Economics and Director of Durham University's Center for Islamic Finance, Durham, United Kingdom.

INNOVATION AND AUTHENTICITY

The Nobel Laureate and Harvard professor Robert Merton was invited to give a keynote address to the forum, which is included in this volume. Viewed with hindsight from the aftermath of the financial crisis the address is interesting, as it highlights some of the achievements of financial engineering in separating the management of risk exposure from expenditure on physical capital. In other words, it is to some extent a defense of derivatives and the spreading of risks, believed by many as the mechanism through which the United States sub-prime crisis became a global financial crisis.

Islamic finance is concerned with sharing risk, bearing each other's burden in a moral sense, and thereby justifying the reward of profit. This is often the opposite of what derivatives traders do, their aim being to transfer risk to others while closing out their own positions for a secure profit. Of course much of the wealth created by what Merton describes as the efficient management of risk has now been destroyed. This demonstrated its transitory nature and the danger of separating the financial from the real economy, a separation that Islamic economists reject.

Although Islamic finance has not come unscathed out of the financial crisis of 2008, most Islamic banks fared better than their conventional counterparts. They could not of course invest in the toxic collateralized debt obligations at the heart of the crisis, as such assets paid interest. Rather as with classic banking, most of their deposits were used for client funding, eliminating the need to borrow in the inter-bank markets, which dried up with the credit crunch. In other words, the risks were internalized; the opposite of what was the case with the hedge funds and investment banks to which Merton is referring.

Umer Chapra addresses the issue of innovation and authenticity from an academic perspective, using an approach which combines the analysis of technical financial detail of product innovation with an assessment of the consequences when systems cease to work, which has moral implications. He focuses in particular on the causes of the financial crisis, which was significantly deepening by the time the Eighth Harvard University Forum was held. He attributes the crisis to excessive lending and a dependence on doubtful collateral when defaults occur, rather than appraising the business potential when

making financing decisions.[2] Chapra believes that if finance were based on profit and loss sharing rather than interest there would be better incentive structures that would encourage bankers to appraise risks, not least because their depositors also had a vested interest in the bank's profitability, which is not the case in conventional banking. It is evident with hindsight that much of the innovation was in ways of packaging collateral, to make dubious assets appear of higher worth, rather than in transforming the banking system to the more prudent and fairer model suggested by Chapra.

While Chapra defends existing Islamic banking practice, and sees it as far preferable to conventional interest-based finance, he nevertheless would like to see Islamic banks more engaged in profit and loss sharing contracts rather than relying on *murabaha, ijara, salam,* and *istisna'*, all of which involve debt. Although these methods of finance are fair and certainly *shari'a* compliant, he believes that if Islamic banking is to be more authentic, then there should be more emphasis on equity participation and profit and loss sharing. As moral hazard and principal–agent conflicts explain the failure of profit and loss sharing to take off, Chapra investigates how the influence of these factors could be mitigated. Controversially Chapra casts doubt on the independence of *shari'a* board members, believing that the fact that they are paid by the institutions they serve compromises their position. The same, however, can be said of financial auditors, yet few contest their independence.

Chapra, however, does not oppose a devolved system of *shari'a* governance, but suggests that greater transparency over what is actually being approved might bring market discipline, as customers become reluctant to continue being involved with institutions whose financial products and overall business strategy is questioned. He suggests that centralized *shari'a* boards could be a way forward, and of course some countries such as Malaysia have such boards, but a contrary argument is that these could potentially stifle innovation and result in political agendas being imposed. He also argues the case for international standards for *shari'a* compliance. The Islamic Financial Service Board (IFSB) *Guiding Principles on Shari'a Governance*,[3] issued since Chapra wrote his contribution, covers best practice with regard to

[2] See also Umer Chapra, "The global financial crisis: can Islamic finance help?" *New Horizon*, London, January 2009, http://www.newhorizon-islamicbanking.com.
[3] Freely downloadable from www.ifsb.org.

shari'a compliance procedures, although it does not adopt a one size fits all approach. Standardization of *fatwas* on financial matters seems unlikely, as since the early years of Islam there have always been different schools of Islamic jurisprudence, and there is no central Islamic authority.

Chapra makes two innovative suggestions on *shari'a* governance; the first being that scholars should examine how far newly proposed Islamic financial products conform to the spirit of Islamic law, and not just the legalities of *fiqh*. This might involve a change in the terms of reference governing the remit of *shari'a* boards. The second suggestion is to have independent *shari'a* audit firms whose remit is to ensure that the *fatwa* approved by the *shari'a* board are actually implemented in the day-to-day business of the Islamic bank. This would involve visiting the banks' premises to undertake inspections. At present assurance at the implementation level is provided by the internal *shari'a* audit units of Islamic banks, whose independence can be questioned, even though their prime accountability is to the *shari'a* board. Having an external auditor which is independent of both the bank and the *shari'a* board could have some merits, although this was not a model considered in the IFSB guidelines.

The most theoretical contribution is that by Mansoor Shakil. He attempts to apply the approach of Iman Al-Shatabi to the objectives of the *shari'a,* which can be interpreted as the "well-being" of people. In the context of the debate on innovation and authenticity it could be argued that the latter is essential for "well-being" in the deepest sense, but can the same be said of innovation? Some innovations in Islamic finance are useful and others less so; indeed far from contributing to well-being, they might actually undermine it. An example of this cited by Shakil is *tawarruq,* a convenient device that provides cash advances to clients who want the flexibility to shop around rather than being obliged to accept a specified commodity as with *murabaha*. The difficulty is that although *tawarruq* can conform to the letter of *shari'a* jurisprudence, it lacks substance. Instead of contributing to well being, its excessive use may encourage profligate spending and indebtedness, hardly desirable attributes of an Islamic economic system. The decision of the Organization of the Islamic Conference (OIC) Fiqh Academy in May 2009 to prohibit *tawarruq* in most circumstances has therefore

been widely welcomed, the only cases where it can continue without condemnation being where it is unintentional.[4]

Abdurrahim Habil critiqued the industry's heavy reliance of *hila*, a casuistic legal stratagem commonly used to substitute certain general principles of the Islamic law of transactions (*fiqh al-mu'amalat*) such as the principle of *daman* (a contractual liability that serves as a guarantee). He further proposed that the use of *hila* may, at times, indirectly implement the principle of *daman*, yet the use of *hila* would, at other times, be used to evade the primary legal criterion of *daman*.

Habil identified three important disagreements within the industry: (1) fundamental differences among scholars on the legality of some major modes of finance, such as *ijara muntahiya bi'l-tamlik* (purchase and lease-back ending in ownership) and *tawarruq* (cash seeking; monetization; commodity *murabaha*), potentially calling the Islamic authenticity of such modes into question; (2) court disputes on the authenticity (or legal authority) of *shari'a*-based contracts, as in the case of *Beximco Pharmaceuticals v. Shamil Bank of Bahrain*, where *shari'a* principles were ignored and instead English law was referred as the sole governing law; (3) general uncertainty regarding the authenticity of Islamic finance as a whole, rejecting the necessity of an independent Islamic finance system.

Habil further elaborates on the spread of *hiyal* (plural of *hila*), the issue of undisclosed intentions of parties in these types of contracts, the complex structures of multiple documents, and a survey of basic principles and contracts employed in the industry in light of the authenticity of *daman*. Habil concludes by arguing that the authenticity of contemporary Islamic finance is called into question because of its use of *hiyal*, and that in order to ensure authenticity, the concept of *daman* must be employed as a criterion of legality.

NATIONAL FINANCIAL REGULATION AND ISLAMIC MONETARY UNION

Islamic financial institutions have emerged in a legal and regulatory environment that was established to serve conventional banks rather than the particular requirements pertaining to *shari'a* compliant assets and liabilities. Shamshad Akhtar, former Governor of the State Bank of

[4] http://www.islamicbanker.com/tawarruq-fiqh-academy-aaoifif.html (accessed June 8, 2009).

Pakistan, addresses the issue of authenticity and innovation from a practical regulatory perspective.[5] She highlights the success of Islamic finance in overcoming the high level of financial exclusion in many developing economies. She believes Islamic finance widens choice and complements rather than replaces conventional finance; indeed she sees much benefit in exploiting the synergies between conventional and Islamic finance.

Akhtar views Islamic finance as inherently authentic as it approaches finance from an ethical and equitable perspective and stresses partnerships based on profit and loss sharing. However, she recognizes the gap between theory and practice, as many of the Islamic financial products have involved tweaking to ensure that the returns converge with those offered by conventional financial institutions. In practice profit and loss sharing contracts such as *mudaraba* and *musharaka* are relatively little used, partly reflecting aversion to market risk when capital cannot be guaranteed and the absence of an adequate legal framework governing property rights in many developing economies. With political will the latter can be remedied, but less can be done about risk aversion, not least because profit and loss sharing contracts are long term in nature, but Islamic banks, like their conventional counterparts, have a preference for less risky self-liquidating short term finance.

From a regulatory perspective Akhtar sees a number of issues that are specific to Islamic banks as being of importance. These include reputational risk, which will be determined to some extent by the effectiveness of *shari'a* governance, including lines of reporting between the *shari'a* boards, directors, and management. Investor protection is also an issue, including the responsibilities to *mudaraba* investment account holders.

The diversity of the papers presented at the Eighth Harvard Forum is demonstrated by Joseph DiVanna's evaluation of the feasibility and sustainability of an Islamic monetary union. Although a distant prospect which faces many obstacles, as the attempts at a much more limited Gulf Co-operation Council (GCC) monetary union illustrate, DiVanna believes such a union is economically feasible if there is

[5] The full text of Shamshad Akhtar's speeches while Governor of the State Bank of Pakistan, including the 8th Harvard Forum address, is available on the State Bank of Pakistan's website: http://www.sbp.org.pk/about/speech/governors/dr.shamshad/2008/index2.asp.

political will among the potential participants.[6] Such a union would open up interesting possibilities for Islamic financial institutions, and DiVanna believes it would accelerate the growth of the Islamic banking industry and bring cross-border investment opportunities. He points to the initiative of the OIC in 2005 in proposing a ten-year program of action to meet the challenges facing the Muslim *umma* in the twenty-first century. This initiative included a call for an Islamic common market, which in the case of the European Union was what preceded monetary union and the eventual adoption of the Euro.

The issues are complex but worth considering here, although the prospects of an Islamic monetary union actually being achieved are remote, and certainly more distant than DiVanna suggests. Wisely he provides no timetable. The issue of an Islamic monetary union raises fundamental questions about the scope for faith-based economic cooperation. Economic unions usually encompass geographically contiguous countries that have similar economies and political systems and already have a high level of intra-union trade, such as the European Union. The OIC countries are clearly not geographically contiguous and when attempts have been made to form unions between non-adjacent states, as in the case of the short-lived United Arab Republic between Egypt and Syria, or the union of West and East Pakistan, they have not lasted.

Even the proposed GCC monetary union has experienced difficulties, with Oman withdrawing and Kuwait using a trade-weighted basket to benchmark its exchange rate rather than pegging to the US dollar like the other five GCC states. Most recently in May 2009 the UAE surprised its neighbors by announcing that it was withdrawing from the proposed GCC monetary union, largely in retaliation to the decision of the other states to select Riyadh as the location for the GCC central bank in preference to Abu Dhabi. The project is being continued by the remaining four members, but it remains to be seen how viable it will prove with the region’s second largest economy excluded.

There have been proposals in the past for a single Islamic currency, most notably from former Prime Minister Mahathir bin Mohamad of Malaysia, who urged the adoption of an Islamic gold dinar, similar to the medium of exchange used in the early centuries of

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[6] Emilie J. Rutledge, *Monetary Union in the Gulf: Prospects for a Single Currency in the Arabian Peninsula,* Oxford: Routledge, 2009.

Islam.[7] However, there was little follow-up to this, although Malaysia used gold to pay for some imports of oil from Iran, but this scheme was soon abandoned because of the lack of practicality.

DiVanna rightly distinguishes monetary union from the adoption of a common currency, as the former involves the coordination of monetary policy, whereas with respect to the latter countries with failed currencies, such as Zimbabwe, have simply abandoned these and adopted the US dollar as a means of payment. During colonial times common currencies, such as the East African shilling, were usually managed by currency boards, which lacked the monetary powers of a central bank. This, however, raises an issue not considered by DiVanna, the degree of autonomy central banks in the Islamic world actually enjoy, as often they have little policy-making freedom and simply serve as the monetary agents of the finance ministries rather than being able to make independent decisions. There is also the issue of whether Muslim countries would be willing to cede monetary sovereignty to an Islamic central bank. A parallel can be drawn with British opposition to the loss of sovereignty implied with the adoption of the Euro and its reluctance to abandon Sterling.

The European Central Bank is the sole example today of an institution managing a currency used by multiple states, and the GCC Central Bank intends to draw on its experience. It sets interest rates and conducts repurchasing operations for the entire Eurozone, and tries to assess what is the optimal monetary policy for the fifteen economies involved, a difficult task as inflation, growth, and unemployment rates vary considerably across the member states. However, there is a high degree of intra-zone trade and free capital and labor mobility, conditions not found among OIC member states, or indeed even within the GCC sub-group, where intra-area trade remains limited.

DiVanna raises the pertinent question of whether an OIC monetary union should use conventional policy instruments such as interest rate changes to curtail inflation, or whether instruments accepted as *shari'a* compliant should be used. Obviously, for supporters of Islamic finance the latter approach is preferable, but although there is a small literature on monetary policy from an Islamic perspective, no country anywhere

[7] Mohd. Ma'sum Billah, "Islamic Gold Dinar: A Socio-Economic and Regulatory Analysis," unpublished paper, Jeddah, 2003.

in today's world is actually pursuing a monetary policy based on *shari'a* compliant instruments.[8]

Some countries such as Bahrain issue ninety-day *salam* sovereign *sukuk* which Islamic banks use for their liquidity management, and Malaysia has an interbank Islamic money market, but in both jurisdictions monetary policy still relies largely on interest based instruments to control inflation. DiVanna envisages that in an Islamic monetary union interest would continue to play a role, even if named differently as in Iran, but that over time it would gradually be phased out. For this to happen alternative *shari'a* compliant monetary instruments would have to be held by Islamic banks that could be purchased by central banks when they want to increase the money supply, and sold by central banks when they want to reduce customer advances by Islamic banks to curtail inflation. Such a system could be viable, and work at least as well as conventional tools of monetary policy, but additional work is required if the type of instruments used in Kuala Lumpur are to be adopted more widely, including in the GCC.

Huma Soder looks at the legal and regulatory context of national financial regulations and notes that despite references in the constitutions of many Muslim states to Islam and *shari'a*, in practice the framework governing Islamic banking derives from civil or common law. Disputes over Islamic financial contracts are seldom dealt with by the *shari'a* courts whose remit is largely confined to family matters and inheritance. Instead, Islamic financial institutions have to resort to the national courts, which of course will differ across jurisdictions in their interpretation of the contracts that have been approved by *shari'a* boards. These boards will have approved the contracts, but in most cases will have no formal legal status as far as the national courts are concerned. Under English common law the *shari'a* board members could potentially be called upon as expert witnesses, but in practice this has never happened.

Of course if the parties to a *shari'a* compliant commercial contract agreed that disputes should be referred to a *shari'a* court, and this was written into the contract, this should not present a problem in a

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[8] The issue was addressed at the Second Harvard University Forum on Islamic Finance in 1998 but not much progress seems to have been made since then. For a more recent study on the subject see Adam B. Elhiraika, "On the Design and Effects of Monetary Policy in an Islamic Framework: The Experience of Sudan," Islamic Development Bank Islamic Research and Training Institute, Research Paper No. 64, Jeddah, 2004.

common law jurisdiction, as *shari'a* courts exist even in largely non-Muslim countries such as the United Kingdom. Indeed if disputes arising from such contracts were brought to a national court by one of the parties, the courts may refuse to hear the case, arguing that the wording of the contract implies it should be dealt with elsewhere, namely by the *shari'a* court. In a civil law jurisdiction, however, the position will be different, as the court may feel it has the authority to get involved in any dispute within its authority, and it may refuse to recognize an informal *shari'a* court. Indeed it might view the *shari'a* court as a challenge to its authority because of the notion that a state can only have a single legal system. Ironically, all of the Arab world and Turkey are civil law jurisdictions.

In practice all this remains theoretical, as the parties to most Islamic commercial contracts do not believe the *shari'a* courts have the capacity and competency to adjudicate in financial disputes which are often very complex. There is too much uncertainty about what the *shari'a* courts might decide for those involved in Islamic financial contracts, often worth millions if not billions of US dollars, to want to take on the legal risks. Hence modern Islamic commercial contracts are drafted by major law firms, which are qualified and competent in ensuring that the clauses in the contracts will be subject to clear interpretation in the event of litigation through the national courts. The role of the *shari'a* boards is to approve the contracts, not to draft them, as they lack the training in and knowledge of modern commercial law. In other words, in the case of litigation, it is the modern commercial jurisprudence which establishes precedence, such as the *Shamil Bank versus Beximco* case of 2004 in the English courts, and not *fiqh* jurisprudence.[9] The difficulty which Sodher correctly points out is that as there have been relatively few cases of litigation in common law jurisdictions, the jurisprudence with respect to Islamic banking remains very limited.

In civil law jurisdictions there is a need for special legislation on Islamic finance to enable contracts to be properly enforced. However, often such laws are very general, as in Indonesia, and do not help greatly with dispute resolution. An International Islamic Centre for Reconciliation and Arbitration (IICRA) was established in Dubai in 2004 which may help in the longer run, provided it is specified in the documentation on instruments such as *sukuk* as the authority where disputes should be handled, which will allow IICRA to build up its own

[9] Lovells, *Shariah Law in the English Courts,* London, September 2004.

jurisprudence.[10] Five years later, however, IICRA has yet to handle a single case.[11] Sodher suggests the establishment of specialized dispute settlement institutions at the national level, either attached to the courts or as subsidiary branches. These dispute settlement institutions would be presided over by a team of judges with expertise in banking matters and *shari'a* scholars with expertise in *fiqh*. Such a legal infrastructure could prove very helpful for Islamic financial institutions, especially if disputes were rapidly resolved without excessive spending on legal and court fees.

SUKUK ISSUES

Three contributions deal with *sukuk* issues, that by Andrew Coats and Habib Motani on purchase undertakings, Armen Papazian on standardization, and Hatim El-Tahir on Islamic securitization. This concentration of interest on *sukuk* reflects the widespread debate on *sukuk* structures following Taqi Usmani's critique of *sukuk* in November 2007 suggesting that the majority were not *shari'a* compliant, followed by the AAOIFI clarification of March 2008 that it was *mudaraba* and *musharaka sukuk* structures that were problematic, and not *ijara sukuk*, the most popular form of issuance.[12] The contribution by Andrew Coates and Habib Motani addresses the key issues raised in the AAOIFI statement by examining the legal obligations in specific *musharaka sukuk* originated by large corporations in the GCC. The AAOIFI statement was by the organization's *Shari'a* Board, whereas Coats and Motani are approaching the issues as professional lawyers. They provide a helpful flow chart to illustrate the structure of *musharaka sukuk* which involves a partnership between the originator or sponsor of the *sukuk* that contributes assets in kind and the *sukuk* issuer, a special purpose vehicle (SPV) which injects cash into the *sukuk*. The SPV acts as agent for the investors and holds the assets of the *sukuk*. The originator and the issuer as partners will draw up a joint plan for the management of the *sukuk* assets, and appoint an agent, typically the originator, to

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[10] www.iicra.net/English/page1endex.htm.
[11] Reuters, "Islamic finance industry unclear on arbitration law," *The Peninsula*, Doha, June 9, 2009.
[12] http://www.aaoifi.com/aaoifi_sb_sukuk_Feb2008_Eng.pdf (accessed June 8, 2009).

execute the plan. During the life of the *sukuk* the assets held in the SPV should generate income, which will be shared between the issuer and the originator in fixed proportions as agreed in the original contract.[13]

The principles of this arrangement differ from classical *musharaka* in two important respects. Firstly it is the SPV and the originator who are the partners, not the Islamic investors who provide the cash to the SPV for their share of the *musharaka*. In other words, the Islamic investors are indirect rather than direct participants, and are not partners, and certainly not active partners. Secondly, although the issuer and the originator share in any profits according to a pre-agreed formula, there is no provision for loss sharing. The issuer cannot inject additional capital in the case of loss, as the SPV has no capital of its own, and would have to revert to the Islamic investors for additional funds. They would be unlikely to agree to this, although under classical *musharaka* this could happen.

How losses are treated under classical *musharaka* deserves some attention. As with other *fiqh* contracts the aim is to ensure justice to all the participants, the principle being that they should share losses in proportion to their capital contributions. Once a venture gets into difficulty the partners should club together if possible to save the *musharaka*, which may involve fresh capital contributions. There was no concept of limited liability in traditional *fiqh*, as this concept was only introduced in Europe with the establishment of joint stock companies, which are contractually different from partnerships in terms of the liability of investors. However, as active partners *musharaka* investors have to be consulted if the venture takes debt financing onto its books. This offers some measure of protection which equity investors do not have. Conventional interest bearing loans would be precluded, but *murabaha, salam,* or *istisna‘* could be utilized if the *musharaka* partners agreed, but high levels of leveraging are unlikely if well informed *musharaka* partners wish to limit risk. Indeed, if the venture is in difficulties they may prefer to inject further capital themselves rather than see the venture restructured with possibly expensive debt capital introduced.

Rather than dealing with how temporary losses can be covered, the documentation for *musharaka sukuk* typically deals with dissolution events. These result from the originator defaulting on payments or other

[13] For a discussion of wider *sukuk* matters see Nathif J. Adam and Abdulkader Thomas, eds., *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk,* London: Euromoney Books, 2004.

breaches of covenant. Usually with *musharaka sukuk* such breaches will, according to Coats and Motani, result in the issuer petitioning a court for obligations under the purchase undertaking to be met. This, they argue, is not the same as a guarantee on a conventional bond which will be automatically triggered, as the court may reject the petition for the early reimbursement of the original investment. The AAOIFI clarification did not make this distinction, and Coats and Motani recognize the greater risks associated with purchase undertakings. Coats and Motani examine the purchase undertakings of a number of GCC *sukuk* contracts in considerable detail, including the Jebel Ali Free Zone *sukuk* and the issuances on behalf of Tamweel, the Saudi Electricity Company and the Saudi Arabia Basic Industries Corporation (SABIC). They suggest that these *sukuk* meet the criteria set out in the AAOIFI statement, the implication being that those involved in structuring major *sukuk* issuances have been more faithful to *fiqh* than some of their critics might suggest. Support for this position comes from Abdurrahman Habil's contribution on *daman*.

While the Coats and Motani contribution provides some reassurance on existing *sukuk* structures, Armen Papazian and Hatim El-Tahir in their separate contributions make some interesting suggestions regarding how the *sukuk* market should develop. Papazian believes that some degree of *sukuk* standardization is desirable, and to bring this about he proposes a *sukuk* facilitator, which could either be public or private, or a mixture of both. He suggests that it could act as a central counter party to a wide range of transactions, a role that some originally suggested for the International Islamic Financial Market based in Bahrain, but which it lacked the resources to take on. Papazian suggests the facilitator could create SPVs and administer them, tasks currently undertaken by law firms. Although Papazian states that the facilitator should not act as a law firm, this may well be the perception of at least some of its functions, which could result in opposition from existing law firms involved with SPV establishment and administration.

Hatim El-Tahir's suggestion is that GCC financial institutions could benefit from the growth opportunities in neighboring economies, notably those of South Asia and the Middle East and North Africa (MENA). With respect to *sukuk* this could mean the *sukuk* being arranged in the GCC where credit ratings are higher, but the funds actually utilized in neighboring countries with lower ratings. The idea is timely, as even before the financial crisis, increasing amounts of GCC investment were going to these markets, but since the recession

which has impacted more on western than on neighboring markets, the propensity to invest nearby has increased. Second, Islamic banks from the GCC are establishing a presence and building branch networks in these markets.[14] Therefore there is a growing knowledge in the Islamic finance industry of the available opportunities, and in the longer run this may give Islamic investors in the GCC an advantage over conventional investors from elsewhere, including from the West.

ISLAMIC AND SOCIALLY RESPONSIBLE INVESTMENT (SRI)

Kilian Bälz's contribution compares and contrasts Islamic investment with SRI. The approach of Islamic investment is seen as formalist in the sense that the aim is to ensure conformity with the strict legal rules of *shari'a*, whereas SRI is concerned with business values. Bälz sees only limited overlap between Islamic investment and SRI, but nevertheless believes that those involved in either can learn from each other. Bälz is more critical than Shamshad Akhtar of Islamic financial practice as he notes the debates on *sukuk* and *tawarruq* in Harvard Islamic Finance Project workshops. Most will agree that these financing methods serve the same purpose as their conventional counterparts, only the legal contracts are different in order to satisfy *shari'a*. However, there are differences in how the funds can be used, as the promotion of *haram* activities is not permitted in Islamic finance. Bälz does not discuss this point, his main concern being the neglect of SRI in Islamic finance.

Bälz takes two case studies to demonstrate the shortcomings of current Islamic finance practice, the first being the subprime debacle that underlay the financial crisis. He asks the relevant question that if the finance had been predominately Islamic rather than conventional, would it have made a difference? Part of the problem was of course the securitization of the interest based mortgages, especially the practice of bundling subprime with higher quality debt within a securities issuance to secure a better rating. Clearly Islamic banks were not involved in this, as debt trading is forbidden unless it is asset backed, and in the case of subprime debt the value of the debt greatly exceeded the value

[14] Rodney Wilson, *The Development of Islamic Finance in the GCC*, Kuwait Program for the Development, Governance and Globalization in the Gulf States, London School of Economics, 2009.

of any collateral offered. There are nevertheless moral dilemmas. Encouraging poor people to own rather than rent housing is in many respects desirable, as once they have an asset it can lift them out of poverty. Hence a strict mortgage approval policy will simply help the better off. What was reprehensible on the part of conventional lenders was the system of charging high upfront mortgage fees to make short term profits and generate staff bonuses, while neglecting the longer term ability of borrowers to meet their obligations, as by then the debt would have been securitized and sold to investors, eliminating any further exposure by the mortgage lenders. Bälz is not confident, however, that Islamic banks would have been more responsible in their policies.

The second case study is whether *shari'a* scholars would endorse emission trading, the system adopted in the Kyoto Protocol for combating climate change.[15] There are several objections from an Islamic perspective, the first being whether an emission allowance constitutes property (*mal*), even if it has value. The second issue is whether a right relating to a future time period can be sold given the possibility of *gharar*. A third question is whether a right to pollute constitutes *mal mutaqawwam*, as there could be moral objections in enabling rich countries to pay to continue polluting, even though from some perspectives the payment might be seen as a fine. Clearly it is unlikely that emission trading will receive *shari'a* approval, even if it may help in solving a significant global problem which faces both Muslim and non-Muslim countries.

Bälz examines the similarities and differences between SRI and Islamic investment and notes that they both involve criteria which are not solely economic and based on an appraisal of risks and returns. Instead, "values" are defining criterion: in the case of SRI those based on ethical standards, and in the case of Islamic investment religious principles. This does not mean that risks and returns can be ignored, merely that the target companies or projects chosen for investment will be screened to ensure the values of the investors are respected. Both SRI and Islamic investment rely on external independent validation to provide formal assurance of the legitimacy of the investments, with SRI investors using advisory bodies and Islamic investors using *shari'a*

[15] For a discussion of some of the wider issues, see Fazlun M. Khalid, "Islam and the Environment" in Peter Timmerman and Ted Munn, eds., *Encyclopedia of Global Environmental Change,* Chichester: John Wiley & Sons, 2002, vol. 5, pp. 332 – 339.

boards. Of course there are differences not only between SRI and Islamic investors, but also within each group, a point made by Bälz but not much developed. Some SRI investors, for example, are reluctant to sanction investment in food production unless it is organic and free from genetic manipulation, which rules out not only pork products, but also most poultry rearing and feedstock production. Other SRI investors assert that organic production is more expensive, and beyond the budget of poorer consumers, even if there are both human health and animal welfare concerns.

Within Islam the different schools of *fiqh* are reflected in *shari'a* board membership, and although there is agreement about the broad principles of screening, there is disagreement over the detail. For example, some believe that investment should be prohibited where a business is engaged in any activity which is not *shari'a* compliant, while others suggest that as much as 10 percent of the activity may be non-compliant, as long as any profit the investor derives from such activity is donated to charity to purify the income.

Having discussed the similarities and differences between Islamic investment and SRI, Bälz recommends a stakeholder approach to Islamic investment using the language of the corporate governance literature. He identifies the stakeholders of a company as the shareholders, employees, customers, business partners, and the supporting regulatory, legal, and tax authorities, as well as the interests of the wider public with respect to the company's environmental footprint. The operational implications are explored by Bälz, the starting point being that the *shari'a* scholars will have to consider these wider issues and suggest solutions. There will of course be differences between the scholars, but such healthy debate should be welcomed, even if in the end specific principles and policies need to be formulated. Here industry associations such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) can play a role, as can the OIC *Fiqh* Academy.

This closing paper serves as a notable gateway into future discussions on SRI during Harvard University's Ninth Forum in 2010, entitled "Building Bridges across Financial Communities," involving a deeper discussion of the success of current Islamic financial products in enabling socially responsible outcomes, as well as key lessons, perspectives, best practices, and potential synergies between Islamic finance and corporate social responsibility, socially responsible investing, and social entrepreneurship.

CONCLUSION

The Eighth Harvard Forum was held before the full impact of the financial crisis had become apparent with the subsequent global recession of 2009. Nevertheless, what is evident from the contributions, and reinforced by the lessons from the crisis, is that care is needed with innovation, which in the case of *fiqh* jurisprudence means *ijtihad*. Reinterpretation should not be a one-way street, with *shari'a* scholars doing all the adapting and making all the compromises to endorse a range of Islamic products which are possibly not needed or even wanted. It is clear from the crisis that some conventional products such as collateralized debt obligations were fatally flawed, and that many of the institutions, notably hedge funds, were of dubious integrity. The crisis has made the debate over the permissibility of Islamic hedge funds seem unnecessary and probably irrelevant: of course they were impermissible and there are some asset classes which can be ruled as out of bounds for *shari'a* compliant investors.

In summary, *fiqh* scholars should reject new financial structures that are designed to achieve the same objectives as conventional products if they are clearly at variance with the principles of *shari'a* on how to handle risk.

This notion, as well as the various sub-topics that are key to the development of the industry, are elaborated within the context of general frameworks and special topics, such as innovation and authenticity, Islamic monetary union and national financial regulation, *sukuk* issues, and Islamic socially responsible investing.

Part I

Innovation and Authenticity

Innovation and Authenticity

Robert C. Merton[1]

INTRODUCTION

The study of Islamic finance is not a specialty of mine, and thus I will not attempt to address the rich set of technical issues and questions on the subject. Instead I will give an individual perspective in identifying a very important area for economic development and for the management of risk in an efficient way in the economy. My remarks will make three points.

First, that modern financial engineering permits the separation of risk exposure selection and management from physical and capital expenditure plans. Risk exposures can be radically changed without affecting capital, trade, or income flows, or even the traditional balance sheet. Market-proven financial technologies exist that make it possible to deal with risk of a much larger size with a much lower cost than had existed in the past, and thus as a practical matter, risk is now a separable decision, and a separable dimension of managerial decisions.[2]

Second point, risk transfer innovations using existing market-proven financial contracting technologies offer the prospect to eliminate or greatly reduce the classic economic trade-off between pursuing comparative advantage, which by necessity requires that you pursue a very few and quite related items, a well-known dictum of

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[1] Nobel Laureate, John and Natty McArthur University Professor, Harvard Business School, Boston, MA. Keynote speech delivered at the Eighth Harvard University Forum on Islamic Finance, April 2008.

[2] Robert C. Merton, "You Have More Capital Than You Think," *Harvard Business Review* 83(11), November 2005, pp. 84–94.

economics, and another well-known dictum from economics, undertaking efficient risk-diversification, which by its very nature says invest in many different things, and preferably diverse and uncorrelated ones.[3]

So in this conflict between these two dictums, we face an economic trade-off. Now this trade-off applies at the level of households, firms, or even whole countries. I will briefly illustrate with the case of a strategic management of country risk, which offers the opportunities to smaller and developing countries to develop their economic potential with efficient risk transfer and risk-bearing.

Now my third point: I have done a little investigation on risk transfer within Islamic finance. I have asked questions, not provided answers, in an attempt to find out for a layman such as myself, what you can and cannot do and where the challenges are. To make full use of the innovations I will be talking about in finance, while at the same time maintaining the principles of Islamic finance, is indeed a challenge.

INNOVATIONS IN FINANCE

New financial products and market designs, improved computer and telecommunications technology, and the advances in finance over the last generation have led to dramatic and serious changes in the structure of global financial markets and institutions. The scientific breakthroughs in finance theory in this period both shaped and were shaped by the extraordinary innovations in finance practice that coincided with the revolutionary changes in the structure of world financial markets and their institutions. The cumulative impact has significantly affected all of us, as users, producers, or overseers of the financial system. Financial science impacts practice across a wide spectrum, while offering powerful prescriptions for portfolio allocations, asset management performance measurement, risk management, and corporate financial decisions. But surely the exemplifying case is the development, refinement, and broad-based advancement of contractual technologies, derivatives securities such as future options swaps and contractual agreements. It is estimated that there is nearly five hundred trillion US dollars notational amount of

[3] Arthur Sullivan and Steven M. Sheffrin, *Economics: Principles in Action,* Upper Saddle River, New Jersey: Pearson Prentice Hall, 2003.

derivatives sloshing around the world.[4] It used to be millions that got our attention, then we had to talk about billions, then when it came to asset management, in recent years, unless it had a "t" on it, it couldn't get you attention. So now we are up to "q" quadrillion — half a quadrillion of notional amounts! Now innovations in financial contracting technology have improved efficiency by expanding and reducing information and agency costs, lowering transaction costs, and improving risk sharing. And they would not have been possible without the contributions that came from the academic and scientific community. And these innovations offer enormous potential for improvements in risk sharing and, with that, material improvements in economic growth.

INTERNATIONAL SWAPS AND GAINS FROM INTERNATIONAL RISK SHARING

Now the example I offer is a relatively simple one to describe. And it is one that is doable today with existing technology in size, in scale, and at reasonable costs. But as far as I know, it is not really being done, so it is a little time warp for everybody. And that is on the idea of the trade-off between comparative advantage, which is focused on what you are good at, and efficient diversification, which says spread everything out. So how do you deal with that? Well I thought of some examples, even though it may be controversial, I believe using of contractual agreements such as swaps and so forth requires a lot of attention to see whether it would be consistent with *shari'a*. To remind you, the swap is a contractual agreement that permits one to exchange one set of risky returns for another set of risky returns on the same total investment base and therefore, except for transaction fees, it doesn't cost anything, because it is a pure exchange.[5] I trade you a million dollars worth of risk in the Standard and Poor's 500, for a million dollars of risk in the FTSE 100. So it is a pure exchange, a fair exchange in value, and therefore, no money changes hands with the contract. So there's no capital flow, no payments, but there is an enormous risk transfer.

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[4] Semiannual OTC derivatives statistics at end of December 2008, available at http://www.bis.org/statistics/otcder/dt1920a.pdf (accessed June 29, 2009).

[5] K. C. Brown and D. J. Smith, *Interest Rate and Currency Swaps: A Tutorial,* Charlottesville, VA: Financial Analysts Research Foundation, 1995.

Consider a hypothetical country that is not subject to Islamic finance, so therefore I would not be presupposing the feasibility of doing it. Consider a country like Taiwan, a small country, strong economically on the whole, but very, very concentrated in the industry of computer chips.[6] That, we could assume, is the comparative advantage of Taiwan; it doesn't have very many other industries represented. To the extent that this is the comparative advantage, Taiwan would be pursuing the right strategy. So what is the problem? The problem is from the diversification point of view: it makes the country very concentrated in one area and industry, and while I use computer chips and Taiwan, you may substitute any other industry or country that comes to your mind. It is the same principle. So how might we address this issue of allowing the pursuit of its comparative advantage but at the same time getting efficient diversification for a country?

Suppose that Taiwan were to enter into a swap, let's say on a nice big number, like $10 billion USD. So that is a large amount, a swap in which it paid that total return, each quarter or each year, on an index of stocks in the chip industry—Intel, AMD, and so forth. So that is what it pays. So each year Taiwan would look at the total return on the portfolio, apply that total return to $10 billion, and that is what Taiwan would owe. What does Taiwan receive back for that? I would suggest, how about the world portfolio of equities? By that I mean, you invest in all the equities, or at least all the ones you can invest in the world. Now theoretically, the best-diversified portfolio in the world is the world portfolio, not just of stocks, of course, but of all assets, at least until we go to Mars or Venus. So that moves Taiwan in the direction of becoming much better diversified, because instead of its risk being concentrated in one industry, it now has risk exposure to the whole world.

Taiwan starts out invested in Taiwanese chip industry. There are two risks associated with it. The sensitivity of Taiwan's chip industry to the world chip industry. Obviously what happens to the world's chip industry influences the relative success of Taiwan. The other is a Taiwan-specific component: what Taiwan does in terms of the efficiency in which it manages its industry, how it taxes its industries, and so forth. And that is specific to Taiwan. So the return to the Taiwan

[6] "The Ugliest Economy of Them All," *The Economist,* February 12, 2009, available at http://www.economist.com/world/asia/displaystory.cfm?story_id=13109874 (accessed June 29, 2009).

industry can be broken up into two parts: the part that is not under the control of Taiwan but that influences in a significant way the return earned by Taiwan, which is the world chip industry; and then its own specific component. What we have done with the swap is that we have paid out the total world chip risk and replaced it with receiving the whole world portfolio. So Taiwan, in this simple-to-describe transaction, has transformed ten billion dollars of world chip risk and replaced it with ten billion dollars of world diversified risk. So its return would now be total world return, a highly diversified risk, the extra return from the comparative advantage in its expertise chip industry, plus the incremental risk it has to take to get that extra return. Now when you look at the breakdown of country risk, a big part of that did come from the world chip industry and that was concentrated in one industry. We have replaced it with much more diversified risk using a simple contract. It is non-invasive and non-disruptive, meaning that the day before Taiwan was to enter into this, employees went to work. And the day after they went to work, they see or feel no difference. Same thing with the other components; it is a pure transfer of risk.

If Taiwan were to introduce this policy, and two years or six months from now it was determined that there was a better policy, what could Taiwan do to undo this? It would simply have to enter into a swap reversing the original swap by receiving world chip risk and paying world portfolio risk, and we are back where we started. A change in the contractual agreement after that second change had happened is non-disruptive and non-invasive: people going to work the day before and the day after are not affected. There are two components of this strategy which are characteristics of contractual solutions: one is that they tend to be non-invasive, relative to starting up a new industry to try to diversify their country, which is very disruptive. And it is reversible; all you need to do is enter into a reverse contractual agreement. Imagine you started an industry and five years later you decided it was a mistake—that is not easily reversible. So our approach has these features.

There are other benefits to this swap agreement. It retains both the risk and the benefits of local contributions of the industry. So incentives are aligned, so-called moral hazard issues are minimized, and you are putting in people’s hands that part of the risk which they have more control over, for which they are more responsible and take the risk, compared to the world chip portfolio in this example, where they would not have control. Without getting too technical, I will just say that the credit risk for this $10 billion transfer of risk is very

minimal. Because it is not like loans, there's no principal capital flow, it is not like FDI or foreigners owning local shares; there's no capital flow. Therefore the exposure to non-performance for the amount of risk that you are transferring is rather small. Furthermore, half the time you owe the counterpart money versus it owing you. And if you are the creditor (when I say creditor, I mean the counterpart owes you risky returns, not a fixed amount of cash). Furthermore, it is also robust because it can be applied for risk transfer in countries that don't even have a stock market. Something that cannot be done with having foreigners hold shares as a means for doing it. So you can use it because it doesn't take capital flows again.

I give this example because it sounds relatively simple to describe. It is a way of transferring risk but without capital flows. I also wanted to show that the benefits potentially are great, particularly to smaller countries, if they could solve this problem of pursuing their comparative advantage, whether it is one industry or three, but getting much better diversification. You all have seen the standard risk-returns frontier. Y-axis: expected return. X-axis: standard deviation of portfolios. A colleague of mine, Andre Perold at HBS, measured the average returns and average standard deviations as a measure of risk for several kinds of world portfolios over the last thirty years of the twentieth century. And he plotted them. I am making use of it now. One particular point is a portfolio of developing-country equities. It already has diversification relative to a single country. Now I can tell you what the return on that portfolio was in dollars for that 30 years: it was somewhere over 9 percent average return, with a standard deviation of 22 percent. Had you been holding a well-diversified world portfolio of all industries for the same 30 years, for the same risk, the return would be close to 16 percent. So in simple terms, in the limit (we won't ever get there perfectly) of a fully-diversified portfolio, the pick-up in those 30 years would have been around 600 basis points a year. Now to put that in perspective let's use the Rule of 72.[7] It is a fast way, when you don't have a computer, calculator, or even a piece of paper, to figure out how many years it takes to double your money at some rate of return. You take the rate of return, you divide it into 72, and that is roughly the number. 72 / 6 = 12. You double your money approximately every 12 years. If you earn an extra 6 percent a year,

[7] Wikipedia, Rule of 72, available at, http://en.wikipedia.org/wiki/Rule_of_72 (accessed June 29, 2009).

over 30 years that is around 5 or 6 times more wealth. That is a very big number for a whole country.

I give you those numbers not to suggest that they will repeat themselves over the next 30 years. That is not the point. The point is that when we talk about efficient risk transfer, it is usually viewed either as providing safety, making things safer, or yeah it is nice, it will add a little bit. I give you these numbers to say that this is a big deal, this is a big event. Four or five or six times more wealth in 30 years is a huge gain. And if the next 30 years is not that big, let's say half that much, it is still big! That is why I am telling you this story and saying that through efficient risk transfer, efficient diversification, the ability to improve performance of returns, either in lowering risk for the same return, or getting much higher returns on average for the same risk, is a big deal. This is beneficial for developing countries, which by their nature tend to be more concentrated in risk. This transaction could be done tomorrow, in size. So this is not something in a laboratory that you might be able to do 20 years from now, you could do this tomorrow and it has the features of reversibility. Can we do it tomorrow within the context of Islamic finance? That becomes our challenge. How can we take advantage of these tools that offer the potential for significant improvements in economic growth, particularly in smaller, developing countries?

I did a little investigation on the acceptability of swaps in Islamic finance for this very reason, because I thought this might be an interesting case to point out, since it manages the risk of a whole country in a non-invasive way. I am not an expert on *shari'a*, but it is not an example of receiving interest, or exchanging something risky for a sure thing; you are just exchanging one risky return for another. And we could make the underlying portfolio of equities compliant if you needed to. At first pass, when I asked if this works, I got favorable responses. So I thought, oh, maybe this would be the theme of my talk. Then thanks to the efforts of the Islamic Legal Studies Program, they, as they should, pursued it more deeply with more people and the feedback wasn't so clear. Maybe you couldn't do it. It is not for me to describe why that might not work, but it might be doable. Hence I put it this way: look, here's something that I think is pretty important. Question is, can we find a way to be able to make use of this kind of tool within *shari'a*? And that is really my question to you as we go forward.

FINANCIAL INNOVATION AND FINANCIAL CRISIS

Now some further remarks about the relation between innovations and financial crisis. I will point out to you—there are structural elements that suggest that innovations will often be involved when it comes to financial crises. And the structural reason is that it is inherent that infrastructure will lag behind successful innovation in finance. The reasons are structural because if you think about it, you have a hundred ideas for innovation and you try those hundred. Maybe two are really successful if you are lucky. So you cannot go out and make infrastructure for each potential innovation in advance of knowing it is a success—by infrastructure I mean the oversight, testing, the whole nine yards of support for wherever that innovation's being used. You cannot, as an economic matter, go out and build an infrastructure for every innovation, because 98 out of a 100 won't be worth it. Most will fail; they are not even going to exist! That is a pretty costly approach, and if you tried, you will get today's innovation done somewhere in the next century. So I think it is structurally the case that the successes are going to be ahead of the infrastructure that supports them. So that sets up not the guarantee of a crisis, but the conditions for a crisis. If you permit me a metaphor: the tension here is if we consider a high-speed train, certainly an innovation, one with great use, but if the tracks, i.e., the infrastructure, have not been built to sustain that train's potential speed, then running the train at full speed on those tracks is a dangerous proposition. So since it takes time to build the infrastructure, you need control, you need oversight, you need to make sure you don't run that train too fast! But it is not that simple. You can certainly avoid any accidents. Just put a regulation that the train cannot go any faster than any of the other trains that ran on the track before this innovation. But then of course you get no benefit of the innovation. So it is a trade-off. If you are too restrictive, too slow, you will lose out on that innovation. If you are not careful enough to oversee it, you run too big a risk. And that is a metaphor for what we are seeing in finance and financial innovation. And that is real, and that is why I would say that the two are inexorably going to be linked to one another structurally.[8]

That said, there is a second behavioral finance perspective, which is to take two things which I can objectively show have identical risks.

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[8] Robert C. Merton, "Financial Innovation and the Management and Regulation of Financial Institutions," *Journal of Banking and Finance* 19, July 1995.

One that you are familiar with and one with which you are not familiar. The perception of the risk of the one you are not familiar with will be way out of proportion to the one that you are. A quick case in point: If I hear a song for the first time, I like the tune but don't get the lyrics. When I listen to it 10 times, I eventually get the lyrics. So in that spirit, please hear what I am saying now. Take a defined benefit pension plan, a corporate pension plan in the United States, which holds 75 percent equities in its plan. It is very traditional, we have been doing it for 35 years, and it seems very, very sedate. I can show you as a matter of structural arithmetic, the decision to hold equities in that portfolio rather than match off the risk is equivalent to entering into a total-return swap of the same magnitude of the pension investments in which you receive the returns on the stock market and you pay a fixed payment liability. Now, putting in context for General Motors, which at one point had $75 billion in equities in its pension plan, could you imagine the CEO standing at a stakeholder meeting, and saying, we, this auto company, have decided this year to enter into a $75 billion total returns swap where we receive stock market returns and pay fixed rates, which means we are speculating not only on the stock market, but on the interest rates as well. This is in a context for a company at the time whose entire market cap was less than $20 billion. That is a pretty risky bet! If framed this way, I believe the board would probably postpone the meeting, and ask that the CEO take a vacation for a while. But I can show you that identical risk is contained in corporate pension plans, where there is not a ripple of concern.[9]

The meetings of this forum are not about pension plans, they are not about corporate finance, and they are not about computer chips, but what I will say to you is that the structural issues are exactly the same. That which we are familiar about, we tend to underestimate how much risk is involved, and that which we aren't, we often over-estimate.

That is a behavioral problem. The innovation element of it, though, is structural, and we will have to address that. And we will always have to live with the tension between the benefits of innovation and keeping the infrastructural support for safety. Now I thank you very much for your attention. Although I have not been involved in the specific subject of Islamic finance but have become interested and am

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[9] Jin Li, Robert C. Merton, and Zvi Bodie, "Do a Firm's Equity Returns Reflect the Risk of Its Pension Plan?" *Journal of Financial Economics* 81(1), July 2006, pp. 1–26.

ready to learn, I hope that I brought something to the table for discussion.

Innovation and Authenticity in Islamic Finance: Suggestions for Maximizing the System's Potential

M. Umer Chapra[1]

INTRODUCTION

Dr. Muhammad Iqbal, poet-philosopher of the Indo-Pakistan subcontinent, says in a Persian couplet:

> I am, as long as I move;
> Not moving, I am not[2]

This implies that forward movement through progress and development is the lifeblood of societies. If societies do not move forward, they will not be able to remain stagnant for a long time, they will ultimately start declining. One of the essential requisites to enable societies to move forward is innovation. A well-known legal maxim of Islamic jurisprudence states that "something without which an obligation

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[2] Muhammad Iqbal, *Payam-e-Mashriq,* 1954, p.150.

cannot be fulfilled is also obligatory."[3] If it is necessary for a society to move forward to prevent stagnation and decline, innovation is also therefore indispensable. Don Sheelan has expressed the same idea recently by saying that "innovation is the lifeblood of an organization" and that "without it, not only is there no growth, but, inevitably, a slow death."[4] There is, however, a snag that if the innovations are not well conceived, or if they are misused, they may create problems rather than solve them.

The accelerated development that the world has witnessed after the Second World War would not have been possible without an unending stream of innovations. The financial system has decidedly played an active role in this development, also as a result of innovations, including the revolution in information and communications technology. The financial system is, however, now plagued by persistent crises. According to one estimate, there have been more than 100 crises over the last four decades.[5] Not a single geographical area or major country has been spared the effect of these crises. Even some of the countries that have generally followed sound fiscal and monetary policies have become engulfed in these crises.

This has created an uneasy feeling that there is something basically wrong somewhere. There is hence a call for a new architecture.[6] The new architecture demands an innovation that could help prevent the outbreak and spread of crises or at least minimize their frequency and severity. Since most of the crises that the world has faced are generally of a serious nature and have been recurring persistently, cosmetic changes in the existing system may not be sufficient. It is necessary to have an innovation that would be really effective. It may not be possible to figure out such an innovation without first determining the primary cause of the crises. This is how science makes progress. It tries to determine the cause or causes of

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[3]Abu Ishaq al-Shatibi, *al-Muwafaqat* (n.d.), vol. 2, p. 394; Mustafa al-Zarqa, *al-Fiqh al-Islami fi Thawbihi al-Jadid,* 1967, pp. 784 and 1088; and Ali Ahmad al-Nadvi, *Jamharat al-Qawa'id*, Riyadh, 2007, vol. 1, p. 480.

[4] The quotation from Don Sheelan is on p. 3 of the article on "Innovation" in Wikipedia, accessed on October 1, 2007.

[5] Joseph Stiglitz, "Dealing with Debt: How to Reform the Global Financial System," *Harvard International Review,* Spring 2003, p. 54.

[6] Michael Camdessus, "Main Principles of the Future International Monetary, Financial System," *IMF Survey*, 10 January 2000, pp. 1 and 7-10; Joseph Stiglitz, "Financial Hypocrisy," *The Economist's Voice*, December 2007, pp. 1–3, www.bepress.com/ev.

different phenomena so as to enable us to find an effective remedy for their solution.

PRIMARY CAUSE OF THE CRISES

This makes us look for the primary cause or causes of the crises. There is no doubt that there are a number of causes. However, one of the generally recognized most important causes is excessive and imprudent lending by banks.[7] One cannot blame banks for this because, like everyone else, they also wish to maximize their profits. The more credit they extend, the higher will be their profit. Excessive lending, however, leads to a rise in asset prices, giving boost thereby to an artificial rise in consumption and speculative investment. Excessive lending becomes possible because of high leverage. The higher the leverage, the more difficult it is to unwind it in a downturn. Unwinding gives rise to a vicious cycle of selling that feeds on itself and leads to a serious financial crisis. It is market discipline that is expected to exercise a restraint on leverage and excessive lending. Since this has not happened, there arises the question of what is the reason for it? Is it possible that market discipline is not adequate in the financial system? If this is the case, then why is it so?

The market is able to impose a discipline through incentives and deterrents. These come through the prospect of making a profit or loss. The major source of profit in the conventional system is the interest that the banks earn through their lending operations. The loss comes through the inability to recover these loans with interest. One would, therefore, expect that banks would carefully analyze their lending operations so as not to undertake those that would lead to a loss. There would be a check over excessive lending if the banks were afraid of suffering losses that would reduce their net profit. This does not happen in a system where profit and loss sharing (PLS) does not exist and the repayment of loans with interest is generally guaranteed.

There are two factors that save the banks from losses. The first of these is the collateral, which is necessary to manage the risk of default. The collateral can do this, however, only if it is of good quality. The

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[7] This has been clearly recognized by the Bank for International Settlement (BIS) in its 78th Annual Report (p. 3) released on 30 June 2008, stating that the fundamental cause of today's problems in the global economy is excessive and imprudent credit growth over a long period.

banks are sometimes not very careful and rely heavily on the crutches of the collateral to extend financing for practically any purpose, including speculation. Collateral is, however, exposed to a valuation risk. Its value can be impaired by the same factors that diminish the borrowers' ability to repay. The collateral cannot, therefore, be a substitute for a more careful evaluation of the project financed. Nevertheless, the banks do not always undertake a careful evaluation because of the second factor that provides them protection. This is the "too big to fail" concept that gives them an assurance that the central bank will bail them out.[8] Banks that are provided with such a safety net have incentives to take greater risks than they otherwise would.[9]

Given that banks lend excessively to maximize their profit, why is it that the depositors do not impose a discipline on the banks? They can do so in several different ways: by demanding better management, greater transparency, and more efficient risk management. If this does not work, they can always punish the banks by withdrawing their deposits. They do not do so, however, because they are assured of the repayment of their deposits with interest.[10] This makes them complacent and they do not take as much interest in the affairs of their financial institution as they would if they expected to suffer losses.

Instead of making the bankers as well as depositors share in the risks of business, the conventional financial system almost relieves them of the risks. The ability of the market to impose the required discipline thus gets impaired and leads to an unhealthy expansion in the overall volume of credit, to excessive leverage, to even subprime debt, and to living beyond means. This tendency of the system gets further reinforced by the bias of the tax system in favor of debt financing — dividends are subject to taxation while interest payments are allowed to be treated as a tax-deductible expense.

This shows that the absence of risk/reward sharing reduces market discipline and thereby introduces a fault line in the financial system. It is this fault line that makes it possible for the financier to lend excessively and also to move funds rapidly from place to place at the slightest change in the economic environment. A high degree of

[8] Frederic Miskhin, "The Causes and Propagation of Financial Instability: Lessons for Policymakers," in Proceedings of the Symposium on Maintaining Financial Stability in a Global Economy, Jackson Hole, Wyoming, August 28–30, 1997, p. 61.
[9] Ibid., p. 62.
[10] Ibid.

volatility thus gets injected into interest rates and asset prices. This generates uncertainty in the investment market, which in turn discourages capital formation and leads to the misallocation of resources.[11] It also drives the borrowers and lenders alike from the long end of the debt market to the shorter end. Consequently, there is a steep rise in highly leveraged short-term debt, which has accentuated economic and financial instability. The International Monetary Fund (IMF) acknowledged this fact in its May 1998 *World Economic Outlook* by stating that countries with high levels of short-term debt are "likely to be particularly vulnerable to internal and external shocks and thus susceptible to financial crises."[12]

One may wish to pause here to ask why a rise in debt, and particularly short-term debt, should accentuate instability? One of the major reasons for this is the close link between the easy availability of credit, macroeconomic imbalances, and financial instability. The easy availability of credit makes it possible for the public sector to have a high debt profile and for the private sector to live beyond its means and to have high leverage. If the debt is not used productively, the ability to service the debt does not rise in proportion to the debt and leads to financial fragility and debt crises. The greater the reliance on short-term debt and the higher the leverage, the more severe the crises may be. This is because short-term debt is easily reversible as far as the lender is concerned, but repayment is difficult for the borrower if the amount is locked up in loss-making speculative assets or medium- and long-term investments with a long gestation period.

While there may be nothing basically wrong in a reasonable amount of short-term debt that is used for financing the purchase and sale of real goods and services by households, firms, and governments, an excess of it tends to get diverted to unproductive uses as well as speculation in the foreign exchange, stock, and property markets. Jean Claude Trichet, president of the European Central Bank, has rightly pointed out that "a bubble is more likely to develop when investors can leverage their positions by investing borrowed funds."[13]

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[11] Bank for International Settlements (BIS), *Annual Report,* Basel, Switzerland, 1982, p. 3.

[12] International Monetary Fund, *World Economic Outlook,* Washington, DC, May 1998, p. 83.

[13] J. C. Trichet, "Asset Price Bubbles and Monetary Policy," Monetary Authority of Singapore Lecture, 2005.

If we examine some of the major crises in the international financial system, like the one in East Asia, the instability in the foreign exchange markets, collapse of the Long-Term Capital Management (LTCM) hedge fund, and the prevailing crisis in the U.S. financial system, we find that the easy availability of credit and the resultant steep rise in debt, particularly short-term debt, are the result of inadequate market discipline in the financial markets due to the absence of risk sharing.[14] In this paper I will refer only to the collapse of the LTCM and the prevailing crisis in the U.S. financial system.

THE COLLAPSE OF LTCM

The collapse of the U.S. hedge fund LTCM in 1998 was due to highly leveraged short-term lending. Even though the name hedge fund brings to mind the idea of risk reduction, "hedge funds typically do just the opposite of what their name implies: they speculate."[15] They are "nothing more than rapacious speculators, borrowing heavily to beef up their bets."[16] These hedge funds are mostly unregulated and are not encumbered by restrictions on leverage or short sales and are free to take concentrated positions in a single firm, industry, or sector-positions that might be considered "imprudent" if taken by other institutional fund managers.[17] They are, therefore, able to pursue the investment or trading strategies they choose in their own interest without due regard to the impact that this may have on others. They now account for close to half the trading on the New York and London stock exchanges.[18]

There is a strong suspicion that these hedge funds do not operate in isolation. If they did, they would probably not be able to make large gains, and the risks to which they are exposed would also be much greater. They therefore normally tend to operate in unison. This becomes possible because their chief executives often go to the same

[14] Chapra, "The Case Against Interest: Is it Compelling?" pp. 166–173.
[15] F. R. Edwards, "Hedge Funds and the Collapse of Long-term Capital Management," *Journal of Economic Perspectives*, 1999, p. 189.
[16] "The Risk Business," *The Economist*, 17 October 1998, p. 21.
[17] Edwards, "Hedge Funds and the Collapse," p. 190; Rene M. Sulz, "Hedge Funds: Past, Present and Future," *Journal of Economic Perspectives* 21(2), Spring 2007, p. 175.
[18] Sulz, "Hedge Funds: Past, Present and Future," p. 175.

clubs, dine together, and know each other very intimately.[19] On the strength of their own wealth and the enormous amounts that they can borrow, they are able to destabilize the financial market of any country around the world whenever they find it to their advantage. Hence, they are generally blamed for manipulating markets from Hong Kong to London and New York.[20] Mahathir Muhammad, Malaysia's ex-prime minister, charged that short-term currency speculators, and particularly large hedge funds, were the primary cause of the collapse of the Malaysian Ringgit in the summer of 1997, resulting in the collapse of the Malaysian economy.[21] It is difficult to know whether this charge is right or wrong because of the skill and secrecy with which these funds collude and operate. However, if the charge is right, then it is not unlikely that these funds may also have been instrumental in the collapse of the Thai Bhat and some other South Asian currencies.

The LTCM had a leverage of 25:1 in mid-1998,[22] but the losses that it suffered reduced its equity (net asset value) from the initial $4.8 billion to $2.3 billion in August 1998. Its leverage, therefore, rose to 50:1 on its balance-sheet positions alone. However, its equity continued to be eroded further by losses, reaching just $600 million, or one-eighth its original value, on September 23, 1998. Since its balance-sheet positions were in excess of $100 billion on that date, its leverage rose to 167 times capital.[23] There was thus tier upon tier of debt, which became difficult to manage. The Federal Reserve had to come to its rescue because its default would have posed risks of systemic proportions. Many of the top commercial banks, which are supervised by the Federal Reserve and considered to be healthy and sound, had lent huge amounts to these funds. If the Federal Reserve had not come to their rescue, there may have been a serious crisis in the U.S. financial system, with spillover and contagion effects around the world.[24] If the misadventure of a single hedge fund with an initial

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[19] J. Plender, "Western Crony Capitalism," *Financial Times*, 3–4 October 1998.

[20] "The Risk Business," p. 21.

[21] M. Mahathir Muhammad, "Highwaymen of the Global Economy," *Wall Street Journal,* 3 September 1997, p. C1; Stiglitz, "Financial Hypocrisy," p. 2.

[22] Sulz, "Hedge Funds: Past, Present and Future," p. 179.

[23] International Monetary Fund, *World Economic Outlook, and International Capital Markets,* Washington, DC, December 1998, p. 55.

[24] This was clearly acknowledged by Alan Greenspan in the following words: "Had the failure of the LTCM triggered the seizing up of markets, substantial

equity of only $4.8 billion could take the United States and the world economy to the precipice of a financial disaster, then it would be perfectly legitimate to raise the question of what would happen if a number of the 9,000 hedge funds managing more than $2.8 trillion of assets got into trouble.[25]

A hedge fund is able to pursue its operations in secrecy because, as explained by the former chairman of the Board of Governors of the Federal Reserve System, Alan Greenspan, it is "structured to avoid regulation by limiting its clientele to a small number of highly sophisticated, very wealthy individuals."[26] He did not, however, explain how the banks found it possible, in a supposedly very well regulated and supervised banking system, to provide excessively leveraged lending to such "highly sophisticated, very wealthy individuals" for risky speculation when it is well known that the higher the leverage, the greater the risk of default. The unwinding of leveraged positions can cause major disruption in financial markets by exaggerating market movements and generating knock-on effects.[27]

This shows that a crisis can come not merely because of improper regulation of banks, as it did in East Asia, but also in a properly regulated and supervised system, as it did in the United States. Even though the hedge funds were not regulated, the banks were. Then why did the banks lend huge amounts to the LTCM and other funds? What were the supervisors doing, and why were they unable to detect and correct this problem before the crisis? Is there any assurance that the regulation of hedge funds would, without any risk sharing by banks, stop excessive flow of funds to other speculators?

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damage could have been inflicted on many market participants, including some not directly involved with the firm, and could have potentially impaired the economies of many nations, including our own." "Statement before the Committee on Banking and Financial Services," U.S. House of Representatives, 1 October 1998, available in *Federal Reserve Bulletin,* December 1998, p. 1046.

[25] The number of hedge funds is from Financial Stability Forum (www.fsforum org). The amount of assets they manage is for the third quarter of 2007 from Institutional Investor News and Hedge Asset Flows and Trends Report, 2008.

[26] Greenspan, "Statement before the Committee on Banking and Financial Services," p. 1046.

[27] International Monetary Fund, *World Economic Outlook, and International Capital Markets*, pp. 51–53.

THE PREVAILING IMBALANCES IN THE U.S. ECONOMY[28]

The lack of discipline in the financial system has also created for the United States two serious problems, both of which ring a worrisome note not only for the United States but also for the world economy. These problems are the public-sector budgetary deficits and the private-sector saving deficiency. The federal government has been running budgetary deficits ever since 1970, except for a brief respite between 1998 and 2001. The budget moved from a surplus of $255 billion in fiscal year 2000 to a deficit of $400 billion in 2004.[29] The deficit declined thereafter to $360 and $262 and $275 billion in 2005, 2006, and 2007 but rose to $455 billion in fiscal 2008.[30] Instead of declining, the deficits are expected to rise further in the near future as a result of the efforts to bail out financial institutions, revive the economy, fulfill the generous campaign promises, and meet the retirement benefits of baby boomers. The continuing deficits had already raised the gross public debt of the U.S. Treasury to more than $10.6 trillion by 26 January 2009, $34,775 on average for every citizen.[31] Of this, the external debt is around 27.5 percent, more than double the 1988 figure of 13 percent.[32] The rise in external debt resulting from continuous current account deficits has had an adverse impact on the strength of the U.S. dollar in the international foreign exchange markets.

These deficits may not have created a serious problem if U.S. private sector savings had not declined precipitously. Net private saving (saving by households and businesses minus investment) has been declining as a result of the borrowing and spending spree by both households and firms. This may not have been possible without loose

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[28] See Donald Kohn, member of the Board of Governors of the U.S. Federal Reserve System, “Imbalances in the U.S. Economy,” address at the 15th Annual Hyman Minsky Conference, the Levy Economics Institute of Bard College, Annandale-on-Hudson, New York, 22 April 2005.

[29] D. I. Kohn, “Imbalances in the U.S. Economy,” *BIS Review,* vol. 28, 2005, pp. 1-2; International Monetary Fund, *Yearbook,* Washington, DC, 2007, p. 602.

[30] International Monetary Fund, *International Financial Statistics,* December 2008, p. 204; and Treasury Summary for FY2008.

[31] Federal Reserve, “Table 1.41,” *Federal Reserve Bulletin,* January 2008, www.federal=reserve.gov/pubs/supplement/2008/table2_41.htm.

[32] Kimberly Amadeo, “The U.S. National Debt and How It Got So Big?” January 2009, available at http://useconomy.about.com/od/fiscalpolicy/p/US_debt.html.

lending by the financial system. Over the last three years (2005–2007), the net saving by households has been less than 1 percent of the after-tax income, compared with an average of 8 percent from 1950 to 2000.[33] Government deficits combined with low private sector saving should have pushed up interest rates. This did not happen, because of the inflow of funds from abroad. This inflow has, however, been only a mixed blessing because it not only raised the U.S. net foreign indebtedness to a record high in both absolute terms as well as a percentage of the gross domestic product (GDP) but also lowered interest rates, which has promoted a steep rise in consumer spending along with a boom in residential real estate prices.

This brings into focus the crucial issue of how long will the foreigners be willing to continue lending. Confidence in the strength and stability of the dollar is necessary to enable it to serve as a reserve currency. This is, in turn, not possible without the willingness of foreigners to hold dollars. What will happen if the deficits continue, create loss of confidence in the dollar, and lead to an outflow of funds from the United States? This is not just a theoretical question. In the last 40 years, the dollar has experienced four bouts of marked depreciation. Since nearly two-thirds of the world's foreign exchange holdings are still in dollars,[34] a movement out of the dollar into other currencies and commodities, as happened in the late 1960s, could lead to a sharp fall in the exchange rate of the dollar, a rise in interest rates and commodity prices, and a recession in the U.S. economy. This might lead the whole world into a prolonged recession. The correction would then come with a vengeance, while market discipline could have led to it much earlier with significantly less suffering. Accordingly, the President's Working Group on Financial Markets (PWG) has rightly concluded in its report on "Principles and Guidelines Regarding Private Pool of Capital," issued in February 2007, that the most effective means of limiting systemic risk is to reinvigorate market discipline.

[33] Kohn, "Imbalances in the U.S. Economy," p. 1; Organization for Economic Cooperation and Development (OECD), *Economic Outlook* 82, 2008, Annex Tables

[34] At the end of the third quarter of 2007, 63.8 percent of the identified official foreign exchange reserves in the world were held in United States dollars, www.imf.org/external/np/sta/cofer/eng/cofer.pdf.

The Subprime Mortgage Crisis

The subprime mortgage crisis in the grip of which the United States finds itself at present is also a reflection of excessive lending. Securitization or the "originate-to-distribute" model of financing has played a crucial role in this. There is no doubt that securitization is a useful innovation. It has provided lenders greater access to capital markets, lowered transaction costs, and allowed risks to be shared more widely. The resulting increase in the supply of mortgage credit contributed to a rise in the homeownership rate from 64 percent in 1994 to 68 percent in 2007.[35] However, even a useful innovation can have a negative impact if it is used in a way that reduces market discipline. Mortgage originators passed the entire risk of default to the ultimate purchaser of the loan security. They had, therefore, less incentive to undertake careful underwriting.[36] Consequently, loan volume gained greater priority over loan quality and the amount of lending to subprime borrowers increased. According to Mr. Bernanke, chairman of the Board of Governors of the Federal Reserve System, "far too much of the lending in recent years was neither responsible nor prudent. . . . In addition, abusive, unfair, or deceptive lending practices led some borrowers into mortgages that they would not have chosen knowingly."[37] The check that market discipline could have exercised on the serving of self-interest therefore did not come into play. This sowed the seeds of the subprime debt crisis and led to not only the financial distress of subprime borrowers but also a crisis in the U.S. financial system that has had spillover effects on other countries.[38] Thus, we can

[35] Ben Bernanke, "Subprime Mortgage Lending and Mitigating Foreclosures," *BIS Review* 104, 2007.
[36] Atif Mian and Amir Sufi, "The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis," January 2008, p. 4, http://www.ssrn.com/abstract=1072304; Benjamin Keys, Tanmoy Mukkerjee, Amit Seru, and Vikrant Vig, "Did Securitization Lead to Lax Screening? Evidence from Subprime Loans 2001–2006," January 2008, http://papers.ssrn.com/abstract=1093137.
[37] Ben Bernanke, "Fostering Sustainable Homeownership," Speech at the National Community Reinvestment Coalition Annual Meeting, Washington, D.C., March 14, 2008.
[38] Roughly 4.2 million mortgages were overdue or in foreclosure at the end of 2007, according to the Mortgage Bankers Association. An additional three million borrowers may default in the near future. David Herszenhorn and

see clearly that the lack of market discipline leads first to excessive lending and then to financial crises and the suffering of a number of people.

When the system has reached a crisis point then it becomes difficult to apply the brakes. Central banks have no choice other than to lower interest rates and provide liquidity to avoid a recession. The Federal Reserve has done the same. It has lowered interest rates and provided liquidity to the market "to help alleviate concerns about funding."[39] While this will help reduce the intensity of the current crisis, it will also tend to aggravate the future crises by enabling the vicious cycle to continue. The liquidity made available now will enable the loose funding to continue. This will be followed by a financial crisis, which will again necessitate the pumping of further liquidity into the system to overcome the crisis. Therefore the more sensible thing to do is to simultaneously think of some effective way of introducing greater discipline into the financial system with a view to check excessive and loose lending. *The Economist* has rightly observed that "the world needs new ways of thinking about finance and the risks it involves."[40] It is here where Islamic finance can make a valuable contribution to the international financial system.

THE ISLAMIC FINANCIAL SYSTEM

One of the most important objectives of Islam is to realize greater justice in human society.[41] This is not possible unless all human institutions, including the financial system, contribute positively toward this end. The financial system may be able to promote justice if, in addition to being strong and stable, it satisfies at least two conditions. One of these is that the financier must also share in the risk so as not to shift the entire burden of losses on the entrepreneur, and the other is

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Vikas Bajaj, "A Bipartisan Bid on Mortgage Aid is Gaining Speed," *The New York Times,* 2 April 2008, p. 2.
www.nytimes.com/2008/04/02/washington/02housing.html?th&emc=th.

[39] Ben Bernanke, "Fostering Sustainable Homeownership."

[40] "The Risk Business," p. 25.

[41] See, for example, al-Qur'an, 57: 25; 5:8; 4:135; 6:152; 4:58; 16:90. For references from the *Hadith, Fiqh,* and other Islamic literature, see Chapra, *Islam and the Economic Challenge,* 1992, p. 209 and Chapra, *The Future of Economics,* 2000, pp. 64–67.

that an equitable share of bank lending should become available to the poor to help eliminate poverty, expand employment and self-employment opportunities, and thus help reduce inequalities of income and wealth.

To fulfill the first condition of justice, Islam requires both the financier and the entrepreneur to equitably share the profit and the loss. For this purpose, one of the basic principles of Islamic finance is: “No risk, no gain.” If we wish to have a gain we must also be prepared to share the risk. Introduction of risk/reward sharing in the financial system should help induce the financial institutions to assess the risks more carefully and to monitor more effectively the use of funds by the borrowers. The double assessment of risks by both the financier and the entrepreneur should help inject greater discipline into the financial system, and go a long way in reducing excessive lending and making the financial system healthier. However, making just the banks share in the risk may not be enough because the desire to maximize profits may still induce the banks to indulge in excessive lending. It is therefore necessary to also motivate the depositors to play a more active role in the enforcement of this discipline. This will be possible if the depositors also share in the profit or loss.

However, since demand depositors do not get any return, it would not be fair to make them participate in the risks of financing. Their deposits must therefore be guaranteed. In contrast with this, investment depositors share in the profit and should therefore participate in the risks. What this will do is to turn investment depositors into temporary shareholders. Placing investment deposits in financial institutions will be like purchasing their shares, and withdrawing them will be like redeeming them. This will motivate depositors to monitor their banks, and demand greater transparency, better governance, and more effective risk management, auditing, regulation, and supervision. Making the depositors participate in the risk would also help motivate them to take greater care in choosing their banks.

Instead of introducing greater discipline in this manner, the primary focus of the international financial system at present is on regulation and supervision. There is no doubt that prudent regulation and supervision are both necessary and unavoidable, and it is a matter of great relief to know that there has been substantial progress in this direction under the aegis of the Basel Committee on Banking Supervision (BCBS). Regulation and supervision cannot, however, be relied upon totally because regulation may not be applied uniformly in all countries and to all institutional money managers as a result of off-

balance-sheet accounts, bank secrecy standards, and the difficulty faced by bank examiners in accurately evaluating the quality of banks' assets. The LTCM collapse, as well as the prevailing financial crisis in the United States, clearly shows how banks can get into difficulties as a result of over-lending, even in an apparently well-regulated system. Regulation and supervision would therefore be more effective if they were complemented by a paradigm shift in favor of greater discipline in the financial system by making the banks as well as investment depositors share in the risks of financial intermediation. Just the bailing-in of banks, as is being suggested by some analysts,[42] may not be able to take us far enough because the capital of banks may be only around 8 percent of their risk-weighted assets. What is also necessary is to strongly motivate not only the banks to undertake careful underwriting of all loan proposals but also the depositors to be cautious in choosing their bank and to monitor their bank's affairs more carefully. The establishment of depositors' associations may make it easier for them to do so.

Islamic finance should, in its ideal form, help raise substantially the share of equity in businesses and of profit-and-loss sharing (PLS) in projects and ventures through the *mudaraba* and *musharaka* modes of financing. Greater reliance on equity financing has supporters even in mainstream economics. Professor Rogoff of Harvard University states, "In an ideal world equity lending and direct investment would play a much bigger role."[43] He further asserts that, "with a better balance between debt and equity, risk-sharing would be greatly enhanced and financial crises sharply muted."[44] The IMF has also thrown its weight in favor of equity financing by arguing that "foreign direct investment, in contrast to debt-creating inflows, is often regarded as providing a safer and more stable way to finance development because it refers to ownership and control of plant, equipment, and infrastructure and therefore funds the growth-creating capacity of an economy, whereas short-term foreign borrowing is more likely to be used to finance consumption. Furthermore, in the event of a crisis, while investors can

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[42] C. Calomiris, "The IMF's Imprudent Role as Lender of Last Resort," *Cato Journal* 17(3), 1998, pp. 275–295; A. Meltzer, "Asian Problems and the IMF," *Cato Journal* 17(3), 1998, pp. 267–274; I. B. Yeager, "How to Avoid International Financial Crises," *Cato Journal* 17(3), 1998, pp. 257–265.
[43] K. Rogoff, "International Institutions for Reducing Global Financial Instability," *Journal of Economic Perspectives* 4(13), 1999, p. 40.
[44] Ibid.

divest themselves of domestic securities and banks can refuse to roll over loans, owners of physical capital cannot find buyers so easily."[45]

Greater reliance on equity does not necessarily mean that debt financing is ruled out. This is because all financial needs of individuals, firms, or governments cannot be made amenable to equity and PLS. Debt is therefore indispensable. Debt does not, however, get created in a truly Islamic financial system through direct lending and borrowing but rather through the sale or lease of real assets via the sales- and lease-based modes of financing (*murabaha*, *ijara*, *salam*, *istisna',* and *sukuk*). The purpose is to enable an individual or firm to buy now the urgently needed real goods and services in conformity with his ability to make the payment later. The conditions, however, are that the asset which is being sold or leased must be real and not imaginary and that the transaction must be a genuine trade transaction with the full intention of giving and taking delivery. In the case of such sales or leases, the rate of return gets stipulated in advance and becomes a part of the deferred payment price. Since the debt is associated with real goods or services and the rate of return is fixed in advance, it will be less risky and therefore more attractive for banks, as compared with equity and PLS financing.

The predetermined rate of return on sales- and lease-based modes of financing may make it appear like interest-based instruments. It is, however, not so because of significant differences between the two for a number of reasons. First, as already indicated, the sales- and lease-based modes do not involve direct lending and borrowing. They are rather purchase and sale or lease transactions involving real assets. The *shari'a* has, in addition, imposed a number of conditions for the validity of these transactions. One of these is that the seller (or lessor) must also share a part of the risk to be able to get a share in the return. He cannot avoid doing this because of the second condition that requires the seller (financier) or lessor to own and possess the goods being sold or leased. The *shari'a* does not allow a person to sell or lease what he does not own and possess except in the case of *salam* and *istisna'* where the goods are not already available in the market but need rather to be produced before delivery. Once the seller (financier) acquires ownership and possession of the goods for sale or lease, he/she bears the risk. All speculative short sales therefore get ruled out automatically. Financing extended through the Islamic modes can thus expand only in step with the rise of the real economy and thereby help

[45] International Monetary Fund, *World Economic Outlook*, 1998, p. 82.

curb excessive credit expansion, which is one of the major causes of instability in the international financial markets.

Second, it is the price of the good or service sold, and not the rate of interest, that is stipulated in the case of sales- or lease-based modes of finance. Once the price has been set, it cannot be altered, even if there is a delay in payment due to unforeseen circumstances. This helps protect the interest of the buyer in strained circumstances. However, it may also lead to a liquidity problem for the banks if the buyer willfully delays payment. This is a major unresolved problem in Islamic finance. Discussions are, however, in progress among the jurists to find a *shari'a*-compatible solution.

REDUCING GOVERNMENT BUDGETARY DEFICITS

The discipline that Islam wishes to introduce in the financial system may not materialize unless the governments reduce their borrowing from the central bank to a level that is in harmony with the goal of price and financial stability. If the governments borrow heavily from the central banks, they will provide more high-powered money to banks than is necessary and thereby promote excessive monetary expansion. It is essentially excessive liquidity that, along with high leverage, enables banks to resort to lax lending. It is therefore necessary to have independent central banks along with legal curbs on the government's ability to borrow so that they do not run deficits in their budgets in excess of what is permissible within the framework of growth with stability.

AUTHENTICITY

This brings us to the question of authenticity in Islamic finance. In ordinary language "authentic", "genuine," and "bona fide" mean that there is conformity between word and deed or, in other words, the practice is exactly in keeping with what is claimed. In existentialist philosophy, it draws a distinction between the self and the non-self and refers generally to the degree to which a person is true to his own personality, spirit, or character. In religious parlance it reflects the degree to which a person is true to his beliefs in spite of difficulties faced in doing so.

The way the Islamic financial system has progressed so far is only partly, but not fully, in harmony with the Islamic vision. It has not been able to come out of the straitjacket of conventional finance. The use of equity and PLS modes has been scant, while that of the debt-creating sales- and lease-based modes has been predominant. This may be condoned because of the near absence of the shared infrastructure institutions that are indispensable for reducing the difficulties faced in equity and PLS financing as a result of the principal/agent conflict of interest and the moral hazard. However, even in the case of debt-creating modes, all Islamic banks and branches or windows of conventional banks do not necessarily fulfill the conditions laid down by the *shari'a*. They try to adopt different legal stratagems (*hiyal*) to transfer the entire risk to the purchasers or the lessees. The result is that the Islamic financial system, as it is being practiced, does not appear to a number of its critics to be a genuine reflection of Islamic finance. If the system does not make significant progress in terms of authenticity, it will lose credibility in the eyes of the Muslim masses and the rapid progress that it has been making may not be sustainable.

WHY THE LACK OF AUTHENTICITY

This raises the question of why the system has been unable to make significant headway in the direction of attaining greater authenticity. One of the primary reasons is that the institutions that are necessary to minimize the risks associated with anonymity, moral hazard, principal/agent conflict of interest, and late settlement of financial obligations have not yet been created. These institutions would enable the banks to obtain reliable information about their clients and to ensure that the funds lent by them to their clients are employed efficiently according to agreement and that the profit declared by them reflects the true picture of the business. They would also help them receive repayments on schedule, and get justice promptly in case of dispute with, or willful procrastination of payment by, their clients. They would also enable banks to gain liquidity when they need it in situations of liquidity crunch resulting from unforeseen circumstances. The establishment of such institutions would go a long way in providing a favorable environment. The longer it takes to establish such institutions, the longer it will take to move in the direction of greater authenticity. Some of the institutions that need to be created are briefly indicated on the following pages.

Centralized *Shari'a* Board

One of the indispensable needs of Islamic finance for realizing greater authenticity is to get verdicts that are in harmony with not just the form but also the spirit of the *shari'a* so as to help realize its cherished objectives (*maqasid*). This demands that the members of the *shari'a* board should not only be men of exemplary integrity and well versed in the *shari'a*, but should also be insulated from moral hazard. This is because the *shari'a* board members, in spite of being individuals of high integrity, are human beings and are liable to be exposed to moral hazard. The hazard arises because every bank itself hires its own *shari'a* board members and pays their remuneration. In addition to being costly, particularly for small banks, this practice leads to conflicting opinions that create inconsistency and uncertainty. It also carries the potential of creating a conflict of interest. It may tempt the board members to give verdicts that are more profitable for the banks but not in keeping with the spirit of the *shari'a*. To overcome this problem, it is necessary to adopt some effective measures. One of these is to make full transparency mandatory with respect to the products allowed by their *shari'a* boards. The risk of getting a bad reputation should help induce the *shari'a* boards as well as the banks to be on their guard.

Another necessary measure is to establish a centralized *shari'a* board in the nature of a supreme court with members who are well respected for their knowledge and integrity and who are also independent of banks. This will enable market participants to challenge any product that they feel is not in conformity with the spirit of the *shari'a*. It will also help standardize the products to the extent to which it is possible. Some differences of opinion are bound to remain. This may, however, be healthy for the financial system because it will promote innovation and also provide different alternatives for doing business instead of imposing a rigid conformity. Transparency should, however, be made mandatory so that the bank's clients and depositors know which alternative the bank has adopted. This will also help raise market discipline by enabling the bank's customers to choose for themselves a bank whose operations are in their opinion more *shari'a* compliant. Since standardization is necessary for the creation of an international Islamic financial market, it is imperative to have standardization at the level of not only individual countries but also all Muslim countries.

Shari'a Clearance and Audit

Among the most crucial challenges before an Islamic bank is to create confidence in its depositors as well as all the other operators in the market about the harmony of its operations with the *shari'a*. For this purpose two important steps need to be taken. The first step is to get clearance from a *shari'a* board about the *shari'a* compatibility of all its products not only in form but also in spirit. The second step is to provide an assurance that all its transactions are actually in conformity with the verdicts of the *shari'a* board. The first step is like going to a legal expert to ascertain whether a specific mode of the bank's operations is in conformity with the country's laws and, if not, what changes need to be introduced in it to make it so. The second is what auditors and banking supervisors do: ensuring that none of the bank's transactions violates the country's laws.

The *shari'a* boards are like legal experts. They can only perform the first task. It is difficult for them to perform the second task, which demands a review of all, or at least a random sample of, the different transactions that have taken place in different branches of the bank to ensure that they are in conformity with the verdict of the *shari'a* board. This demands a visit to the bank's premises to examine its operations in the same way as auditors and supervisors do. It is generally assumed that the *shari'a* boards do perform this task. However, members of the *shari'a* board do not have either the time or the staff to perform such a task effectively. The question that therefore arises is how to ensure the implementation of *shari'a* board decisions by the bank management. If this is not ensured, the existence of the *shari'a* board loses its meaning. There are three alternatives that may be considered for this purpose.

One of these is for the supervisory authority in the country concerned to itself undertake the *shari'a* audit of banks in the course of its normal supervisory visits. This may not be considered desirable by Islamic banks in countries where the government and the supervisory authority are not favorably inclined towards Islamic banking. However, it has the advantage that, if the supervisory authority performs the *shari'a* audit, it will also try to standardize the *fiqhi* decisions.

The second, more preferable, alternative is to establish independent *shari'a* audit firms in the private sector. These firms would have to hire and train sufficient staff to examine the transactions of banks with a view to determining whether they are in conformity with the *shari'a*. This alternative has the disadvantage that it would involve a proliferation of institutions. Inspectors from three different

institutions would knock at the doors of banks at different times. The first of these would be from the supervisory authority to determine the conformity of the bank's operations with the country's laws and the principles of safe and sound banking. The second would be the *shari'a* auditors who would go to the bank to determine the conformity of its operations with the *shari'a*. The third would be the chartered auditors who would go to the banks to ensure that their financial statements have been prepared in conformity with the generally accepted accounting standards. Inspection by all these three institutions might not be convenient for banks because it would keep a number of their staff engaged in assisting these inspectors at different times, and thus add to their costs.

A third and even more preferable alternative is for the existing chartered audit firms to acquire the necessary expertise in the *shari'a* to enable them to undertake the *shari'a* audit. This will help avoid the proliferation of institutions with which Islamic banks have to deal. The banks would probably prefer this alternative because it will be more convenient for them to have the *shari'a* audit at the same time as the accounts audit.

Credit-Rating Agencies, Chambers of Commerce, and Trade Associations

Among the shared institutions are credit-rating agencies that rate banks themselves as well as their counterparties. While such institutions exist in industrial countries, they do not at present exist in all Muslim countries. Credit-rating agencies may not be very helpful if they paint a rosy picture of the firms trying to raise equity or loans in the market. The experience of the Unites State in the case of structured subprime loans clearly indicates the shortcomings of credit-rating agencies. Even though the concern for safeguarding their own reputation may serve as a check on rating agencies, a more effective regulatory framework needs to be developed to serve as a check on the moral hazard.

Legal Reform

Even though Islamic financial institutions have been established in nearly all Muslim countries, the basic legal framework under which they operate has not evolved in the light of the *shari'a*. Cosmetic

changes have been made in the existing conventional legal framework. It is necessary to prepare a comprehensive legal framework to bring the financial system in harmony with the *shari'a*. Preparing such a framework may not be an easy task because it requires expertise in *maqasid al-shari'a*, the *shari'a* compatible modes of Islamic finance, and complexities of the international financial system. Such expertise is rare. However, it is in the process of development and, hopefully, it should be possible to develop a comprehensive legal framework for financial institutions and financial markets operating on the basis of the *shari'a*.

External Audit

The growing complexity of the banking business as well as the crises that the international financial system has witnessed have raised the function of external audit to a position of critical importance in all financial systems. It is, however, even more demanding and challenging in the Islamic financial system. It would be necessary for the external auditor to ensure not only that the bank's financial statements are prepared in all material respects in conformity with the professionally accepted financial reporting standards but also that the profit or loss declared by the bank truly reflects the bank's condition and that its profit has been derived without violating the teachings of the *shari'a*.

It is conventionally not considered to be the task of auditors to perform a *shari'a* audit. They are not even equipped at present to do so. However, if this task is assigned to them in the light of what has been discussed above under the subject of *shari'a* audit, then the external auditors will have to create the necessary expertise to perform this task. This would demand that the training of auditors also includes necessary training in the financial aspects of the *shari'a*, just as it includes training in auditing and law. If such training proves to be too cumbersome for the auditors, it may also be possible for the auditing firm to hire *shari'a* scholars and provide them with some necessary background in auditing to be able to perform the *shari'a* audit.

The experience of the auditing firm Arthur Andersen has clearly revealed that the auditor should be independent and objective and there should not be anything that indicates the auditor's vested interest in protecting the bank's management. It is only such impartial audit that would create trust in the auditor's report and promote confidence in the

bank. Even though it is the job of the internal controls system to prevent, or detect and correct, material misstatements arising from fraud and error, the external auditor cannot be exonerated from the responsibility of ensuring that this has been done conscientiously. He will have to design and carry out audit procedures in a way that would help reduce to an acceptably low level the risk of giving an inappropriate audit opinion.

Shari'a Courts or Banking Tribunals

Another indispensable requirement of the Islamic financial system is availability of some judicial facility that would help the banks recover their loans promptly from clients who unjustifiably procrastinate repayment and also help bank clients get prompt justice at a low cost when the bank is itself acting unjustly. The existence of *shari'a* courts or banking tribunals would be very helpful in getting prompt verdicts on the disputes of banks with their clients and vice versa. Normal civil court verdicts usually take several years in most Muslim countries.

The s*hari'a* courts or banking tribunals would have a greater deterrent effect if the names of banks or their clients whom these courts have found to be guilty were also published in newspapers. The fear of getting bad publicity would help minimize contractual violations. Furthermore, the names of parties who violate habitually may also be sent to the chambers of commerce and trade associations for blacklisting them in order to create the same effect that social ostracism had in the Classical period when the Islamic financial system operated effectively.[46]

Audit Organization

It may also be desirable to have an audit organization jointly owned by banks to evaluate the profit-and-loss accounts of those of their clients who the banks feel have tried to cheat them in a PLS arrangement. The fear of being exposed to a thorough check of their accounts by such an organization would complement the market forces in helping minimize

[46] M. Umer Chapra and Habib Ahmed, *Corporate Governance in Islamic Financial Intuitions*, Jeddah: IRTI/IDB, 2002, pp. 2–8.

the effort made by users of funds on a PLS basis to short-change the banks.

The creation of such an audit organization would save the individual financial institution the need to hire a large staff of auditors. It would thus create a substantial savings in expenses for all financial institutions. It would also give assurance to investors who provide their funds directly to businesses that, in case of need, they will be able to have the accounts properly examined by a qualified, impartial institution.

The whole concept of "audit" may have to undergo a transformation in the case of primary modes of Islamic finance. Conventional auditing is "not expressly designed to uncover management frauds."[47] If the auditor performs a diligent audit and evaluates the financial statements according to "the generally accepted accounting principles," the professional obligations of the auditor have been fulfilled. The auditor has no responsibility to detect management malpractices or to determine the "real" profit. He does not have the responsibility to check and to question.[48] Accounting firms generally tend to accommodate their clients, particularly the big clients who hire them. The auditor would fail in discharging his responsibility in a PLS system if he did not try to detect and disclose dishonest and questionable acts of the management and to determine the real amount of profit so as to ensure a "fair" return to the shareholders and *mudaraba* depositors.

Depositors' Associations

It is of crucial importance to establish mechanisms that would enable depositors to protect their own interest in a PLS financial system. Even demand depositors, and not just investment depositors, need such mechanisms because, even though demand deposits are guaranteed, the deposit insurance system does not generally insure demand deposits beyond a certain limit.

One of the mechanisms that could enable the depositors to protect their interest would be to have a representative on the bank's board of

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[47] K. Elliot and J. J. Willingham, *Management Fraud: Detection and Deterrence,* New York: Princeton University Press, 1980, p. viii.
[48] Alan Lechner, *Street Games: Inside Stories of the Wall Street Hustle,* New York: Harper & Row, 1980, p. 143.

directors and also a voice in the shareholders' meetings. The ease with which shareholders as well as depositors can participate in meetings and use their votes to influence important bank decisions, or to remove directors and senior management from office, can play an important role in improving corporate governance in banks. This may, however, be difficult for depositors to do effectively because they are far more in number than shareholders when even in non-bank corporations, shareholders do not necessarily attend such meetings. Moreover, voting rights can be expensive for shareholders and depositors to exercise if they can do so only by attending the meetings. This would virtually guarantee non-voting. It is therefore necessary for depositors to appoint their representative on the board of directors. This would be easier if the formation of depositors' associations is encouraged. Such associations could also enlighten the depositors on the condition of the bank in addition to having a representative on the board and at shareholder's meetings. However, until such time as such associations start functioning effectively, the external auditors may be assigned the task of acting as guardians of the depositors' interest in the same way as they are expected to guard the shareholders' interest.

Qualified Pool of Talent

To enable the Islamic system to fulfill the requirements of the *shari'a* as well as the BCBS and the IFSB and also ensure greater authenticity, it is necessary to train the management, staff, and clients of banks, as well as the general public, in the principles of Islamic finance. This will, however, not be enough. It is also necessary to create a large pool of experts and highly qualified professionals with in-depth knowledge of not only the *shari'a* and its objectives but also Islamic and conventional finance and financial engineering. This would be possible if first-rate institutions were created for this purpose with the collaboration of financial institutions, central banks, universities, and the governments. Directors and senior management of Islamic banks as well as *shari'a* advisers should also be required to take such courses. If the central banks as well as universities could make arrangements for this purpose, as is done in the case of conventional banking, the task of Islamic banks would become relatively easier.

Islamic Financial Market

The absence of a secondary market for Islamic financial instruments makes it extremely difficult for Islamic banks to manage their liquidity. Consequently, they end up maintaining a relatively higher ratio of liquidity than that which is generally maintained by conventional banks. This affects their profitability and competitiveness. It is therefore necessary to create an Islamic financial market. The establishment of the Islamic Financial Services Board (IFSB), International Islamic Financial Market (IIFM), and the Liquidity Management Center (LMC) is a step in the right direction and will help provide the institutional infrastructure needed for an Islamic financial market.

The IFSB will help promote uniform regulatory and supervisory practices and prudential standards for Islamic financial institutions in the same way as is done by the BCBS. The IIFM will enhance cooperation in the field of finance among Muslim countries and financial institutions by promoting product development and harmonizing trading practices. This will serve as a catalyst for the development and promotion of a larger supply of *shari'a*-compatible financial instruments. The LMC will serve as an operating arm of the IIFM in the effort to facilitate the creation of an interbank money market that will enable Islamic financial institutions to manage their assets and liabilities effectively. It will create short-term *shari'a*-compatible investment opportunities by providing liquid, tradable, asset-backed treasury instruments (*sukuks*) in which these institutions can invest their surplus liquidity. It will also facilitate the sourcing and securitization of assets and trade actively in *sukuks* by offering buy/sell quotations. The three institutions will together help establish an Islamic financial market by removing the drawback experienced by Islamic banks as a result of the lack of standardization of terms and instruments and the non-availability of quality *shari'a*-compatible assets for trading in the secondary markets. This should help the Islamic financial system to expand at a faster rate in the future and create for itself a larger niche in the financial markets of Muslim countries.

Lender of Last Resort

Islamic banks also need some facility akin to the lender of last resort that is available to conventional banks to overcome liquidity crises when they occur suddenly as a result of unforeseen circumstances.

Such a facility is available to Islamic banks at present on the basis of interest and is therefore unacceptable because of its incompatibility with the *shari'a*. Its use exposes them to charges of lack of authenticity. It may be worth considering the creation of a common pool at the central banks to provide mutual accommodation to banks in case of need. All banks may be required to contribute a certain mutually agreed percentage of their deposits to this common pool, just as they do in the case of statutory reserve requirements. They would then have the right to borrow interest-free from this pool with the condition that the net use of this facility is zero (that is, drawings do not exceed contributions) over a given period of time. In a crisis, the central banks may allow a bank to exceed the limit, with appropriate penalties, warning, and a suitable corrective program. This will, in a way, be a more organized means of replacing the framework for mutual cooperation that prevailed among the *sarrafs* during the Classical period.

Reform of the Stock Market

Reform of the stock market is also necessary in the light of Islamic teachings to ensure that share prices reflect underlying business conditions and do not fluctuate erratically as a result of speculative forces. The discipline that the *shari'a* helps introduce, through the prohibition of short sales or the sale of what one does not own and possess, should greatly help in realizing this goal. In addition, rules and procedures need to be streamlined and enforced to protect investors and ensure stability and sanity in the stock market. This will help raise the confidence of savers and investors in the system and enable them to buy or sell shares in response to their circumstances or their perceptions of future market developments. Such a reform would constitute one of the most important pillars for supporting the edifice of an interest-free and equity-based economy.

ADDING ANOTHER DIMENSION OF JUSTICE

While the introduction of risk/reward sharing will help promote justice between the financier and the entrepreneur, it is also necessary to ensure that the benefit of the nation's savings that financial institutions mobilize is also shared equitably by all sectors of the economy. This is because the financial system plays a dominant role in the determination

of the power base, social status, and economic condition of individuals in the economy.[49]

Hence no reform of the financial system can be meaningful unless it is also restructured in conformity with the socio-economic goals of Islam. The system has, however, tended to promote inequalities of income and wealth in almost all countries around the world and particularly so in countries that lack proper bank auditing and supervision and where the political system promotes cronyism. Arne Bigsten has rightly observed, that "the distribution of capital is even more unequal than that of land" and that "the banking system tends to reinforce the unequal distribution of capital."[50] Khwaja and Mian have shown in a recent paper that banks tend to favor politically connected firms.[51] This bodes ominously for society because it leads to the recruitment of entrepreneurs from only one social class and to the failure to utilize the society's entire resource of entrepreneurial talent.[52]

For example, in Pakistan, for which data are available on the distribution of commercial bank deposits and advances by size in the State Bank of Pakistan *Statistical Bulletin*, small depositors having deposits of less than one million rupees ($16,129) were 28.2 million in number and constituted 99.6 percent of all depositors in 2002. They contributed a total of Rs. 919.9 billion or 61.3 percent of the banks' total deposits. Small borrowers borrowing less than Rs. 1 million and constituting 96.4 percent of all borrowers were, however, able to get only Rs. 84.9 billion or 10.5 percent of the banks' total advances. In sharp contrast with this, depositors of more than 10 million rupees, who constituted only 0.03 percent of all depositors and provided only 24.8 percent of all deposits, were able to get Rs. 628.8 billion or 77.6 percent of total advances. (See Table 1 on page 59.) What this implies is that less than 1 percent of the borrowers were able to get more than three-fourths of the total advances. Small borrowers, thus, received far

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[49] See Stijn Claessens and Enricho Perotti, "Finance and Inequality: Channels and Evidence," *Journal of Comparative Economics* 35, July 2007, pp. 748–773.

[50] Arne Bigsten, "Poverty, Inequality and Development," in Norman Gemmell, *Surveys in Development Economics,* Oxford: Blackwell, 1987, p. 156.

[51] Asim Khwaja and Atif Mian, "Do Lenders Favour Politically Connected Firms?: Rent Provision in an Emerging Financial Market," *Quarterly Journal of Economics*, April 2005.

[52] Charles Leadbearer, "Rags to Riches: Facts or Fiction," *Financial Times,* 30 December 1986, p. 5.

less than what they had contributed to the banks. It is even worse in nationalized banks where a number of politically well-connected big borrowers are even able to get their loans written off.[53] Given such an inequitable allocation of advances, along with corruption, one cannot but expect inequalities of income and wealth to continue to rise, rather than decline, in the future—an outcome that is contrary to the socio-economic objectives of Islam.

The problem, however, is that the effort to reduce excessive lending may worsen the inequalities further by depriving primarily the small borrowers from being able to get credit because of their lack of political connection and their being considered, rightly or wrongly, as subprime. Therefore, what needs to be done is to introduce some suitable innovation in the financial system to ensure that even small borrowers are able to get adequate credit to enable them to realize their dream of establishing their own micro-enterprises. Any society where the poor are not able to get out of wage slavery by establishing their own enterprises, and satisfying their basic needs satisfactorily from the higher income earned thereby, cannot be considered a just society. Dr. Muhammad Yunus, founder of the Grameen Bank, has aptly emphasized that financing for self-employment should be recognized as a right that plays a critical role in attaining all other rights.[54] The Select Committee on Hunger established by the U.S. House of Representatives concluded in its report that "the provision of small amounts of credit to micro-enterprises in the informal sector of developing countries can significantly raise the living standards of the poor, increase food security and bring about sustainable improvements in local economies."[55] The Islamic financial system has hardly made any progress in accordance with this vision.

[53] Khwaja and Mian, "Do Lenders Favour Politically Connected Firms?"
[54] Muhammad Yunus, "The Poor as the Engine of Development," *Economic Impact,* 1988, p. 31.
[55] Muhammad Yunus, *Group-Based Saving and Credit for the Rural Poor*, Dhaka: Grameen Bank, 1984, p. v.

Table 1: Distribution of Commercial Bank Deposits and Advances by Size in Pakistan (Amount in Million Rupees)

	2002			
	No. of Accounts	% of total	Amount	% of total
Distribution of Deposits				
Less than Rs. 100,000	26,525,861	93.70	510,998	34.06
From Rs. 100,000-1,000,000	1,677,031	5.92	408,935	27.25
From Rs. 1,000,000-10,000,000	97,785	0.35	208,204	13.88
Above Rs. 10,000,000	7,204	0.03	372.334	24.81
Total	**28,307,881**	**100.00**	**1,500,471**	**100.00**
Distribution of Advances				
Less than Rs. 100,000	906,198	78.04	22,659	2.79
From Rs. 100,000-1,000,000	213,402	18.38	62.284	7.68
From Rs. 1,000,000-10,000,000	31,293	2.70	96.620	11.91
Above Rs. 10,000,000	10,305	0.88	628.836	77.62
Total	**1,161,198**	**100.00**	**810,399**	**100.00**

Source: Derived from data given in State Bank of Pakistan, *Statistical Bulletin.*

Experience has shown that micro-enterprises have generally proved to be viable institutions with respectable rates of return and low default rates. They have also proved to be a successful tool in the fight against poverty and unemployment. The experience of the International Fund for Agricultural Development (IFAD) is that credit provided to the most enterprising of the poor is quickly repaid by them from their higher earnings.[56] Testimony from the Grameen Bank in Bangladesh indicates a constant repayment rate of 99 per cent since the bank's inception.[57]

No wonder a number of countries have established special institutions to grant credit to the poor and lower middle class entrepreneurs.[58] Even though these have been extremely useful, there

[56] *The Economist,* 16 February 1985, p. 15.

[57] Yunus, *Group-Based Saving and Credit for the Rural Poor*, p.12.

[58] For the experience of microfinance institutions in some Muslim countries, see Mohammed Obaidullah, *Role of Microfinance in Poverty Alleviation: Lessons from Experiences in Selected IDB Member Countries,* Jeddah: IRTI/IDB, 2008.

are two major problems that need to be resolved. One of these is the high cost of finance in the interest-oriented microfinance system. A timely study by Qazi Kholiquzzaman Ahmed, president of the Bangladesh Economic Association, has revealed that the effective rate of interest charged by microfinance institutions, including the Grameen Bank, turns out to be as high as 30 to 45 percent.[59] This causes serious hardship to the borrowers in servicing their debt. They are often constrained to not only sacrifice essential consumption but also borrow from moneylenders. This engulfs them unwittingly into an unending debt cycle that will not only perpetuate poverty but also ultimately lead to a rise in unrest and social tensions.[60] No wonder that the Minister of Finance for Bangladesh described microcredit interest rates in that country as extortionate in an address he delivered at a microcredit summit in Dhaka in 2004.[61] It is therefore important that, while the group lending method adopted by the Grameen Bank and other microfinance institutions for ensuring repayment is retained, microcredit is provided to the very poor on a humane interest-free basis. This may be possible if the microfinance system is integrated

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[59] This is highly plausible because some other studies indicate even higher effective rates of interest. According to Nimal Fernando, principal microfinance specialist in the East Asia Department of the Asian Development Bank, the nominal interest rates charged by most microfinance institutions in the region range from 30 to 70 percent a year. The effective interest rates are even higher because of commissions and fees charged by them; N. A. Fernando, *Understanding and Dealing with High Interest Rates on Micro-credit,* Manila: Asian Development Bank, 2006, p. 1. According to Mannan, the effective rates range from 54 to 84 percent; M. A. Mannan, "Alternative Microcredit Models in Bangladesh: A Comparative Analysis of Grameen Bank and Social Investment Bank Ltd. — Myths and Realities," Paper presented at the First International Conference on Enhancing Islamic Financial Services for Micro and Medium-sized Enterprises, Negara-Darussalam, Brunei, 17–19 April 2007, pp. 2 and 12.

[60] Qazi Kholiquzzaman Ahmed, ed., *Socio-Economic and Indebtedness-Related Impact of Micro-Credit in Bangladesh,* Dhaka: Bangladesh Unnayan Parishad, 2007, pp. xvii-xix. See also Sudhirendhar Sharma, "Is micro-credit a macro trap?" *The Hindu,* 25 September 2002, p. 2, www.hinduonnet.com/businessline/2002/09/25/stories/2002092500810900.htm. According to Sharma, "while the Grameen Bank model of micro-credit has landed poor communities in a perpetual debt trap, the rising number of loan defaulters has given a serious setback to the Bolivian experiment."

[61] Cited by Fernando, *Understanding and Dealing with High Interest Rates on Micro-credit*, p. 1.

with *zakat* and *awqaf* institutions. For those who can afford to bear the cost of microfinance, it would be better to popularize the Islamic modes of profit-and-loss sharing and sales- and lease-based modes of finance in Muslim countries not only to avoid interest but also to prevent the misuse of credit for personal consumption.[62]

Another problem faced by microfinance is that the resources at the disposal of microfinance institutions are inadequate. This problem may be difficult to solve unless the microfinance sector is scaled up by integrating it with the commercial banks to enable the use of a significant proportion of their vast financial resources for actualizing a crucial socio-economic goal. Commercial banks do not at present fulfill this need and the Select Committee on Hunger is right in observing that "formal financial institutions in these countries do not recognize the viability of income generating enterprises owned by the poor."[63] This may be because it is too cumbersome for commercial banks to get directly involved in the business of financing micro-enterprises. They do not, however, have to do this. They can operate through their own subsidiaries or through the institutions that already exist for this purpose, like the agricultural banks, cooperative banks, development banks, and leasing and finance companies. Nevertheless, it is important to reduce the risk and expense of such financing for not only commercial banks but also the microfinance institutions.

The risk arises from the inability of micro-enterprises to provide acceptable collateral. One way of reducing the risk is to use the group lending method that has already proved its effectiveness. Another way is to establish the now-familiar loan guarantee scheme that has been introduced in a number of countries. To reduce the burden on the loan guarantee scheme, it may be possible to cover the losses arising from the default of very small micro-enterprises from the *zakat* fund provided that the loan has been granted on the basis of Islamic modes of finance and does not involve interest. A third way is to minimize the

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[62] For some details, see Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB), "Framework and Strategies for Development of Islamic Microfinance Services," Working Paper for IFSD Forum 2007 on Islamic Microfinance Development: Challenges and Initiatives, Dakar, Senegal, 27 May 2007 (in press), p. 30 [hereinafter IRTI/IDB 2007]; see also Ehsan Habib Feroz, "The Halal way to Social Change," *Islamic Horizons,* January/February 2007, p. 42.

[63] Select Committee on Hunger, U.S. House of Representatives, *Banking for the Poor*, Washington, DC, 1996, p. v.

use of credit for personal consumption by providing credit in the form of tools and equipment through the *ijara* (lease) mode of Islamic finance rather than in the form of cash. The raw materials and merchandise needed by them may be provided on the basis of *murabaha*, *salam,* and *istisna'* modes. If they also need some working capital, it may be provided as *qard hasan* (interest-free loan) from the *zakat* fund.[64]

The additional expense incurred by commercial banks in evaluating and financing micro-enterprises also needs to be reduced. In the case of financing provided to the very poor on the basis of Islamic modes of finance, a part of the expense may also be covered from the *zakat* fund, one of the primary purposes of which is to enable the poor to stand on their own feet. For those who are not eligible for *zakat* but still deserve some help, it would be worthwhile for the governments to consider subsidizing a part of the cost, at least in the initial phase, in the interest of helping realize the cherished goals of increasing self-employment opportunities and reducing inequalities of income and wealth. As the system matures, the dependence on *zakat* as well as the government subsidy may tend to decline.

Micro-enterprises, however, may not be able to make significant headway unless a substantial improvement is made in the environment for micro-enterprises through better access to markets and provision of the needed physical and social infrastructure. Such an infrastructure, including vocational training institutions, roads, electricity, and water supply, will help increase the efficiency of micro-enterprises and reduce their costs, thereby enabling them to compete successfully in the market.

CONCLUDING REMARKS

We can thus visualize how the absence of adequate market discipline in the conventional financial system leads to excessive and imprudent lending and serves as a major cause of financial crises. The problem, however, is that the injection of greater discipline into the system may aggravate injustice by making it even more difficult for subprime borrowers to have access to credit. The Islamic financial system addresses both these problems by incorporating a number of

[64] For some details on the risks associated with these forms of financing, see IRTI/IDB 2007, p. 30.

innovations that can help realize greater discipline and justice. However, Islamic finance is still in its infancy and does not fully reflect the ethos of the Islamic system. In order to increase its authenticity it is necessary to establish a number of infrastructure institutions without which the system cannot work effectively.

Theory of Higher Objectives of Islamic Law vis-à-vis Islamic Finance

A study of Imam Shatibi's Theory of the Higher Objectives and Intents of Islamic Law and Its relevance to Islamic Finance

Mansoor Shakil[1]

Thesis Statement

Should our understanding of universals trump our understanding of particulars?

INTRODUCTION

Islamic finance stands at a crossroads. The recent financial crisis has afforded an unprecedented opportunity. The conventional financial system has been shaken to its very core. As the wizards of conventional finance asses the destruction and its causes, Islamic finance too should engage in a bit of self-evaluation. The good news is that the impact on Islamic finance has been minimal and mostly indirect. The concern is that it may have been lucky. Perhaps it is time that Islamic finance practitioners look again at the principles and reassess the practice in light of some of the criticism that it has attracted lately.

One of the primary concerns expressed has been around the issue of preference for contractual form over underlying substance in Islamic finance products. This concern brings us to the challenge of determining the underlying substance. It is the view of the author that this task cannot be accomplished unless a clear methodology is stipulated to achieve it. It is to accomplish this task that the Theory of Higher Objectives of Islamic Law vis-à-vis Islamic Finance becomes relevant.

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The Theory of Higher Objectives of Islamic Law (also referred to "Higher Objectives" in this paper) has been studied as part of *Usul Al-Fiqh* by earlier scholars, though some have argued it to be transformed into an independent discipline.[2] The focus of this paper is on understanding the Higher Objectives as expounded by the Maliki jurist Abu Ishaq Ibrahim ibn Musa al-Shatibi and exploring its relationship with Islamic finance.

Shatibi was brought up in Granada (Spain), which had become a center of learning. Shatibi's family was Bannu Lakhm. His *kuniyat* was "Abu Ishaq" and his surnames were "Al-Lakhmi," "Al-Gharnati," "Al-Maliki," and "As-Shatibi." The date and place of his birth are unknown. However, one of his surnames, As-Shatibi, points to the city of Jatvia, which indicates that he was a descendant of the migrants from that town who settled in Granada. He died in 1388 (8th Shabaan 790 H) in Granada. In Alexandria, Egypt, there is a suburb called Ash Shatibi (or Al Shatby). There is also a particular spot in that suburb a few hundred meters south-southeast of the Biblitheca Alexandrina, the Library of Alexandria, where it is said that Imam Ash Shatibi is buried.[3]

A number of scholars other than Shatibi also tried to lay the foundations for the discipline of Higher Objectives of Islamic Law. These include Abu al-Ma'ali al-Juwayni, Abu Hamid al-Ghazali, al-Izz ibn Abd al-Salam, Shihab al-Din al-Qarafi, and Shams al-Din ibn al-Qayyim. However, the influence of Shatibi has been greatest and his book *al-Muwafaqat fi Usul al-Shariah* (Congruences in the Fundamentals of the Revealed Law) became the standard textbook on the Higher Objectives until the twentieth century.[4]

The key contribution of Shatibi's theory to the evolution of the Higher Objectives could be summed up as moving the theory from "unrestricted interests" to "fundamentals of law," from "wisdom behind the ruling" to "the basis for the ruling," and from "uncertainty" to "certainty." These are very significant positions taken by Shatibi, and the impact of his stance on the evolution of Islamic law is immense. In

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[2] Muhammad Al-Tahir Ibn Ashur, *Ibn Ashur Treatise on Maqasid Al Shari'a*, Herndon, Virginia: International Institute of Islamic Thought, 2006, p. XXII.

[3] http://en.wikipedia.org/wiki/Imam_Shatibi; also see Muhammad Khaled Masud, *Shatibi's Theory of Meaning*, Islamabad: Islamic Research Institute, 1994, pp. 5–6.

[4] Jasser Auda, *Maqasid Al-Shariah as Philosophy of Islamic Law*, The International Institute of Islamic Thought, 2008, pp. 17–21.

particular, his view on making the Higher Objectives "the basis for ruling" encapsulates a response to our thesis statement quoted above. Application of Shatibi's theory, as we shall see later in the paper, could have a significant impact on the future development of Islamic finance.

Shatibi's contribution to the discussion on Higher Objectives has won him a lot of praise. Mustafa Al-Zarqa has these words for Imam Shatibi: "a bright star which illumines and inspires studies on the principles and objectives of Islamic Law, making clear the path ahead and providing authoritative support [for their conclusions]."[5]

PART I: THEORY OF HIGHER OBJECTIVES OF ISLAMIC LAW AND IMAM AL-SHATABI

A. Theory of Higher Objectives

In this part, we will attempt to understand Shatibi's *methodology* to determine the objectives of *shari'a*. However, before we attempt to unravel his methodology, we need to understand what is meant by the phrase "objectives of *shari'a*" or "knowledge of the objectives of *shari'a*."

It is interesting to note that Shatibi did not venture into defining what he means by the term "objectives" in his masterpiece *Al-Muwafaqat.* Perhaps the reason was that he considered it sufficiently clear for someone who has an in-depth understanding of Islamic law. In his own words:

> He who wishes to benefit from this book must have a thorough grasp of the science of Islamic Law — both its roots and its branches, both that aspect of it which has been revealed and passed down in textual form, and our understanding and interpretations thereof. Moreover, he must not be disposed to imitation or to clinging obdurately to this or that school.[6]

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[5] Ahmad Raysooni, *Imam Al-Shatibi's Theory of the Higher Objectives and Intents of Islamic Law*, Herndon, Virginia: International Institute of Islamic Thought, 2005, Introduction, p. xiii.

[6] Ibid., p. xxi. The author has relied on Ahmad's translation of the work of Imam Shatibi throughout this paper with minor modifications to ensure a smooth flow of the style of translation with this paper.

Shatibi does, however, allude to a number of Quranic verses to back his statement that the well-being of the creation is at the heart of *shari'a*.[7] We could, therefore, say that insofar as Shatibi is concerned, the objective of *shari'a* is the "well-being" of people.

Definition of Objectives by Other Scholars

It has been quoted from Sheikh Bakar bin Abdullah Abu Zayed that the purpose of *shari'a* has been revealed to us in the following verse: *Surely Allah enjoins justice, kindness and the doing of good to kith and kin, and forbids all that is shameful, evil and oppressive. He exhorts you so that you may be mindful. (Al-Quran 16: 90.)*[8]

Moroccan scholar Sheikh Allal al-Fasi, after having reviewed a number of verses in the Quran, concluded:

> These verses in their totality make quite clear that the purpose for which the prophets and messengers were sent and for which the divine laws were revealed is to guide human beings into that which will ensure their well-being and righteousness, and to enable them to carry out the responsibility which has been laid upon them.[9]

We could extract the following elements from the above definitions of the objectives of *shari'a:*

1. Well-being of people
2. Doing good (justice, kindness, good to kith and kin)
3. Forbidding evil (all that is shameful, evil, and oppressive)

[7] Abu Ishaq Al Shatibi, *Al-Muwafaqat*, Dar Ibnul Qayyim & Dar Ibn Affan, 2003, vol 2, pp 12–13.
[8] The English translation of the Quran by Dr. Muhammad Taqi-ud-Din Al-Hilali and Dr. Muhammad Mushin Khan has been used.
[9] Raysooni, *Imam Al-Shatibi's Theory of the Higher Objectives,* p. xxiii.

Why is the Knowledge of Objectives Necessary?

To answer the question that has been posed, we will backtrack a little and attempt to understand the discipline of *usul al-fiqh* and the place of *maqasid al-shari'a* within this discipline.

As Muslim rule expanded to include communities outside of the Arab world and Muslim jurists faced an increasing number of new issues to opine on, the focus of their discussion slowly shifted from the "immediate question" to the jurisprudence (*usul*). Two cities, Kufah and Medinah, gained prominence as centers of legal learning. Dr. Zafar Ishaq Ansari notes that:

> As the doctrine of each center became known to the others, and as intellectual and existential contacts between scholars of different parts of the Dar al-Islam increased, the differing legal doctrines came under growing discussion. These discussions gradually led the lawyers to spell out the principles underlying their doctrines. As a result of these discussions, there appeared a new genre of legal literature — *Ikhtilaf* — and led to an enhancement in juristic consciousness and resulted in the formulation of a clearer and more precise juristic theory.[10]

For instance, *istihsan* (juristic preference) came to be associated with the Hanafi school based in Kufah whereas *maslaha mursala* (textually unspecified benefits) came to be identified with the Maliki school in Medinah — tools that are employed to identify *maqasid al-shari'a*.

Ibn Ashur in his treatise on *maqasid al-shari'a* opines that knowledge of *maqasid al-shari'a* is vital for a *mujtahid* who wishes to comprehend *shari'a*.[11]

Shatibi sums it up nicely when he opines that:

> If one reaches a point where he perceives the Lawgiver's intention as it pertains to every question of the Law and every area thereof, he will have achieved a station which qualifies him to serve as the

[10] Zafar Ishaq Ansari, *The Significance of Shafai's Criticism of the Medinese School of Law*, Islamic Research Institute, Islamabad, 1994, p. 6.
[11] Ibn Ashur, *Ibn Ashur Treatise on Maqasid Al Shari'a*, pp. 7–8.

> Prophet's vicegerent in the realms of instruction and the issuance of legal decisions and rulings concerning what God wills.[12]

What Shatibi appears to suggest is that the knowledge of the objectives of *shari'a* is essential for arriving at legal deduction in ascertaining the will of God. And as we have seen from our earlier discussion that "what God wills" is the "well-being of people," we will see more arguments to support this position in other parts of this paper.

B. Shatibi's Theory of Higher Objectives

As discussed earlier, Shatibi notes that the purpose of divine law is to preserve the good of human beings. He quotes a number of Quranic texts to substantiate his claim, such as: "*We have sent you (O Muhammad) not but as a mercy for the 'Alamin (mankind, jinn and all that exists)" (Al-Quran: 21:107),* and *"Allah does not want to place you in difficulty, but He wants to purify you, and to complete His favor to you that you may be thankful." (Al-Quran, 5:6.)*

Shatibi divides the Higher Objectives into two categories:

1. The Higher Objectives of the Lawgiver
2. The Human Objectives

Category One: The Higher Objectives of the Lawgiver[13]

Shatibi further broke down the Lawgiver's Higher Objectives as those that are meant for:

1. Establishing the Law;
2. Establishing the Law for People's Understanding;
3. Establishing the Law as a Standard of Conduct; and
4. Bringing Human Beings under the Law's Jurisdiction.

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[12] Raysooni, *Imam Al-Shatibi's Theory of the Higher Objectives,* p. 331.
[13] The author has attempted to provide a brief overview of Shatibi's theory rather than following Shatibi's methodology of arranging the issues in the form of questions.

For the purposes of this study we will focus on the first and fourth Higher Objective.

The Lawgiver's Higher Objectives in Establishing the Law:

- Shatibi explains that the objective of the Lawgiver in establishing the law is to protect essentials, exigencies, or embellishments.

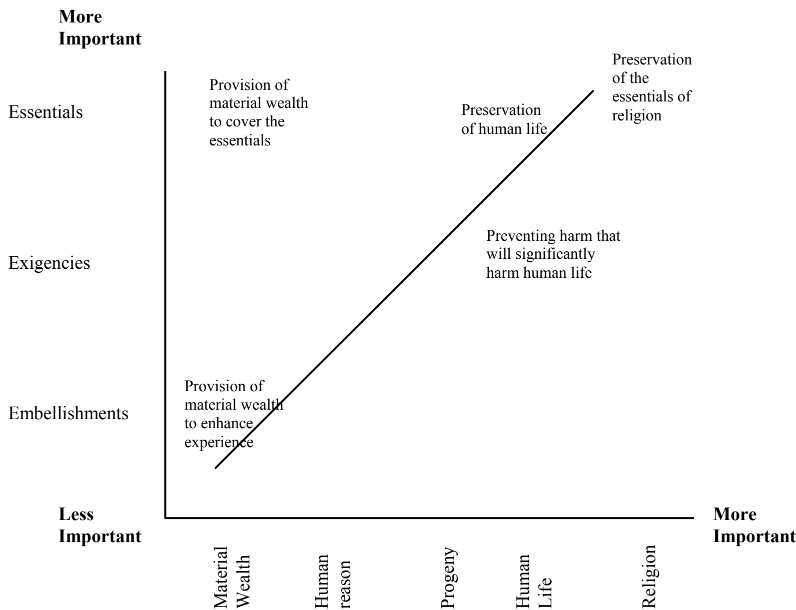
- Essentials (*dharoriyyat*) are things that are necessary for the material or spiritual well being of the human being. The loss of these would corrupt either this life or the life hereafter.

- Exigencies (*hajiyyat*) are things that complement the essentials. Preserving the exigencies relieves people from hardship.

- Embellishments (*tahsiniyyat*) are things that complement the exigencies. Embellishments enhance the experience of those subject to the law (human beings). These are the nice to-haves.

- Shatibi further suggests that an inductive analysis of Islamic law would give us the following five essential objectives/interests of law: religion, human life, progeny, material wealth, and human reason.

Figure 1: A graphic illustration of the Higher Objectives in Establishing the Law



Shatibi goes on to state that exigencies and embellishments are in the service of essential interests. He then fleshes out the meaning of this statement in the form of the following five rules:

1. The essentials are the foundation for exigencies and embellishments.
2. Disorder in relation to the essentials will lead to complete disorder in the latter two.
3. An imbalance in the realm of the exigencies and embellishments does not necessitate an imbalance in the essentials.
4. A complete imbalance in the realm of embellishments or exigencies may lead to a partial imbalance in the realm of essentials.
5. Exigencies and embellishments must be preserved for the sake of the essentials.[14]

[14] Raysooni, *Imam Al-Shatibi's Theory of the Higher Objectives,* p. 111.

The above rules clearly lay out another principle that although embellishments may not need to be protected in of themselves, they must be protected for the sake of exigencies and likewise, exigencies should be preserved for the sake of essentials.

The Lawgiver's Higher Objectives in Bringing Human Beings under the Law's Jurisdiction

The focus of this Objective is on the fact that human beings should subject themselves to the objectives of the Lawgiver and not to their own objectives. Shatibi explains this as follows:

> Once this has been determined, it becomes the basis for a number of rules. The first of these is that every action which is based on the mere fulfillment of one's own desires and without regard for what God has commanded prohibited, or left open to human choice, is invalid without exception. The reason for this is that for every action, there must be a person, a force, a law or the like which moves one to action. Hence, if the intention to obey the Lawgiver plays no role in one's performance of a given action, then it is nothing but a response to one's desires and lusts, and any action which meets this description is, without exception, unacceptable. By the same token, it may be said that every action which is a response to what God has commanded, prohibited, or left open to human choice is acceptable and right. If, on the other hand, an action represents a mixture of the two — in other words, it if is in part a response to a divine command and in part a response to one's own desires — then the ruling on it will vary accordingly, being based on whatever of the two motives is predominant and prior…[15]

The following quote from Shatibi will flesh out his view of the first and fourth Higher Objective:

> The first sub-classification (Higher Objective) refers to the establishment of a system which is capable of bringing happiness in both this worlds and the next to those who adhere to it, while the fourth sub-classification (Higher Objective) refers to the fact

[15] Ibid., pp. 121–122.

> that the Lawgiver calls upon His servants to place themselves in subjection to this system, and not their whims and desires.[16]

Category Two: Human Objectives

Here Shatibi takes us back to the discussion on actions and intentions and emphasizes the point that actions and intentions cannot be separated. He then proceeds to suggest that "The Lawgiver's aim for human beings is for their intention in what they do to be in agreement with His intention in laying down legislation."[17] In other words, "Whoever seeks, through the obligations imposed by the Law, to achieve objectives other than those for which the Law was laid down, has violated the Law, and the action of whoever violates the Law, insofar as it is a violation, is invalid."[18]

Shatibi goes on to discuss the topic of legal artifices (*hiyal)* under Human Objectives. Shatibi divides *hiyal* into three categories:

1. Prohibited: Gift of property for a limited period to avoid *zakat*.
2. Permissible: To tell a lie to save one's life.
3. Unclear: This is the category where the intent of the Lawgiver is not very clear, and deferred payment sale with excess could be one of them.[19]

The gist of Shatibi's view appears to be the need to ascertain the intent of the Lawgiver in every case. If the intent is preserved then the *hila* would be considered acceptable and vice versa. Shatibi proceeds to emphasize that:

> Actions performed in accordance with the law are not intended for their own sake, but for the sake of their objectives. These objectives constitute the meaning of such actions and the interests for the sake of which they are required by the Law. Hence,

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[16] Ibid., p. 120.
[17] Ibid., p. 129.
[18] Ibid., p. 130.
[19] Abu Ishaq Al Shatibi, *Al-Muwafaqat,* Dar Ibnul Qayyim & Dar Ibn Affan, 2003, vol. 3, pp. 124–125.

> whoever performs such actions with some other intent is not conducting himself in a legitimate manner.[20]

We will come back to this later in the paper, but Shatibi makes it clear that one's actions must follow the intention of the Lawgiver. This makes it extremely important for us to understand what the intention of the Lawgiver is.

C. How May the Intent of the Lawgiver Be Known?

So far, we have discussed *what* needs to be established. We now proceed to investigate *how* do we establish that? This, in fact, is the most complex issue in the entire discussion, that is, deciphering the intent of the Lawgiver. How does one say that God intends X and not Y? For instance, the Lawgiver commands us to do justice.[21] While in some cases, such as most criminal cases where scriptures are more prescriptive, it will be relatively straightforward to implement the command to do justice, it will be complex in certain other matters such as "a just economic policy," where *shari'a* has left a lot of room for *ijtihad*. This is precisely the task of a jurist.

In discussing the tools to determine the intent of the Lawgiver, Shatibi lists the following tools that he considers necessary to determine the real intent of the Lawgiver:

1. Legal Commands and Prohibitions: Between *Ta'lil* and Literalism
2. Induction
3. Knowledge of Arabic language
4. Primary and Secondary Objectives of the Law
5. Silence on the part of the Lawgiver

For the purposes of this paper, we will focus on the first two tools.

[20] Raysooni, *Imam Al-Shatibi's Theory of the Higher Objectives,* p. 133.
[21] "Be just: That is nearer to piety." (Al-Quran 5:8.)

1. Legal Commands and Prohibitions: Between **Ta'lil** *and Literalism*

The discussion of do's and dont's. It would be appropriate here to first discuss Shatibi's view on *ta'lil*. Ahmad notes that:

> Shatibi … holds that the validity of interpreting Islamic Law in terms of its concern for human interests is a certainty which admits of no doubt, and that this truth applies to the entire Law with the exception of those rulings having to do with acts of worship, which need to be accepted with unquestioning submission and devotion without regard for what underlies them by way of bases or wise purpose. Hence, the foundation for dealing with rulings such as these is to refrain from *ta'lil,* even though they most certainly do have a basis in both logic and human interest which is known to God Almighty.[22]

What concerns us is the first part of the above statement, attributed to Shatibi. While the claim that Shatibi makes with respect to "concern for human interest" is a subject that has been debated and discussed among earlier scholars and can be the subject of further investigation, we will limit ourselves to what Shatibi has to say about the topic under discussion (i.e., that all actions have an underlying intent except acts of worship, which also has an objective but we leave that to God Almighty). Shatibi further states that:

> If the '*illah* is known, it should be heeded, for whenever it is known, it will be possible to determine what is required by the command or prohibition in question, as well as what is, and is not, its intent. If, on the other hand, the '*illah* is not known, one must cease making definitive pronouncements to the effect that the Lawgiver intends this or that…[23]

In our quest for '*illah* Shatibi warns us of a danger that will become more relevant when we will discuss the interaction of these objectives and intent with finance and economics. He points out that our investigation of '*illa* must not lead us to disregard the apparent meaning:

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[22] Raysooni, *Imam Al-Shatibi's Theory of the Higher Objectives,* p. 174.
[23] Ibid., p. 270.

> Slavish, excessive adherence to texts' apparent meaning is a far cry from faithfulness to the Lawgiver's intention; however, disregard for these meanings is likewise a type of immoderation. Thus, if one conducts himself in accordance with what he understands to be the basis for this or that command or prohibition, he will be proceeding along the right path and be in harmony with the Lawgiver's intention in every respect.[24]

It appears from the above discussion that Shatibi clearly advocates a substance-based approach, and hence the focus on *'illa*, which also conforms to the apparent legal norms.

Shatibi's focus on substance and form will be instructive as we review arguments for and against compliance with form in addition to substance in the third part of the paper.

2. Induction (istiqra')

The principles and rules of Islamic jurisprudence (*usul al-fiqh*) have been largely established through a process of induction from applied legal rulings. Ibn Ashur notes in his treatise on *maqasid al-shari'a* that "This is because the systematic compilation of the science of *usul al-fiqh* (Islamic jurisprudence) was completed only nearly two centuries after the codification of *fiqh*."[25]

Shatibi does not refer to the methodology of induction as a formal tool to ascertain the objectives of the Lawgiver. However, he does use it extensively in his works. 'Abd Allah Darraz in his study of *al-mufaqaat* notes:

> [Shatibi] investigates speculative evidence on the level of its signification, its text, or both, as well as its rational aspects. In so doing, he joins strength to strength, continuing with the inductive process until he arrives at what may be considered definitive certainty on the subject at hand. This is a unique feature of this book in its reasoning and argumentation. It is moreover, a successful method by means of which he achieves what he has set

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[24] Ibid., p. 270.

[25] Ibn Ashur, *Ibn Ashur Treatise on Maqasid Al Shari'a*, p. XVII.

> out to do in all but the rarest instances, may God have abundant mercy upon him.[26]

The following paragraph from *Al-Muwafaqat* illustrates the use of induction in Shatibi's works:

> When the secret which had been so well concealed manifested itself, and when God in His Bounty granted me access and guidance to that which He willed to reveal thereof, I continued to record its wonders and gather together is scattered pieces from the most specific to the most general, citing the evidence thereof from the sources of Islamic rulings with attention to every detail. In so doing, I relied upon all-inclusive inferences rather than limiting myself to isolated particulars, demonstrating the textual and rational foundations [of Islamic rulings] to the extent that I was enabled by grace to elucidate the objectives of the Qur'an and the *sunna.*[27]

Shatibi, in summary, made substantial contribution to the development of the Theory of Higher Objectives. Before Shatibi the Higher Objectives were considered "unrestricted interests." Even al-Ghazali referred to them as the "illusionary interest" (*al masalih al-mawhumah*). However, Shatibi brought them into the realm of "fundamentals of law." He argued his case by referring to a number of Quranic verses that we have referred to in section A of this part.

Shatibi further argued that the Higher Objectives should be the "bases for the ruling" rather than simply the "wisdom for the ruling" when he stated and as quoted above "in so doing, I relied upon all-inclusive inferences rather than limiting myself to isolated particulars."

Shatibi's third contribution to the theory of Higher Objectives is his case for "certainty" of Higher Objectives, which were considered "uncertain" before him. To support his case he argued for the "certainty" of the inductive process that he used to conclude the Higher Objectives.[28]

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[26] Raysooni, *Imam Al-Shatibi's Theory of the Higher Objectives,* pp. 281–282.
[27] Shatibi, *Al-Muwafaqat*, vol. 1, p. 9.
[28] Auda, *Maqasid Al-Shariah as Philosophy of Islamic Law*, pp. 17–21. See also http://en.wikipedia.org/wiki/Imam_Shatibi.

This very brief discussion allows us a peek into the methodology advocated by Shatibi to understand the *intent*[29] of the Lawgiver.

PART II: MUSLIM ECONOMISTS AND THE OBJECTIVES OF ISLAMIC FINANCE

In Part I we completed our brief discussion of *"What needs to be established?"* And "*How do we establish that?"*

In Part II we will consider if we can establish general economic objectives to guide us in interpreting *ahkam* (legal rules) relevant to economics and finance.

Views of Contemporary Muslim Economists

Nejatullah Siddiqui comments in his book *Riba*, *Bank Interest and the Rationale of Its Prohibition*:[30]

> There is no disputing the point that all Islamic provisions relating to economic affairs are directed at justice and growth. The conception of growth in Islam is, however, broader and more comprehensive than the narrowly conceived 'economic growth' in capitalism. As implied by the verses of Qur'an,[31] it refers to an all rounded human personality and a society free of corruption. *Maslaha* and the protection of life, religion, reason, progeny and property, as also preservation of dignity and freedom, are rightly

[29] We find that the classical text uses a number of terms to refer to objectives. Some scholars have used it interchangeably and others have ascribed specific meaning. It is not possible for us to discuss the various uses of the terms *'illah* (underlying reason), *hikmah* (wise purpose), and *qasad* (meaning) in this short paper but it makes a very interesting study.

[30] Nejatullah Siddiqui, *Riba, Bank Interest and the Rationale of Its Prohibition*, Jeddah: Islamic Research and Training Institute, 2004, p. 22.

[31] "Even as We have sent unto you a messenger from among you, who recites unto you Our revelations and causes you to grow in purity, and teaches you the Scripture and wisdom, and teaches you that which you know not. (2:151); Allah verily has shown grace to the believers by sending unto them a messenger of their own who recites unto them His revelations, and causes them to grow in purity, and teaches them the Scripture and wisdom; although before (he came to them) they were in flagrant error." (Al-Quran 3:164)

> seen as corollaries to the broader goals of justice and growth. These are the principles scholars discover by analyzing the textual provisions, these are what Quran and *sunna* declare to be the objectives and these are what the legislators are supposed to keep in view while making new laws to handle new situations."

It thus appears that the primary objective, so far as Siddiqui is concerned, of Islamic economic teachings is "*justice and growth*."

Umer Chapra, on the other hand, has preferred to refer to broad principles in characterizing an Islamic economic system. Chapra argues for:

> a socially agreed filter mechanism to enable them [Muslim countries] to distinguish the *efficient and the equitable use of scarce resources* from the inefficient and the inequitable; (b) a motivating system to induce individuals to use these resources in conformity with the dictates of such a filter mechanism; and (c) a socio-economic restructuring that would reinforce the above two elements in bringing about the kind of reallocation and distribution of resources that *hayat tayyibah* (i.e., "the good life") demands.[32]

In addition to focusing on efficient and equitable use of scarce resources, Chapra in one of his articles emphasizes "justice" as one of the cornerstones of an Islamic economic system.[33]

Irfan Ul Haq notes that "One of the central aims of Islam is to establish an ethical, egalitarian and just social order." He further states that "Islam's economic doctrines and methodology, as will be seen, lie squarely within the domain of social economics."[34] Masudul Alam Chowdhury surveys the definition of social economics to suggest:

> Walras viewed social economics as a field of inquiry intermediate between social ethics and economics. In this sense, social economics is a rational socioeconomic study of the application of religious thought to the economic, political and social domain,

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[32] M. Umer Chapra, *Islam and the Economic Challenge,* Herndon, Virginia: International Institute of Islamic Thought, 1992, p. 342.

[33] M. Umer Chapra, "Islamic Economic Thought and the New Global Economy," *Islamic Economic Studies* 9(1), September 2001, pp.1–16.

[34] Irfan Ul Haq, *Economic Doctrines of Islam*, Herndon, Virginia: The International Institute of Islamic Thought, 1996, pp. 81–82.

> calling for applied judgments and reforms. Tawney believed that social economics as the means of studying society should be guided by a just appreciation of spiritual ends in order to use its material resources to promote the dignity and refinement of the individual human beings who compose it.[35]

Irfan Ul Haq further goes on to provide us with "Foundational Principles" of an Islamic economy. The gist of his view is that an Islamic economy is based on the principles of equitability and justice.[36]

Khurshid Ahmad appears to agree with the other economists when he suggests that the Islamic concept of development has a comprehensive character and includes moral, spiritual and material aspects. Economic development is a multi-dimensional activity, focused on man, purporting to generate a quantitative and qualitative impact with optimal utilization and equitable use and distribution of resources on the basis of right and justice.[37]

Synthesis of Objectives of an Islamic Economic System

A quick review of the above suggests that, by and large, Islamic economists suggest the following objectives for an Islamic economic system:

1. Comprehensive welfare of human beings is the primary objective of an Islamic economic system.
2. This welfare can be brought about through efficient and equitable use and distribution of resources.
3. This use and distribution of resources must be in line with the principles of justice.

In this part, we have established that a majority of Islamic economists share certain key economic objectives, which revolve around the concept of the "welfare of human beings." As such these

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[35] Masdul Alam Chaudhry, "The Micro-Economic Foundations of Islamic Economics," *The American Journal of Islamic Social Sciences* 3, 1986, p. 236.
[36] Irfan Ul Haq, *Economic Doctrines of Islam*, p. 84.
[37] Khurshid Ahmad, "Economic Development in an Islamic Framework," in *Studies in Islamic Economics*, Markfield, Leicester: The Islamic Foundation, 1980, pp. 179–180.

economic objectives are in line with the objective of Islamic law, which as we have seen earlier, is the well-being of people.

PART III: HIGHER OBJECTIVES AND ISLAMIC FINANCE

In our discussion, so far, we have addressed the following questions:

- What needs to be established?
- How do we establish that?
- What are the common economic objectives that are to be established?

In this part, we will leverage part of the earlier discussion to discuss an objective-oriented interpretation of Islamic law. We will then review some of the current practices in the Islamic finance industry to see what lessons could be learned by the Islamic finance industry from the methodology of interpretation advocated by Shatibi.

A. Toward a *Maqasid*-based *Ijtihad*

Ibn al-Qayyim al-Jawziyyah notes that:

> The basis of the *shari'a* is wisdom and welfare of the people in this world as well as the Hereafter. This welfare lies in complete justice, mercy, well-being and wisdom. Anything that departs from justice to oppression, from mercy to harshness, from welfare to misery and from wisdom to folly, has nothing to do with the *shari'a*.[38]

However, the Islamic concept of welfare is not limited to what humans know as good. The God Almighty says "*It may be that you dislike a thing which is good for you and that you like a thing which is bad for you. Allah knows but you do not know*." (Al-Quran 2:216.) This is because human knowledge is limited *"And of knowledge, you (mankind) have been given very little"* (Al-Quran 17:85). Imam Ghazali refers to this when he says:

[38] Chapra, *Islam and the Economic Challenge*, p. 1.

> As for *maslaha,* is essentially an expression for the acquisition of *manfa'ah* (benefit) or the repulsion of *madarrah* (injury, harm), but that is not what we mean by it, because acquisition of *manfa'ah* and the repulsion of *madarrah* represent human goals, that is, the welfare of humans through the attainment of these goals. What we mean by *maslaha*, however, is the preservation of the ends of the *shari'a*.[39]

Nyazee makes the following observations on the above definition:

1. That the pursuit of human goals and the principle of utility based on human reason is not what is meant by *maslaha*.
2. That *maslaha* is the securing of goals or values that the Lawgiver has determined for the *shari'a*.
3. That the goals determined for the *shari'a* by the Lawgiver may or may not coincide with values determined by human reason. Thus, reasoning based upon the principles of utility or on economic analysis may sometimes be acceptable to the *shari'a*, but it may be rejected at other times when there is a clash of values.[40]

Nyazee further argues that the larger doctrine of *maslaha* requires that during the use or employment of rational sources (*qiyas*, *istihsan* etc.) to discover the law, each derived law must be checked against the purposes of Islamic law or the *maqasid al-shari'a*. If there is some compatibility between the derived law and the purposes then the law is valid, otherwise it may be rejected. His view appears to be in line with what we have quoted from Shatibi earlier. However, this then begs an answer to our thesis statement "*Should our understanding of universals trump our understanding of particulars?*" Perhaps we could quote from Shatibi when he stated that:

> If one reaches a point where he perceives the Lawgiver's intention as it pertain to every question of the Law and every area thereof, he will have achieved a station which qualifies him to serve as the

[39] Imran Ahsan Khan Nyazee, *Islamic Jurisprudence*, Henrdon, Virginia: International Institute of Islamic Thought, 2000, p. 196.
[40] Ibid., pp. 196–197.

Prophet's vicegerent in the realms of instruction and the issuance of legal decisions and rulings concerning what God wills.[41]

Clearly, in present times, there is a lot to learn from Shatibi, and Islamic finance would be one area that could benefit from Shatibi's insights.

B. Current Practices in Islamic Finance and Objectives of *Shari'a*

Islamic finance has come a long way from the nascent concept that it was a few decades ago. It has grown in size and sophistication. Islamic financial institutions have clearly fared the recent financial crisis better than others. This can partly be explained due to some of the inherent differences between Islamic and conventional finance. Some of the more salient differences include prohibition of interest, sale of debt, and speculation; emphasis on equity participation and risk sharing; and a linkage to the real economy. While the principles remain unchanged, application of these principles has been severely tested.

Practical complications in achieving equity participation and risk sharing in any meaningful way continue to dwarf Islamic finance practitioners. Products such as *tawarruq* have severed the link between real and financial economy and *shari'a* compliant wrappers, albeit less widely accepted, make sale of debt and speculation possible. Given where we are in terms of financial crisis, it is entirely possible that some of these products would be scaled back partly because the conventional market for these products has dried up. However, it does draw our attention to the process through which these products are filtered.

While some of the Islamic economists have argued that each Islamic finance product must fulfill the requirements of the Higher Objectives of Islamic law, it is understandable that in the absence of having these objectives formulated in a pragmatic economic framework, individual scholars faced with the task would choose to rely on their understanding of "general need" rather than goals that have not been defined. It is this challenge to which Zarqa had alluded to in the following words:

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[41] Raysooni, *Imam Al-Shatibi's Theory of the Higher Objectives,* p. 331.

> Specifying a reasonable well-defined social welfare function in Islam is a matter of momentous significance to society, policy-makers, and especially to Muslim economists and jurists . . . to define this welfare from an Islamic viewpoint must be the *sine qua non* for making practical Islamic recommendations on any social or economic issue.[42]

Zarqa further notes that "Muslim jurists have a central role to play in defining in collaboration with other social scientists, including economists — details of a social welfare function relevant to present-day society."[43]

The task that Zarqa identifies is not straightforward by any means. However, if we consider our discussion in the earlier part, we know that it is the well-being of human beings that is clearly the objective of *shari'a*, even if, at times, we fail to understand the apparent logic. Let's consider this larger goal (substance) within the known prescription of *shari'a* (form) as we have seen Shatibi to advocate:

> Slavish, excessive adherence to texts' apparent meaning is a far cry from faithfulness to the Lawgiver's intention; however, disregard for these meanings is likewise a type of immoderation.[44]

Clearly, while Shatibi emphasizes the absolute importance of the substance of a transaction he does not discount the importance of the form. This indeed, is the nature of every legal system. Now, if we were to take the substance of Islamic finance, which we have argued is the welfare of human beings, and combine that with the contractual architecture of Islamic law, we have a strong compass to direct the future growth of Islamic finance.

The big challenge here, however, is the definition of "economic welfare." The author thinks that economic welfare may be defined with the help of the fundamental concepts of economics guided by the traditional legal theory of Islamic law and that of *maqasid al-shari'a*. In Part I.B of our paper we discussed the order of priority in the objectives of *shari'a*, which is protection of religion, human life,

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[42] Anas Zarqa, "Islamic Economics: An Approach to Human Welfare," in *Studies in Islamic Economics*, Markfield, Leicester: The Islamic Foundation, 1980, pp. 16–17.
[43] Ibid, p. 17.
[44] Raysooni, *Imam Al-Shatibi's Theory of the Higher Objectives,* p. 270.

progeny, human reason, and material wealth. Accordingly, resources in an Islamic economy must protect human life over material wealth. Similar inferences could be drawn to identify other goals of an Islamic economic system down to more micro details.[45] In terms of current practices in Islamic finance, this could mean that products that are geared to providing solutions in healthcare and education could be accorded a higher priority as compared to products that simply provide access to something "nice to have."

On the other spectrum let's consider an existing concept to test our compass. The *shari'a* compliant wrapper ("SCW") had been at the head of the last tide in product development in Islamic finance. Let's consider a SCW that provides exposure to the default risk of a conventional loan portfolio to see if this structure will pass the dual filter of *substance* (read "welfare") and *form* that we have discussed. While the structure of this SCW may comply with the formal requirements of Islamic contract law, its substance appears to contradict the welfare intended by the Lawgiver when He prohibited interest.

Admittedly, the above is a very simplistic analysis of a much more complex situation. There would be instances when the intention of the Lawgiver would not be as clear as it is in the case just cited. In those cases, where the intention of the Lawgiver is not clear, we will have to revert to general principles arrived at by induction to guide our understanding of economic welfare intended by the Lawgiver.

The above discussion also holds an answer to our Thesis Statement "*Should our understanding of universals trump our understanding of particulars?*" Shatibi clearly, in his quote above, advocates balancing both form and substance in pursuit of the objectives of *shari'a*.

Islamic finance has, so far, navigated the challenges of competing with conventional financial industry reasonably well. It now faces the most daunting task of securing its fundamental distinguishing characteristics that have been discussed earlier. It would do well to listen to the likes of Shatibi while exploring new products as it aims higher.

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[45] Please further see Imran Ahsan Khan Nyazee, *Theories of Islamic Law—The Methodology of Ijtihad*, Herndon, Virginia: International Institute of Islamic Thought, 1994, pp. 263–264.

There has come to you from God a light, and a Book Manifest whereby God guides whosoever follows His good pleasure in the ways of peace, and brings them forth from the shadows into the light by His leave; and he guides them to a straight path. (5: 15–16)

Authenticity of Islamic Finance in Light of the Principle of *Daman*

Abdurrahman Habil[1]

INTRODUCTION

Islamic finance is perhaps the most important peaceful attempt to revive Islamic law in the contemporary world. It has recently gained even more importance as some of the underlying causes of the current global financial crisis, such as excessive lending, securitization of debt, and inaccurate credit ratings, have drawn attention to certain characteristics of Islamic finance as an ethically based system, especially its restrictions on speculation and the sale of debt.[2] However, Islamic finance is still more important for its potentialities than its actual practices. There seem to be several indications that Islamic finance itself is undergoing a critical transition, at the very beginning of its young life. There are in fact serious disagreements and a general lack of standardization regarding some major modes of Islamic finance, disputes of the genuineness of its transactions before the courts, and general uncertainty about its authenticity.

First of all, there are serious fundamental disagreements among scholars on several basic issues of contemporary Islamic finance. These disagreements are far from academic, as they have become stumbling

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[2] See, e.g, the Vatican publication quoted in Aamir A. Rehman, "The Relevance of Islamic Finance Principles to the Global Financial Crisis," Discussion Paper for the Harvard Islamic Finance Project Panel Discussion on the Evolution of the Global Financial System from the Current Crisis, March 16, 2009, p. 1.

blocks to standardization. They center upon the legality of some major modes of Islamic finance, such as *ijara muntahiya bi-tamlik* (purchase and lease-back ending in transfer of ownership),[3] and, most of all, *tawarruq* (monetization; cash seeking; liquidity raising; commodity *murabaha*).[4] As we shall see below, the authenticity of such modes of finance may seriously be called into question.

Secondly, the authenticity of Islamic finance is increasingly disputed before the courts. For instance, in the now famous case of *Beximco Pharmaceuticals v. Shamil Bank of Bahrain*, the English Court of Appeal upheld a judgment for an Islamic bank but only on the grounds that the governing law of the contracts at issue was English law. The *shari'a* issue at stake was the legality of certain contracts and the transactions implementing them from a *shari'a* standpoint, as it was argued before the court that "the transactions were intended to serve as disguised interest-bearing working capital loans."[5] However, the court only addressed itself to issues of English law as the governing law, and the *shari'a* legality of the Islamic finance transactions in question was left open to doubt.

Likewise, in *Islamic Investment Company of the Gulf (Bahamas) Ltd v. Symphony Gems NV & Ors*,[6] the court disregarded arguments

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[3] On "purchase and lease back ending in ownership" as "usurious (*ribawi*) *hila*" and its applications in some types of *sukuk*, see Nazih Hammad, "*Ijarat al-Ain li-man Ba'aha,*" paper delivered at Al Rajhi Banking and Investment Corporation Fourth Juristic Forum Proceedings, 17 December 2003, pp. 9–15.

[4] See on *tawarruq*: Frank Vogel and Samuel Hayes, *Islamic Law and Finance*, The Hague: Kluwer Law International 1998, pp. 102, 141–143. *Tawarruq*, as currently practiced by Islamic banks, has been declared unlawful by the Fiqh Academy of the Muslim World League in its 17th Session convened from 19 to 23/10/1424h. Also in its 19th Session (from 22 to 27/10/1428h (8 November 2007)) the Academy has confirmed the unlawfulness of "reverse *tawarruq*," i.e., when the Islamic bank itself is the purchaser in the *tawarruq* transaction.

[5] Antony Dutton, "Appeal Brings Certainty to Islamic Financial Investments," *MEED,* 12–18 March 2004, p. 8. See also, Nicholos H. D. Foster, "Islamic Finance Law as an Emergent Legal System," *Arab Law Quarterly* 21, 2007, p. 172 n.9 and the references cited therein.

[6] 13th February 2002, 2001 Folio 1226 per Justice Tomlinson, 2002 West Law 346969, QBD (Comm Ct). See Kilian Bälz, "A *Murabaha* Transaction in an English Court," *Islamic Law and Society*, 11(1), 2004, p. 125: "delivery of goods is not a prerequisite to recovery by the seller of the relevant installments of the sale price from the purchaser because the agreement is no orthodox contract of sale"; p.126: "the allocation of risk under the contract at hand

based on references to *shari'a* in the agreements under dispute and upheld the agreements as valid under English Law. The *shari'a* arguments centered upon the defense of non-delivery of goods (a defense obviously relevant to any genuine sale contract!) and the argument that liquidated damages in the agreements were "thinly disguised interest." However, the court rejected both arguments on the grounds that the agreement in question was "no orthodox contract of sale." As in the *Beximco* case, the court avoided *shari'a* issues, as irrelevant to the governing law, but the authenticity of the *shari'a* transactions was again left in doubt. Ironically, it was the fact that both the *Beximco* and the *Symphony* judgments disregarded *shari'a*-related arguments that prepared the way for ruling in both cases in favor of the Islamic financiers. The refusal of Western common-law based courts to recognize or factor in *shari'a* considerations is understandable. However, the point remains that the authenticity of Islamic finance was seriously disputed in both cases.[7]

Thirdly, there seems to be general uncertainty about the authenticity of Islamic finance in principle. Some individual prominent '*ulama* even voice their criticism of contemporary Islamic finance as a whole, rejecting in principle any necessity for an independent Islamic finance system.[8]

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reflects a widespread practice in Islamic finance, through which the *murabaha* . . . is effectively turned into a credit vehicle with *autonomous* payment obligations," i.e., irrespective of the defense of non-delivery; p. 132: "the transaction, explicitly labeled a *murabaha* agreement, in effectively construed as a financing agreement with *abstract* payment obligations." Emphasis added.

[7] In some other cases Islamic finance transactions were openly held to be fictitious. Such cases were in particular brought in recent years in the United Arab Emirates. An *Amr Sami* (Emiri Order) of 27 February 1995 had banned bank loans without adequate securities. Several Islamic financing facilities (*murabahas*) allegedly advanced without sufficient securities were characterized as "loans" on the grounds of formalism, and claims for recovery by Islamic banks were accordingly rejected. See, for example, the United Arab Emirates Federal Supreme Court's ruling in Commercial Cassation Lawsuit No. 259-Judicial Year 27 (17 October 2006), where a *murabaha* contract was held to be a fictitious (*suri*) contract hiding a loan transaction.

[8] See e.g., interview with the Rector of Al-Azhar, Shaikh Tantawi, in *Al-Watan* newspaper, Kuwait, 24 May 2007: "there is no difference between the Islamic banks and all the conventional banks." For more details, especially on the so-called "fixed profit rate *fatwa*s." See also Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics, and Practice*, Cambridge University Press, 2006, p. 139; see also the recent joint *fatwa* of most of the senior *muftis* of Pakistan

It will be argued below that the authenticity of contemporary Islamic finance is called into question because of its use of *hiyal* (plural of *hila*, i.e., stratagem, artifice, device, or ruse). Following a discussion of the various implementations of *hiyal* in contemporary Islamic finance, it will further be argued that the dominance of *hiyal* in contemporary Islamic finance is due to casuistic legal methodologies and aversion to reasoning in light of general legal principles (*maqasid al-Shari'a*). An inductive survey of some basic rules of the Islamic law of financial transactions (*fiqh al-mu'amalat*) as it relates to the major modes of Islamic finance would bring into focus the principle of *daman* ("contractual liability") as one of the most fundamental principles of the law. Interestingly, the use of *hiyal* in contemporary Islamic finance is apparently an attempt to substitute them for the principle of *daman*. As we shall see in detail, some times the *hiyal* are used to implement the principle of *daman*, albeit indirectly, but at some other times they are used to evade it. The whole Islamic finance system seems to revolve around the principle of *daman* as the primary criterion of legality.

The general principles of the law, such as the principle of *daman*, form the connecting link between "metalegal" (ethical and socio-economic) values and specific legal rules.[9] Ethical and socio-economic values are often difficult to relate to specific legal rules. For instance, the link may sometimes be difficult to see between the Qur'anic ethical injunction against exploitation and unjust enrichment (e.g., Qur'an: II:

(signed by more then 30 *muftis*) on the unlawfulness of the contemporary system of Islamic banking, available at: http://www.thenews.com.pk/daily_details.asp?id=132723 and http://www.al-inaam.com, (last visited on May 19, 2009). See also Haidar Ala Hamoudi, "Jurisprudential Schizophrenia: On Form and Function in Islamic Finance," *Chicago Journal of International Law*, 7(2), Winter 2007, pp. 605-622; Timur Kuran, *Islam and Mammon: The Economic Predicaments of Islamism*, Princeton: Princeton University Press, 2004; Mohammad Fadel, "*Riba*, Efficiency, and Prudential Regulations: Preliminary Thoughts," available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1115875, (last visited on 19 May 2009); Lawrence Freeborn, "*Shari'ah* and Banking: Compatible or Unsuitable?" *Islamic Horizon,* January–March 2008, pp. 10–12; Tarek El Diwany, "Islamic Banking Isn't Islamic," available at: www.islamic-finance.com/item 100-f.htm.

[9] See, e.g., Peter Stein and John Shand, *Legal Values in Western Society*, Edinburgh: Edinburgh University Press, 1984, p. 258: "Legal principles are the meeting-point of rules and values."

188) and some cases of interest taking, as the risk of exploitation is not always evident in such cases. However, as we shall see in detail later, interest taking involves *daman* ("contractual liability") on the part of the borrower to repay the principal and the interest without a corresponding *daman* (like that of the seller, for example) on the part of the lender. On the other hand, when underlying tangible assets are required for the purposes of some modes of Islamic finance, this is not necessarily to evade the ban on interest taking, as sometimes conjectured by some critics, but primarily to implement the principle of *daman*, as shall also be seen below in more detail. It also follows that any imbalance of liabilities is unlawful even if unlawful *daman* is disguised as a lawful one, as *tawarruq* ("liquidity raising") is disguised as sale, as we shall see below in detail.

THE SPREAD OF LEGAL STRATAGEMS (*HIYAL*)[10]

Normally, legal fiction is a technique occasionally used to adjust the law to practice when the gap starts to widen between the law and social realities. Examples of such useful legal fiction are *fiction de droit* or *présomption de droit* in the civil law system.[11] In Islamic law, such techniques are recognized as *makharij* or *hiyal mashru'a* ("lawful *hiyal*") in contrast to *hiyal ghayr mashru'a*, *madhmuma*, or *fasida* ("unlawful *hiyal*," "blameworthy tricks"). The first type of *hiyal* is supposed to facilitate the functioning of the legal system, the latter is devised to circumvent it.

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[10] See on *hiyal* in general: Joseph Schacht*, An Introduction to Islamic Law,* Oxford: Clorendon Press, 1964, pp. 78–84; Noel J. *Coulson*, *A History of Islamic Law,* Edinburgh: Edinburgh University Press, 1994, pp. 100, 139–141; Vogel and Hayes, *Islamic Law and Finance*, pp. 39–41, 143, 183; Wael Hallaq, *A History of Islamic Legal Theories,* Cambridge: Cambridge University Press, 1997, pp. 173, 185–187; *Al Mawsu'a Al-Fiqhiyya,* Kuwait: Ministry of Awqaf and Islamic Affairs, 1996, art. "*Makharij al-Hiyal*"; Abdurrahman Habil, "The Tension between Legal Values and Formalism in Contemporary Islamic Finance," in *Integrating Islamic Finance into the Mainstream: Regulation, Standardization and Transparency*, ed. S. Nazim Ali, Cambridge, MA: Harvard Law School, 2007, pp. 109–118.

[11] On legal techniques in French law in general, see François Gény, *Science et Technique en Droit Privé Postif,* Paris: Sirey, 1921, Part III. See also Lon Fuller, *Legal Fictions*, Stanford: Stanford University Press, 1967, passim.

However, whether lawful are not, when *hiyal* dominates the legal scene, they may become alarming signs of a juridical predicament. They may be symptoms of intellectual incoherence, simplistic reasoning, and preoccupation with the form at the cost of substance. Besides, once the *hila* box is opened, there is no guarantee that only lawful *hiyal* will be employed, as all types of evasive devices can gradually creep into the system until the benign *hiyal* is hardly distinguishable from the destructive one.[12]

Be that as it may, the disagreements and the uncertainty surrounding the authenticity of contemporary Islamic finance may be chiefly due to its heavy reliance on *hiyal*. By their very nature, *hiyal* are a major source of disputes and uncertainty. Their dominance in contemporary Islamic finance is evidenced by the phenomena of (1) prearrangements, (2) the undisclosed intentions of the parties, and (3) the complex structures and the multiple documentation.

Prearrangements (*Tawatu', Muwata'a*)

Prearrangements play a central role in several products of Islamic finance and are the first indication of the dominance of *hiayl*. Chief among these are promises, involvement of third parties, agency, and special purpose vehicles.

Contemporary Islamic finance's heavy reliance on the device of promises is evident, for instance, in *murabaha* (sale with an agreed-upon profit markup on the cost), which is inconceivable without promises. The customer must first make a binding promise before the financier can purchase the goods. Some financial institutions have attempted to deemphasize the importance of promises in small deals such as motor vehicle finance by prearrangements with the vehicle dealers or by setting up their own dealerships, but a great role is still left for promises to play in any large *murabaha.*

In *ijara* (lease) the lessor (the financier) must promise to sell (or donate) the leased asset at the end of the lease (call option). The lessee (the customer), in his turn, usually promises to purchase the leased

[12] See Fuller, *Legal Fictions*, p. vii: "the fiction represents the pathology of the law. When all goes well and established legal rules encompass neatly the social life they are intended to regulate, there is little occasion for fictions. . . Only when legal reasoning falters and reaches out clumsily for help do we realize what a complex undertaking the law is."

asset upon certain termination events (put option). Such promises are considered "unilateral," albeit binding, and kept separate from each other and from the main lease document as far as possible. They are not considered incompatible with the contracts of sale or lease (*shart munaf li-muqtada al-'aqd*).[13] However, the lease contract is most often preceded by a sale contract between the customer himself and the financial institution, as the leased asset is usually an asset originally owned by the customer (the would-be lessee) and sold to the financial institution (the would-be lessor) to provide an object (asset) for the contract of lease. It may be difficult to see how a binding promise by the purchaser to sell back the purchased asset and a binding promise by the seller to purchase it back may be compatible with the contract of sale and its most important legal outcome of the transfer of ownership. The very fact that the *ijara* in such transactions is called *ijara muntahiya bi-tamlik* ("lease ending in transfer of ownership to the lessee") indicates that the initial sale from the would-be lessee to the would-be lessor is structured as a "temporary" sale, which is incompatible with the concept of sale itself.[14]

In addition to promises, involvement of third parties is another essential prearrangement in contemporary Islamic finance. An Islamic bank cannot deal directly with its customers without prearrangements with a third party in the two major finance modes of *murabaha* (markup sale) and *istisna'* (commissioned manufacture). The third party is either a supplier of goods, as in *murabaha*, or a contractor or manufacturer, as in *istisna'*. This reveals the simple fact that the Islamic bank is not originally a trader or a contractor. A trader or manufacturer would usually deal with its customers without the mediation of a third party.[15]

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[13] See *al-Ma'ayir al-Shar'iyya*, Manama: Accounting and Auditing Organization of the Islamic Financial Institutions, 2007, pp. 415–432.

[14] The promise (or the undertaking) of the issuer or manager of *sukuk* (*shari'a*-compliant bonds) to purchase back the *sukuk* assets or to redeem the *sukuk* at maturity or upon default at nominal value is also one of the major issues in *sukuk* structure. It is clear that such a promise is a device of risk shifting to evade redemption of the *sukuk* at the market price. See, e.g., Muhammad Taqi Usmani, "*Sukuk* and Their Contemporary Applications," pp. 3, 7–11, available at: www.failaka.com/downloads/Usmani_SukukApplications.pdf, (last visited on 19 May 2009).

[15] In addition to the two above mentioned types of prearrangements, the device of agency has an important role in several products of Islamic finance, e.g., in *murabaha*, *tawarruq*, and *ijara* (see below). Another widespread form of

The Undisclosed Intention of the Parties

The second indication of the dominance of *hiyal* is the undisclosed intention of the parties in several finance transactions. A financier would normally act as *rabb al-mal* ("finance provider"). A financial institution may only assume the role of trader, manufacturer, or a real estate developer under the guise of *hila*.[16] In *murabaha,* for example, the Islamic bank acquires the goods before selling them to the customer. Likewise, in *istisna'* the Islamic bank orders the asset to be manufactured before delivering it to the customer. However, in both instances the true intention is obviously credit sale, not simply trade or manufacture. The true trader or manufacturer is the original supplier between whom and the customer the bank mediates as a financer.

The Complex Structures and the Multiple Documentation (*Al-uqud Al-murakkaba*)[17]

Another indication of the spread of *hiyal* is the phenomenon of complex structures and multiple documentation. *Murabaha* (markup sale) more or less starts with an order and promise to purchase from the customer to the bank, followed by purchase of the goods by the bank from a third party supplier (often through the customer's own agency in large deals), and ending in sale of the goods by the bank to the customer. Agency from the customer to the bank to sell the goods on behalf of customer is used in the in case of *tawarruq*.

Itisna' (commissioned manufacture) is invariably accompanied by *istisna' muwaz* (back-to-back *istisna'*), whereas an *istisna'* contract is signed between the customer and the bank and an *istisna'* (or

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prearrangement are the special purpose vehicles (SPVs), which are a mainstay of *sukuk*. See, e.g., El Gamal, *Islamic Finance*, pp. 21, 23.

[16] On the point that *shari'a* boards and *fiqh* councils have allowed some financing deals which were closer to *hiyal* than to genuine Islamic finance when Islamic banks were few in number and undergoing difficult circumstances, see Usmani, "*Sukuk* and Their Contemporary Applications," p. 13.

[17] On the medieval legal ruse of the *contractum trinius* used by European merchants in the Middle Ages to circumvent the ban on usury and lend at fixed rate, see J. J.Henning, "The Mediaeval *Contractum Trinius* and the Law of Partnership," *Fundamina*, 13(2), 2007.

muqawala) contract between the bank and the contractor along with a design and supervision contract between the bank and the consultant.

Ijara (lease) is also characterized by complexity and multiplicity of documentation, as the bank purchases the asset (often from the customer himself) and leases it to the customer. The bank promises to sell the asset back to customer upon discharge of liability. Service agency is signed between the bank and the customer, to shift responsibility for insurance and maintenance to the customer on behalf of the bank. Transfer of ownership from bank to customer takes place upon payment of liability.

Tawarruq as an Illustration of *Hila*[18]

The above-mentioned three indications of *hila* are best illustrated by *tawarruq* (monetization; cash seeking; liquidity raising; commodity *murabaha*). Prearrangements (*tawatu'*) take place between a bank and two brokers: the first broker arranges for the purchase of commodities by the bank, the second broker arranges for the purchase of the same commodities from the bank as an agent of the customer after the latter purchases them from the bank. The two brokers are necessarily affiliated; usually one of them is a subsidiary of the other. The customer promises to purchase the commodities as soon as they are purchased by the bank. The three devices of *tawatu'* (promises, third parties, and agency) are thus utilized in *tawarruq*.

The intention of the parties in *tawarruq* is invariably the cash and never the purchase or sale of commodities. No commodities are changing hands and no payments are made to the supplier or the first broker or by the second broker or any ultimate purchaser, as only book entries (and brokerage) are at work, and the ultimate outcome is the cash received by the customer from the bank. The paperwork is absolutely irrelevant to the intention of the parties.

The structural and documentational complexity is also most evident in *tawarruq*. As can be easily seen, no less than six steps are involved in every single transaction, not to count preexisting master agreements between the bank and the two brokers and between the latter two themselves.

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[18] On *tawarruq* as *hila*, see Husain Hamid Hassan, "*Mura'at al-Maqasid al-Shar'iyya wa Ma'alat al-Af'al fi –A'mal Al-Masarif al-Islamiyaa*," Albaraka Seminar, 2007, p. 138.

MAQASID AL-SHARI'A AND "THE GENERAL PRINCIPLES OF THE LAW"[19]

The dominance of legal stratagems in contemporary Islamic finance, and consequently its conceptual predicament and the doubts surrounding its authenticity, may be mainly due to its casuistic legal methodologies and its aversion to reasoning in light of general principles.[20]

However, the problem is further compounded by the lack of any developed system of general principles in Islamic law. Despite genuine attempts by several eminent scholars, research in *maqasid al-shari'a* (the "aims of the law," Islamic legal theory, the general principles of Islamic law) is almost in its infancy when compared to writings on *usul al-fiqh* (methods of derivation of the Law) and on *qiyas* (analogical reasoning) in particular. In Islamic legal theory, legal rules are essentially derived through the methodology of *qiyas*, and particularly through the process of *takhrij al-manat* or *takhrij al-'illa* (derivation of the ratio legis; *manat* in this context is in the same sense of *'illa*, ratio legis). One of the main characteristics of the *'illa* is its being *mundabita* (objectively verifiable). This means that an acceptable *'illa* cannot vary from one situation to another or from one person to another. The classical example of *'illa mundabita* is traveling as the ratio legis of

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[19] See on *maqasid* in general, Ibrahim bin Musa al-Shatibi, *Al-Muwafaqat*, Cairo: al-Maktaba al-Tijariyya al-Kubra, 1994; Muhammad al-Tahir Ibn 'Ashur, *Maqasid Al-Shari'a Al-Islamiyaa,* Amman: Dar al-Nafa'is, 2001; Ahmad Al-Raisuni, *Nazariyyat al-Maqasid'ind al-Imam al-Shatibi,* 4th edition, Riyad: Al-Dar al-'Alamiyya li'l-Kitab al-Islami, 1995; Izz al-Din Ibn Zughaiba, *Maqasid al-Shari'a al-Khassa bi'l-Tasarrufat al-Maliyya,* Dubai: Markaz Jum 'a Al-Majid, 2001; Yusuf Hamid Al-Alim, *Al-Maqasid al-'Amma li'l- Shari'a al-Islamiyya,* 2nd edition, Riyad: Al-Dar al-'Alamiyya li'l-Kitab al-Islami, 1994. On the general principles and "internal structure" of Islamic contract and commercial law, see Frank E. Vogel, "Ijtihad in Islamic Finance," in *Proceeding of the Fifth Harvard University Forum on Islamic Finance*, Cambridge, Harvard University, 2003, p. 122.

[20] See on casuistry, Schacht, *An Introduction to Islamic Law*, pp.150, 205–206; Vogel and Hayes, *Islamic Law and Finance*, pp. 42–43; Vogel, "Ijtihad," pp. 121–122; Baben Johansen, "Casuistry: Between Legal Concepts and Social Praxis," *Islamic Law and Society* 2, 1995, pp. 135–156. Despite the apparent casuistic nature of Islamic law, its underlying general principles indicating "internal logic and structure," albeit often unarticulated, may be recognized without difficulty. See Vogel, "Ijtihad," pp.121–122.

shortening the quadruple canonical prayers and breaking the fast in the month of Ramadan. Only a traveler may enjoy this *rukhsa* (license). Although the "wisdom" (*hikma*) or the "benefit" (*maslaha*) behind this license is obviously the alleviation of the hardship of travel, the wisdom or the benefit by itself is not an acceptable *'illa*, because it is not *mundabita* as it varies from one situation to another and from one individual to another. Although details on the minimum distance and the maximum period of time relevant to this license differ from one school to another, traveling remains an objectively verifiable situation, while hardship for the non-traveler is not an acceptable *'illa* for prayer shortening or fast breaking, even if the hardship for a particular non-traveling individual in a particular situation may be much greater than the hardship, if any, encountered by "a king traveling in luxury." As in every legal system, a line must be drawn to achieve uniformity and applicability despite some marginal cases of apparent unfairness.[21]

Maqasid al-shari'a, literally translated as "aims of the Law," do not yet enjoy the same degree of objective verifiability of the '*illa* of *qiyas*. Despite the general agreement that *maqasid al-shari'a*, whether in the form of general "aims," general "principles," or general theoretical foundations of the law, do exist, scholars are often suspicious of their applicability in any objective, practical manner like that of the '*illa* of *qiyas*. That is because the *maqasid* are still formulated as very general, abstract rubrics such as *hifz al-din* (protection of religion), *hifz al-nafs*, (protection of life), *hifz al-mal* (protection of wealth), *hifz al-nasl* or *al-ird* (protection of family or honor), and *hifz al-aql* (protection of intellect), these five values being the so-called five necessities (*al-daruriyyat al-khams*). Obviously, when it comes to practical issues such as prayer and fasting on a journey, for example, one cannot draw much from the broad and vague rubric of *hifz al-nafs*.

Having said that, one of the practical approaches to *maqasid al-shari'a* may be to tackle them as "General Principles of the Law." One of the methods of derivation of *maqasid* is *istiqra*' (inductive reasoning). If it is shown by induction that a certain identical principle underlies each individual legal rule in a certain body of rules, could such a principle be one of the *maqasid al-shari'a*, i.e., one of the

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[21] See on *qiyas*, Hallaq, *A History of Islamic Legal Theories*, pp. 83–107. As far as one can see, the central issue of the objective verifiability (*indibatiyya*) of the *'illa* of *qiyas* is nowhere emphasized in this book.

General Principles of the Law? That is the argument to be tested in the following pages in relation to the contemporary Islamic law of finance.

INDUCTIVE SURVEY OF SOME BASIC PRINCIPLES OF ISLAMIC FINANCE

"God has allowed sale and forbidden *riba*."[22] Why is sale allowed and *riba* forbidden? To tackle this millennium-old question, let us start by a quick survey of the basic rules characterizing the law of financial transactions (*fiqh al-mu'amalat*) insofar as it relates to the major modes of Islamic finance.[23]

Mudaraba (Capital-Management Partnership):

Liability of the *mudarib* (the manager-partner) for the *mudaraba* capital or the profit is not acceptable, absent negligence or misconduct. In other words, the unacceptability of *daman* (liability, guarantee, assumption of risk) on the part of the *mudarib* seems to be the most basic rule underlying *mudaraba* in Islamic law. Third party guarantee of the profit in favor of the capital provider is not permissible for the same reason, as security in such a case would be enjoyed by the capital provider only.

Sharika (Partnership)

A partner cannot be held liable for his partner's share or profit. Exclusion of the partner's *daman* appears to be the dominant rule in any partnership. Third party guarantee of the profit in favor of one partner is likewise unacceptable.

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[22] Quran: 2:275.
[23] For more details on the contracts and concepts discussed below, see the relevant articles in al-Mawsu'a al-Fiqhiyya, the relevant standards in *al-Ma'ayir al-Shar'iyya*, the relevant sections in Vogel and Hayes, *Islamic Law and Finance*, and Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, Karachi: Idaratul Ma'arif, 1999.

Wakala (Agency)

Absent negligence or misconduct, the *wakil* (agent) in investment *wakala* is not liable for the amounts he invests on behalf of the *muwakkil* (principal) nor for the expected profit therefrom. In other words, there is no *daman* (liability) on the *wakil* without negligence or misconduct. Otherwise, *daman* by the *wakil* would render the *wakala* practically indistinguishable from a guaranteed loan.

Kafala (Suretyship, Guarantee)

Consideration for *kafala* is illegal.[24] For instance, if a benevolent loan is guaranteed by a third party for a consideration, then the loan will be practically rendered interest-bearing if the guarantee is called. Moreover, an issue of *gharar* (uncertainty, speculation) may be here involved, as the surety would receive the consideration without a corresponding definitive liability on his part, as we shall see below in the discussion of *gharar* and concomitant issues.

Ijara (Lease)

The lessee's *daman* for loss of the leased asset (absent negligence or misconduct) is illegal. Accordingly, maintenance and insurance, even in the case of capital lease ending in ownership, are the responsibilities of the lessor. That is why Islamic financial institutions resort to the device of service agency to shift the liability for maintenance and insurance to the lessee. However, the law is clear that *daman* of the leased asset is on the lessor and only *daman* of the rent should be assumed by the lessee.

Bay' (Sale)

The seller's liability (*daman*) for defects (*daman al-'aib*) and vindication (*daman al-istihqaq*, *daman al-istirdad*, *daman al-darak*,

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[24] See, e.g., Proceedings of Abu Dhabi Islamic Bank Seminar on the Letter of Guarantee, Abu Dhabi, November 11, 2000, p. 106.

third party claims) counterbalances the purchaser's *daman* to pay the price.[25]

Riba (Usury)

Prohibition of *riba* seems to revolve around the principle of (contractual) *daman*. For instance, interest on credit is unlawful in view of the *daman* on the part of the borrower to pay back principal and interest, without a corresponding *daman* on the part of the lender.

Gharar (Uncertainty, Speculation)

The issue of *daman* seems also to underline the prohibition of *gharar*. For instance, in the sale of the "stray camel," the seller offers no *daman* for defects or third-party claims, or even for deliverability, whereas the purchaser is liable for the price. Moreover, the "stray camel," perhaps analogous to some contemporary speculative financial instruments, would never be sold at a fair price, when the ultimate outcome is accounted for. If such "camel" is later found, the seller would be at a great disadvantage. If it is never found, the purchaser is obviously the loser.[26] The whole deal is defective due to the lack of balance of *daman*.

The above-mentioned rules, being among the most basic in the Islamic law of financial transactions, seem to be dominated by the principle of *daman* (liability, contractual liability).[27] A transaction is

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[25] *Daman al-darak* is the *Hanafi* term for vindication. *Daman al-'uhda* includes both defects and vindication in the *Shafi'i* and *Hanbali* terminology. See *Al-Mawsu'a al-Fiqhiyya*, art. *Daman*, pp. 273, 311.

[26] See, e.g., Abdul Razzaq al-Sanhuri, *Masadir al-Haqq-fi'l-Fiqh al-Islami*, Beirut: Dar Ihya' al-Turath al-'Arabi, 1997, vol. 3, pp. 31–39.

[27] The rules relating to *daman* are prominent in the literature of *qawa'id* ("general rules," often translated as "maxims"). Many of the *qawa'id* may actually be "maxims" but there are certain genuine general principles among them, such as *al-kharaj bi-daman* ("profit goes with liability") and *al-ghurm bi-ghunm* (loss, i.e., liability, goes with gain). See Ibn Nujaim, *al-Ashbah wa'l-Naza'ir*, pp. 127–128; al-Suyuti, *al-Ashbah wa'l-Naza'ir*, pp. 295–296; Baz, *Sharh al-Majalla,* pp. 56–58. See on *qawa'id* in general, Vogel, "Ijtihad," pp.121–122; Vogel and Hayes, *Islamic Law and Finance*, pp. 35, 72. See also Hassan, *Mura'at al-Maqasid*, p. 99. Although some of the *qawa'id* may appear to be in conflict or rather, overlapping, with some others, the principal

acceptable as long as "justified *daman*" is there and no "unjustified *daman*" is involved. *Riba* and *gharar* are disallowed because of unjustified *daman*, e.g., liability on the part of the borrower in *riba* and on the part of the purchaser in *gharar* without a corresponding liability on the part of the lender or the seller. The presence of justified *daman* and the absence of unjustified *daman* in every transaction excludes both *riba* and *gharar*.

Getting back to the question of why sale is lawful and *riba* is not, the lawfulness of sale (including a premium over cash in credit sale) seems to be due to the justified liability of the seller for defects and third-part claims to counterbalance the purchaser's liability to pay the price. *Riba* is unlawful because of the unjustified liability of the borrower to pay back both principal and interest without a corresponding liability on the part of the lender (in contrast to liability of the seller for defects and third party claims or liability of the lessor as regards the leased asset). Generally speaking, *daman* seems to be a *shart* (prerequisite) in sale and lease, and a *mani'* (invalidating element) in *mudaraba* and partnership, and, most importantly, in interest-bearing loans.

AUTHENTICITY OF ISLAMIC FINANCE IN LIGHT OF THE PRINCIPLE OF *DAMAN*

If it is admitted that the Islamic law of financial transactions is underlined by some coherent structure of essential principles, then the principle of contractual liability (*daman*), as illustrated in the preceding pages, is perhaps one of those principles. A quick review of the major modes of contemporary Islamic finance in light of this principle may now be in order.

Murabaha for the Purchase Orderer

The legality of *murabaha* for the purchase orderer (*murabaha li'l-amir bi'l-shira'*) is usually justified in contemporary Islamic finance jurisprudence by the existence of *daman*. However, what is meant by *daman* in this case is basically a pre-sale *daman* (*daman al-yadd*) that is different from the concept of contractual *daman* (*daman al-'aqd*)

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ones among them, such as the mentioned *al-kharaj bi-daman*, may represent important general principles rather than just "maxims."

explained above.[28] A "pre-sale *daman*" means "risk of loss" or "risk of ownership" or "liability of the owner for loss" arising from the mere fact of ownership. According to this view, the Islamic bank is only required to purchase the goods and "bring them under its *daman*" before selling them to the customer. This widely accepted argument, that the pre-sale "liability for loss" is the only *daman* required in *murabaha* to justify the profit and exclude *riba*, seems to emphasize risk for the sake of risk as it overlooks the fact that such liability is of no practical significance inasmuch as no counterparty is drawing any benefit from such liability or risk. This argument also seems to mistake an issue of *gharar* for one of *riba*. Pre-sale *daman* may exclude *"bay' ma laysa* '*indak*" (selling what you do not have) but not "*ribh ma lam yadman*" (profit from what one is not liable for), as stated in the well-known Prophetic saying.[29] The *daman* that justifies the profit in sale cannot be the pre-sale *daman* that is irrelevant to the sale itself, but rather the contractual *daman* arising from the sale transaction.

Be that as it may, the contractual *daman* does exist in *murabaha* and may still serve as justification for this product. Although the pre-sale *daman* is the declared justification for *murabaha*, the fact that the sold goods are usually the intended subject of sale entails actual contractual *daman* on the part of the Islamic financial institution. Despite the fact that such institution is actually a financier, it does act as a seller, liable for defects (unless such liability is legally excludable) and third-party claims. The *hila* underlying *murabaha* for the purchase orderer is therefore a "lawful *hila*," as it requires the existence of the underlying tangible assets necessary for *daman*, and is thus closer to legal fiction in the positive sense than it is to evasive artifices. This is, of course, subject to the condition that the goods are actually intended to be acquired by the customer so that the contractual *daman* is not deliberately circumvented, as we have seen and shall see more below in the case of *tawarruq*. In other words, a *hila* in *murabaha* may still be a lawful *hila as long as the object of the sale financing is actually the object of the contract,* and is therefore under *daman* for defects and third party claims.

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[28] See *Al Mawsu'a Al-Fiqhiyya,* art. *Daman*, p. 258: *yadd al-malik*: "the owner is liable (*damin*) for what he owns and is under his control."

[29] See, e.g., Muhammad b. Isma'il al-San'ani, *Subul al-Salam,* Beirut: Al-Maktaba al-'Asriyya, 2003, vol. 3, pp. 27–28.

Back-to-Back *Istisna'*

As in *murabaha* for the purchase orderer, the rationale behind the back-to-back *istisn'* in contemporary Islamic finance jurisprudence is the same concept of "ownership risk." The Islamic bank orders the asset to be manufactured or constructed by a specialized contractor before delivering it to the customer so that the asset "is brought into the *daman*" of the bank to justify the profit of financing. However, as just argued above in the case of *murabaha*, the justification for the legality of the back-to-back *istisna'* should not be sought in the pre-sale "owner risk" but in the contractual *daman* arising from the *istisna'* sale itself. It follows that, as in *murabaha* for the purchase orderer, *istisna'* ends up in contractual *daman as long as the manufactured asset is actually the intended object of the contract*, and may therefore be considered a "lawful *hila*."

Ijara (Purchase-Lease-Sell)

The *ijara* artifice is perhaps the most "lawful *hila*."[30] That is because the contractual *daman* created by *hila* in sales such as *murabaha* and *istisna'* can be transitory, whereas utilization of the leased asset and consequently the liability of the lessor therefor normally coincide with the tenor of the facility. Although the supplementary device of "service agency" shifts the liability to the lessee as "agent" of the lessor for the purposes of maintenance and insurance, the lessor remains liable for total destruction of the leased asset as long as the *ijara* would be terminated in such event.

However, the *ijara* rental payments, including the profit embedded therein, are justified by contractual *daman* only when utilization of the leased asset by the customer is the actual intention of the parties, such as when the asset is originally purchased by the bank from a third party, or in the case of forward lease when construction of the asset is financed by the bank. Otherwise, the *ijara* would turn into an "*ijara tawarruq*" as we shall see below. In short, the *hila* of *ijara* may be a "lawful *hila*" *as long as the object of the lease agreement (i.e., the leased asset) is the true object of the financing facility* and is accordingly under *daman*.

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[30] On purchase and lease as a "lawful *hila*" (or *makhraj*, solution), see Hammad, *"Ijarat al-Ain li-man Ba'aha*," p. 8.

Murabaha Tawarruq

Confusion between pre-sale *daman* and post-sale *daman* is at the heart of the problem of *tawarruq*. Insistence on the pre-sale *daman*, or the "owner liability" has inevitably paved the road to *tawarruq*. As long as the commodity "has been brought into the bank's *daman,*" the argument goes, the transaction is lawful from the *shari'a* standpoint. This argument overlooks the fact that the so-called ownership by the bank may in the case of *tawarruq* be so fictional and transitory that it may last for no longer than a few minutes and the fact that the so-called "ownership risk," if it exists here at all, is irrelevant as far as the sale of the commodity to the customer is concerned. The seller's pre-sale "ownership risk" can never convincingly justify the profit charged by the bank for *tawarruq* since the purchaser draws no benefit whatsoever from this risk. *Tawarruq* is therefore often confused with interest-taking since (1) cash is the real subject of contract; (2) the customer is liable for payment of the cash plus profit margin; and, (3) the customer's liability is as unjustifiable as that of an interest-bearing loan's borrower, as the liability for the principal and the profit is not counterbalanced by any liability of the bank. In other words, the net result of *tawarruq* is the "unjustified *daman*" on the part of the customer and the absence of "justified *daman*" on the part of the bank, as the commodity is immediately sold on behalf of the customer. The customer has no interest in the commodity, which is only superimposed by the bank to maintain some pretense of *daman*. When the test of *"object of financing must be object of contract"* is applied to *tawarruq*, it becomes evident that the object of the financing facility is the raising of cash liquidity, which is never disclosed in the *tawarruq* agreement itself, as the declared object of this agreement is the sale and purchase of commodities. The true object of the facility is not covered by *daman*. *Tawarruq* is a *hila*, and of very doubtful legality at that.

"*Ijara Tawarruq*" (Purchase–Lease Back–Sell Back)

It may be objected that *tawarruq* is not conceivable in *ijara* as the lease usually coincides with the tenor of the facility and the leased asset remains subject to *daman* for the same period. However, as already argued above, *daman* of the leased asset is relevant to *the object of the facility* only if the leased asset is the actual object of the facility, as in forward lease or when the asset is first purchased by the bank from a third party. If the asset is actually purchased by the bank from the

customer then leased back to him, the lease ultimately ending in sale-back of the same asset to the same customer, then a totally different product is at hand. Obviously, such a transaction is devised to provide the customer with cash liquidity (*tawarruq*) and the lease is only superimposed as an attempt to create *daman*. It is true that *daman* does exist here, contrary to the *murabaha tawarruq*, but is nevertheless purely fictitious, as the object of the facility is the cash, not the leased asset, and the cash is not covered by any *daman*. Contrary to forward lease and purchase-and-lease, purchase-and-lease-back does not even rise to the level of "lawful *hila*" but is simply a variation of *tawarruq*.[31]

CONCLUSION

The authenticity of contemporary Islamic finance cannot be meaningfully discussed in the absence of any agreed-upon general principles of Islamic finance law. Experience has showed that the two concepts of *riba* and *gharar* may be too broad to form any solid basis for agreement. This is evident from (1) the lack of standardization and the current disagreements on the legality of some major modes of Islamic finance; (2) the increasing disputes of authenticity of Islamic finance before the courts; and, (3) the widespread uncertainty about the authenticity of contemporary Islamic finance in general.

The disputes and the uncertainty surrounding the authenticity of contemporary Islamic finance may be chiefly due to its heavy reliance on the casuistic technique of legal stratagem, or *hila*, instead of general principles. One of the best approaches to the issue of authenticity of Islamic finance may therefore be from the *hila* standpoint. Upon careful analysis, the major current controversies of Islamic finance are at heart disagreements on *hila*, that is, whether this or that product is lawful or unlawful *hila*, e.g., whether *tawarruq* is an acceptable application of *murabaha* financing, *murabaha* financing itself being essentially *hila*.

The general principle of *daman* seems to underly several basic rules of the Islamic law of financial transactions (*fiqh al-mu'amalat*). When major modes of contemporary Islamic finance are examined in light of this principle, some of them turn out to be applications of lawful *hila* (or *makharij shar'iyaa)* as they tend to create some

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[31] On "purchase and lease back ending in ownership" as "usurious (*ribawi*) *hila*" and its applications in some types of *sukuk*, see Hammad, "*Ijarat al-Ain*," pp. 9–15.

"justifiable *daman,*" and some turn out to be products of unlawful *hila*, as they lack "justifiable *daman*" and represent transformations of "unjustifiable *daman.*" The above-suggested test of *"object of financing must be object of contract"* demonstrates the centrality of the concept of *daman* in Islamic finance. Whenever the object of the financing facility is actually the object of the contract, the requirement of *daman* is somehow fulfilled, as in the lawful *hiyal* of *murabaha* for the purchase orderer, back-to-back-*istisna'*, and the simple purchase-lease-sell *ijara*. If the true object of the financing transaction is not the actual object of the contract, then only unlawful *hila* is at work, as the underlying purpose of the transaction is to circumvent *daman*, such as in *murabaha tawarruq* and "*ijara tawarruq*." With the exception of *mudaraba* and investment *wakala*, where no immediate underlying tangible assets are required at the time of contracting and no *hila* is therefore needed, all other major modes of contemporary Islamic finance seem to fall under lawful *hila* or unlawful *hila*.

The authenticity of Islamic finance may be restored if the issue of *hila* is brought out into the open and lawful *hila* is transparently distinguished from unlawful *hila*.

Part II

Islamic Monetary Union and National Financial Regulation

Islamic Finance: Authenticity and Innovation — A Regulator's Perspective

Shamshad Akhtar[1]

INTRODUCTION

The impetus for Islamic finance (IF) comes not only from its strong appeal and demand both from Muslims and now from the Western world, but from the recognition and reality that IF is indeed an alternate and viable financing mechanism. If appropriately nurtured, it has the potential to broaden and deepen financial markets. This is critical for financial markets that suffer from (1) a low level of financial penetration—the level of financial exclusion in developing markets is as high as the level of financial inclusion in developed markets; (2) high dependence on banks and debt-based systems; and (3) speculative capital markets. IF's appeal lies in its inherent ability to enrich and supplement conventional finance—by offering options and solutions that address gaps in the existing financial system—while effectively and efficiently allocating capital and allowing opportunities to optimize economic value and activity.

Triggered by growing knowledge and research undertaken by *shari'a* scholars and academics, IF is now being nurtured more by industry experts and practitioners[2] as they recognize the benefits of exploiting synergies between IF and conventional finance.

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[1] The author is the former Governor of the State Bank of Pakistan, Karachi, Pakistan. This paper was adopted from the keynote address she delivered while Governor at Harvard Law School during the 8th Forum of the Harvard Islamic Finance Project.

[2] See, e.g., Muhammad Ayub, *Islamic Banking and Finance: Theory and Practice,* Karachi: State Bank of Pakistan Press, 2002; Hossein Askari, Zamir Iqbal, and Mirakhor Abbas, "New Issues in Islamic Finance and Economic: Progress and Challenge," *Wiley Finance,* July 2008; *Encylopedia of Islamic Finance,* ed. Aly Khorsid, Euromoney, 2008.

Conventional finance has steered the global financial markets for ages backed by well-tested policy, legal and regulatory prescriptions, tools, and structures; now IF is offering its own ideology, approaches, modalities, legal and contractual structures, and risk management perspectives in recent times. It is inevitable that the two disciplines have come into juxtaposition and transposition with each other to foster innovation and mutually benefit the financial markets while prompting cross-border flows and offering new perspectives on financial stability and sustainability.[3]

The debate on authenticity of IF is simplified, provided that developing synergies and an interface between IF and conventional finance is considered acceptable to scholars. In carrying forward this strand of thought, I propose to:

(i) Make the case that IF is by design authentic. Authenticity here refers to originality of IF discipline given its unique ideological, economic, and social settings and its ability to offer new ethical and equitable perspectives to the world of finance. IF is distinct and distinguishable from the conventional finance in a number of ways ranging from the stance it takes on prohibition of *riba* and other conventional instruments to the flexibility it allows to recognize the benefits and principles of risk sharing in the financial transactions that implicitly serve well investors/depositors.

(ii) Show that it allows flexibility to nurture businesses based on partnership and profit and loss sharing (PLS) mechanisms based on a fair and just contractual framework. The application of these IF guidelines and principles to well-tested tools of conventional finance itself ought to be treated as an innovation.

(iii) Highlight that the engineering of IF has facilitated the proliferation of Islamic products that include a range of (a) stand-alone products that have been tweaked to ensure conformity and convergence of returns with conventional finance, (b) hybrid Islamic products structured by blending two to three Islamic products that suit the financing requirements of businesses, and (c) equity-based funds, products, indices and insurance.

[3] Shamshad Akhtar, Governor of State Bank of Pakistan, “Islamic Finance: Its Sustainability and Challenges,” Keynote Address, Georgetown University, Washington, DC, October 18, 2007.

(iv) Highlight that while financial innovation is occurring in IF, there is scope for unleashing its potential further to facilitate financial stability. To start off, there is a need to recognize that IF has strong potential for serving as a framework for delivery of financial services because it offers flexibility of economic and trade business transactions. To unleash this power and flexibility of Islamic finance, one needs to be creative and constructive in order to apply the basic principles and structures of Islamic finance to the different types of financial transactions and also to seek opportunities to blend IF with conventional structures.

In this context, I propose to offer a few selective perspectives on IF's distinguishing features, its interface with conventional finance, and the range of financial engineering that has already occurred in IF through applying IF principles to conventional finance tools. Going forward, it is critical that the IF industry starts to exploit more deeply and substantively the PLS modalities that promote equity-based financing options and offer better risk sharing arrangements between financial institutions and customers. However, it has to be recognized that this would require further enhancing the IF legal, regulatory, and supervisory frameworks. It would also require instituting proper governance standards for PLS modalities that provide adequate safeguards for investment account holders. A greater appreciation and understanding of risk frameworks and the development of intellectual capacities would facilitate the adoption of complex Islamic products and would help in enhancing the depth and breadth of IF.

IF FEATURES AND ITS INTERFACE WITH CONVENTIONAL FINANCE

Distinguishing Features of IF

At one level, it is now well established that IF is quite different from conventional finance simply because IF is based on Quranic and *shari'a* injunctions and principles. Islam prohibits exploitative interest rate-based transactions (*riba*), transactions involving uncertainty (*gharar)*, speculative behavior (*maisir*), and trading of debts. In

conjunction, IF advocates "material finality" that underscores backing financial transactions with real economic activity and transactions.[4] The two key ideological differences between IF and conventional finance are these prohibitions and IF's emphasis on economic activity on the principles of equity and mutual sharing of benefit to all the involved parties.

Also, IF encourages relationships between financiers and entrepreneurs (borrowers) in which the lender and borrowers share investment risks in businesses and assets. Under these arrangements, returns are not fixed but commensurate with the identifiable rights and obligations of stakeholders. These transactions are well anchored in an elaborate contractual framework that derives its structure and application from IF. The ideological underpinnings of Islamic economics, its supportive contractual framework, and the wide range of financial and business transaction options permissible under IF allows for a rich array of approaches, options, and modalities in IF.

IF and Conventional Finance Interface

At another level, to properly nurture IF, it is inevitable that IF relies on the conceptual framework of conventional finance and its tools. The interface and linkages between Islamic and conventional finance will help promote the development of IF, though this process needs to be delicately managed. To ensure the acceptability and originality of IF while it converges and conforms to conventional finance's basic principles, the process should be achieved without compromising IF's ideological and spiritual distinction and uniqueness, which is critical for public confidence in the system. Concurrently, there is a need to recognize that the comparative advantage of IF is rooted in *risk sharing* through PLS features of IF modalities, as opposed to interest-based modalities in conventional finance.

[4] Alsadek H. Gait and Andrew C. Worthington, "A Primer on Islamic Finance: Definitions, Sources, Principles and Methods," *Working Paper*, University of Wollongong, School of Accounting and Finance Working Paper Series No. 07/05, 2007.

FINANCIAL ENGINEERING AND INNOVATION

Generally, the IF industry has witnessed an explosion of Islamic products that approach close to a full menu of conventional finance industry options and instruments. Today, the industry offers stand-alone or hybrid Islamic products, capital markets options for fund management, and insurance products via *takaful* to meet the requirements for the sovereign, corporate, and retail sectors. To ensure competitiveness, the IF industry has turned to replicating conventional products and aligning returns on Islamic products with them. This has generated concerns regarding the excessive concentration of banks on one or two products. Practically, the Islamic industry is currently bank-based. Product diversification, albeit slow, is emerging with engineered returns to ensure conformity and convergence with the conventional industry. IF product innovation can be grouped as follows:

(i) ***Islamic Core Products.*** Broadly, a number of Islamic products have been structured to achieve the same goals as their conventional product equivalents.[5] Three core structures are most popular: (a) *murabaha*[6] synthetic (debt-based) products that are backed by sale-repurchase agreements or back-to-back agreements of a borrower-held asset or lender's purchase; (b) *ijara* leasing (asset backed) provide financing; and (c) equity-based profit sharing contracts, such as *musharaka,*[7] *mudaraba*, and crop sharing (*muazarah*).

(ii) ***Engineering of Islamic Synthetic Products.*** Drawing from the core products identified above, new products can, in some cases, be created to suit new needs by careful structuring and engineering. Examples include the reverse

[5] Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance—Theory and Practice*, Hoboken: Wiley Finance Editions, John Wiley & Sons, 2006.
[6] In its original form, *murabaha* refers to a buy and sell contract at an agreed cost plus profit margin selling price for a specified kind of asset. See Islamic Financial Services Board, "On Strengthening Liquidity Management," Technical Note*,* 2008; hereinafter cited as IFSB (2008).
[7] *Musharaka* refers to an investment partnership where all partners are entitled to a share in profits from a project on the basis of mutually agreed terms and losses shared in proportion to investments. See IFSB (2008).

murabaha,[8] diminishing *musharaka*[9] (to provide house financing), *sukuk* and its variants along with *Musharaka* Term Finance Certificates (MTFCs). MTFCs have greater appeal since these are issued against the strength of the issuer's balance sheet, rather than specific assets of the corporation, and are close to a PLS framework.

(iii) ***Hybrid Islamic Products.***[10] Hybrid Islamic Products have grown considerably, combining the characteristics of both equity and debt. Supported by advances in Islamic securitization, there has been acceptance of Islamic Investment Certificates, i.e., *sukuk* bonds that are *shari'a* complaint and tradeable asset-backed securities. Although the industry has floated various types of *sukuk*, only 14 or so forms are widely recognized and used. Most *sukuk* are sponsored by sovereigns, both in domestic and international markets, and backed by approved government assets. Although *ijara* (asset-based) s*ukuk*[11] are the most popular, other hybrid *sukuk*, such as *sukuk* backed by synthetic loans, sale-lease-backs or head-lease/sublease *ijara* and profit sharing structure, are now emerging to be quite popular. The underlying pool of assets for some *sukuk* consist of *istisna'* and *murabaha* receivables as well as *ijara*.[12] Another example is the convertible *sukuk*—whether pure *ijara* or

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[8] Reverse *murabaha* (or *tawarruq*) is often used for personal financing when a customer buys something on credit from the bank on a deferred payment basis and then immediately resells it for cash to a third party without taking an interest-based loan. See http://www.hsbcamanah.com/1/2/hsbc-amanah/about-islamic-banking/glossary.

[9] Diminishing *musharaka* allows participation and sharing of profits on a pro rata basis whereby the financial institution's ownership of the project decreases over a period of time with the settlement of payments. Ultimately, the asset is transferred to the participant. See http://www.alburaq.co.uk/glossary.asp.

[10] Andreas A. Jobst, "The Economics of Islamic Finance and Securitization," IMF *Working Paper* No. 07/117, 2007.

[11] *Ijara sukuk* refers to financial obligations, issued by a lessor, and backed primarily by cash flows from lease receivables from a credit lessee.

[12] A. Arsalan Tariq, "Managing Financial Risks of Sukuk Structures," Masters Dissertation, Loughborough University, 2004, available at: http://www.sbp.org.pk/departments/ibd/sukuk-risks.pdf.

hybrid, it can have an embedded option allowing it to be converted into another asset form depending on the specified conditions.

(iv) ***Islamic Mortgages.*** These are fast gaining ground and are being structured as: (a) the *ijara* (lease) contract along the lines of a conventional mortgage; (b) an equity partnership (diminishing *musharaka*), where the mortgagee (lender) and mortgagor (borrower) jointly share ownership of the house and the the ownership is transferred to the mortgagor over a period of time as the mortgagor buys shares of the lender's ownership interest each month, thereby allowing the lender to generate a return on their investment out of the fair rental value of the property; (c) *murabaha* (sales transaction) is practiced in the United Kingdom, where the property transfer tax (stamp duty) discriminates against the *ijara*- or *musharaka*-based mortgage; and (d) cooperative societies, where members buy equity (*musharaka*) membership and help each other to purchase property from the pool of the society's funds.

In parallel to these developments, IF is making key inroads in the development of Islamic capital markets.[13] Among the significant initiatives on this front are:

(i) ***Islamic benchmarks*** are evolving as Islamic sovereign papers are being issued, that in turn are helping central banks to offer instruments for liquidity management. Among others,[14] some key initiatives in this areas include the launching of (a) Investment Certificates by the Government of Sudan based on a pool of *ijara, salam,* and *murabaha* instruments to raise long term financing and one-year maturity Government *Musharakah* Certificates based on equity partnerships; (b) Government Investment Issues by Malaysia, called b*ay' al-dayn* (debt trading); and (c) *salam sukuk* by Bahrain, whereby the government agrees to sell forward to Islamic banks a commodity

[13] Michael J. T. McMillen, "Islamic Capital Markets: Developments and Issues," *Capital Markets Law Journal*, 1(2), 2006, p. 136.
[14] These initiatives are further elaborated in http://www.ifsb.org/docs/mar2008_liquidity (last visited on July 9, 2009).

(typically aluminum) against spot payment. In turn, Islamic banks designate the government as their agent to sell the commodity to a third party on delivery, and the price of the sale determines the price of the *sukuk*.

(ii) ***Islamic Investment Indices.*** Equity benchmark indices are designed to track the performance of leading publicly trading companies that are involved in activities consistent with Islamic *shari'a* law. Examples of this are Dow Jones and FTSE Islamic indices, which focus on a limited range of companies and exclude companies that are involved in products and businesses not permissible under Islam.

(iii) ***Islamic equity funds*** include *shari'a*-compliant equity and hedge funds, commodity, leasing, and trade related funds. Barring equity funds, other funds are low risk. In the case of leasing, the fund is a securitized pool of lease contracts dealing with collateralized assets generating a steady stream of cash flow. Similarly, commodity funds have a short-term exposure in markets that are efficient and have developed forward markets, thus reducing the level of risk. In contrast, equity funds are similar to conventional mutual funds and are exposed to a higher degree of risk. Such funds are designed to ensure that equity stocks included in the fund are not only well diversified but also fully compliant with the *shari'a*'s guidelines.

(iv) ***Development of Derivatives and Their Equivalents.*** There is a debate on whether IF allows future price-setting. Some scholars argue it is not permissible. Others have a more flexible interpretation that forward trades are permissible in Islam if they are structured to provide the specific quantity, time, weight, and date. Devising solutions that are acceptable to all players is further complicated by the difficulties in structuring contractual obligations and structuring methods of eliminating risk inherent in the derivatives contract, such as counterparty and operational risks, and the lack of benchmark data. Despite these impediments, a few Islamic over-the-counter (OTC) financial derivatives, similar to conventional ones, have been structured. Some examples include the Islamic Cross Currency Swap (US$ 10 million) by Standard Chartered and Bank Muamalat Malaysia and the five-year US$ 230 million Currency Profit Rate Swap

floated by Citigroup. Work is also underway to float some other financial derivatives, such as a Forward Rate Agreement (equivalent to the conventional Forward Rate Agreement) and a Profit Rate Swap (equivalent of interest rate swap).

WAY FORWARD FOR ISLAMIC FINANCIAL INNOVATION

The industry's effort to engineer financial innovation has been impressive, but authenticity demands that the industry continue its efforts to innovate. To facilitate this, there is a need for the IF industry and regulators to consider a change in mindset. Moreover, this needs to be accompanied by an enhancement of the legal, regulatory, and supervisory infrastructure backed by proper governance framework to allow banks to transact in equity-based transactions. Traditionally, banks have been primarily focused on debt financing and regulators have been conservative in allowing banks to indulge in equity products or nonbanking businesses. However, the market-led consolidation and conglomeration has pushed the financial industry to universal banking and other structures that allow them to retail diversified and innovative financial products. Structural moves of this nature have promoted the scale and efficiency of the financial sector and institutions, while requiring regulators to make appropriate changes in their regulatory and supervisory framework. These developments, combined with the special features of IF, offer a rich perspective on how IF should position itself to move and compete in tandem with conventional finance.

Consistent with IF provisions, one concrete way forward is to develop the right framework and applications for PLS-*shari'a* compliant products. Currently, equity investment shares in IF range from zero to 24 percent of the Islamic banks' books. PLS modalities such as *mudaraba* and *musharaka*, driven by equity partnership arrangements, offer interesting options for innovation, but weaknesses in the legal, policy, and regulatory infrastructures have impeded the growth of such options. Some of the constraints to their effective application[15] include (1) equity holders' and entrepreneurs' aversion to risk given the uncertainties and variability of return on PLS business

[15] Humayon Dar and John R. Presely, "Lack of Profit Loss Sharing in Islamic Banking: Management and Control Imbalances," *International Journal of Islamic Financial Services*, vol. 2 no. 2, 2002.

arrangements; (2) the absence in most countries of proper property rights that could facilitate the protection of PLS contracts in case of litigation; (3) PLS does not lend itself to short term financing; and (4) equity transactions underlying PLS are taxed more than interest income.

Nevertheless, promoting the PLS modality would help move the financial system from being bank-centric to being market based and thereby facilitate sector-wide risk diversification. The benefits of PLS that involve different stakeholders include greater emphasis on project rigor, soundness and productivity, and appropriate sharing of losses between financial institution and investors. Workable solutions to reducing principal-agent problems and supportive screening and monitoring of projects upfront would go a long way to promote efficiency in capital allocation as it links financial returns with real project returns due to PLS. Promoting equity-based products would help address the issue of the mis-match of assets and liabilities and reduce IF's excessive reliance on short-term, low-profit, and fixed-income assets. However, it has to be recognized that the risk-sharing edge of IF products for customers is neutralized when Islamic banks pay investment account holders benchmark returns regardless of the performance and profitability of the business venture.

Another important area where work is under way but needs to be accelerated is in the development of prudential regulations and proper *shari'a* guidelines for Islamic banks. Guidance on prudential regulatory frameworks should incorporate appropriate amendments and refinements to the Basel or other best international practices with the objective of providing effective treatment of risks associated with the Islamic financial products and institutions. An important contribution in IF is the introduction of profit equalization reserves on the balance sheets of financial institutions, which is created for the PLS modalities to provide a cushion for displaced commercial risk[16] (risk of flight of customer deposits due to inadequate returns). To safeguard the interest of investment accountholders, Islamic banks have to incorporate the interests of depositors who are considered creditors and first claimants on the banks' assets and provide goal congruence with the management goals. Accompanying this is the *shari'a* corporate governance framework that protects the interest of the investor and customer by

[16] Islamic Financial Services Board, *Guiding Principles of Risk Management for Institutions Offering Islamic Financial Services*. Kuala Lumpur, December 2005.

underscoring the need for compliance and ethics, as well as maintaining a high degree of transparency and disclosure.

Before delving into the mechanics of the *shari'a* supervisory framework, it is pertinent to highlight the key challenges faced by Islamic banks with respect to *shari'a* governance. These challenges are interlinked and mutually reinforcing:

- The reputational risks arising from product and institutions' lack of understanding or uncertainty on *shari'a* compliance;
- Demarcation, responsibility and accountability between the board, management and *shari'a* advisor;
- Investment policies—compliance with *shari'a* prohibitions;
- Investors' protection;
- Disclosure and transparency of *shari'a* rulings;
- Harmonization of *shari'a* rulings and offerings; and,
- Vigilance and oversight of the supervisor to deal with these factors.

Currently, in the absence of a well-conceptualized framework, *shari'a* compliance standards and their oversight varies across jurisdictions:[17]

- In Iran, the Council of Ministers and Regulators under the Usury Free Banking Act of 1983 serves as the *shari'a* board and sets guidelines for the IF industry;
- In Malaysia, under Central Bank Act of 1958, the *Shari'a* Advisory Council has sole responsibility for IF and the court of arbitration refers disputed cases to this council for their position/advice;
- In Indonesia, the National *Shari'a* Board (NSB) is responsible for *shari'a* rulings on Islamic products, with IF institutions required to establish a *Shari'a* Division in the institutions and the NSB approving the *Shari'a* Supervisory Board to oversee the division;
- In Pakistan, a three-tier model of *shari'a* framework is put in place. This includes a *Shari'a* Advisory Board at the Central

[17] Ausaf Ahmad, *Instruments of Regulation and Control of Islamic Banks,* Jeddah: Islamic Development Bank, Islamic Research and Training Institute, 2000.

Bank that provides advice and guidance on prudential regulations, guidelines, modes of financing, and model agreements for the Islamic industry. Second, a *Shari'a* Advisor, meeting the Central Bank's fit-and-proper criteria, appointed by the banks to oversee their Islamic banking operations. Last, a mechanism for a *Shari'a* Audit System that inspects the *shari'a* compliance of all bank operations. The *Shari'a* Advisory Board includes both *shari'a* scholars and industry representatives.

- Bahrain, Sudan, and Syria have adopted *shari'a* standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and some other countries use them as guidelines.

Both prudential regulations and *shari'a* inspections and supervision are integral elements of the checks and balances needed to ensure that products and transactions meet the test of authenticity and compliance with *shari'a*. While these systems may not be in place right away, the development and implementation of this regulatory and supervisory infrastructure requires the build-up of capacities both at the institutional and regulatory level and will pave the way for building confidence in the Islamic system.

CONCLUSION

In conclusion, from a regulator's perspective, the development of IF in tandem with conventional finance will help broaden and deepen financial markets. This will help not only meet diverse requirements, but will also infuse financial stability. The evolution and path pursued by the IF industry has triggered debates regarding the authenticity of innovations. What is critical to recognize is that IF, by design, is authentic and brings in superior corporate governance frameworks as good ethical practices are embedded in IF. The authenticity and superior corporate governance frameworks, along with risk-sharing structures and product diversity that the system offers, lend itself to innovation.

Product diversification, expansion of security markets, and the development of Islamic exchanges and fund management will help nurture the financial diversification from a bank-based to a market-centric system. The proper application of a PLS system will help

provide greater opportunities for innovation provided it is backed by the right corporate governance structure.

On their part, regulators have provided the industry a free rein. Cooperation among regulators has helped to develop core and supportive IF infrastructures, which better weaves in the unique features and nuances of IF. The development of Islamic prudential regulatory and supervisory frameworks, which subscribes to Basel standards for conventional banking, will pave the way for the development of IF while tweaking the regulations to accommodate the special risk characteristics of IF. The institutional framework and evolving approaches for supervision systems will help build confidence among investors and customers. It is my belief that the proper and practical application of IF has the potential of taking global finance to new frontiers and heights.

Islamic Monetary Union: Feasibility, Viability, and Sustainability of a New Global Currency

Joseph A. DiVanna[1]

INTRODUCTION

One can argue that the financial activities of Islamic nations are growing at a rate that, if sustained, has the potential to strongly impact the twenty-first-century global economy. As industrialized economies struggle from a banking crisis and lapses in consumer confidence, the economies of Islamic states, although inextricably linked with Western economies, are undergoing dramatic changes. While the overall size of the Islamic financial market is small in the context of the world's financial assets, the growth of the industry coupled with current trends in infrastructure investment, the development of Islamic finance networks, and progress toward galvanizing regulatory and supervisory systems have bolstered confidence in the potential of Islamic economies.[2] Even though petrochemical production is playing a large role in the reshaping of the economies in the Gulf States, a large share of the new economic renaissance is purely due to changing economic conditions brought about by a fundamental revision in social structures within Islamic nations. In short, the financial activities of Muslims worldwide are shifting in three distinct ways: wealthy Muslims are expanding the diversity of their investment portfolios; there is a rising Muslim middle-class emerging in developed and developing nations; and there is a migration of vast numbers of Muslims into formal banking systems as many previously unbanked Muslims gain access to financial services.

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[1] Managing Director, Maris Strategies Limited, Cambridge, U.K.
[2] Mohammed El Qorchi, "Islamic Finance Gears Up," *Finance and Development*, International Monetary Fund 42.4, December 2005.

The emerging economic environment has created a fertile environment for the development of Islamic finance.[3] In addition to this, the changing wealth of Muslims worldwide can partly be attributed to the rapid growth of the *shari'a*-based banking industry, which has seen a rise of 27.8 percent in *shari'a*-compliant bank assets from USD $500.4 billion[4] in 2007 to USD $639 billion in 2008.[5] The rapid growth can be attributed to three distinct factors: a growth in the number of quality *shari'a*-compliant financial instruments, greater access to financial instruments for Muslims, and the appeal of *shari'a*-compliant financial services to non-Muslims. As the Islamic finance industry grows and matures, it begins to present a greater opportunity for financial innovation whereby Islamic nations seeking to provide a higher quality of life for Muslims globally can establish economic coopetition on an unprecedented scale. Events like the creation of the forthcoming Gulf Cooperation Council (GCC) single currency are perhaps a precursor to a higher degree of economic interoperation between Muslim nations on a larger scale.

The culture of Islam is not new to financial innovations. In our quest for financial efficiencies in today's world, we often overlook the many innovations brought forth from the Islamic world such as the letter of credit (*hawala*), bills of exchange (*siftajah*), specialized trading centers (*fundauq*), and checks (*sakk*), in addition to simple mathematical principles such as Arabic numbers and the zero.[6] Certainly, Islamic financial innovations have played a role in the rise of modern finance. Now, with the sudden rise in significance of Muslim wealth and higher volumes of financial transactions by Muslims worldwide, our attention has shifted to Islamic finance.

Across the globe, market conditions have manifested a wholly new economic environment whereby significant changes in the flow of international capital are enabling Islamic states to redefine themselves and the competitiveness of their nations. What is evident is that the

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[3] Karina Robinson, "Islamic finance is seeing spectacular growth," *International Herald Tribune*, November 5, 2007.
[4] Stephen Timewell and Joseph DiVanna, "Supplement: Top 500 Islamic Finance Institutions," *The Banker*, November 2007, p. 3.
[5] Ibid., p. 4.
[6] S. M. Ghazanfar, "Post-Greek/Pre-Renaissance Economic Thought: Contributions of Arab-Islamic Scholastics During the 'Great Gap' Centuries," in *Medieval Islamic Economic Thought,* ed. S. M. Ghazanfar, London: Routledge-Curzon, 2003, p. 174.

growth of outward Foreign Direct Investment (FDI) from emerging markets has outpaced the growth from industrialized countries in recent years, rising from US$12 billion in 1991 to US$99 billion in 1999 to an estimated US$210 billion in 2006.[7] The transference of the epicenter of capital flows combined with the growth in Muslim wealth and the erosion of the U.S. dollar as the world's primary reserve currency is leading toward a multiple reserve-currency system.[8] One key development is a steadfast collaboration between Muslim nations to strengthen the international Islamic financial architecture with the establishment of the Islamic Financial Services Board (IFSB), the International Islamic Financial Market (IIFM), and the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI). These circumstances have created a set of conditions for Islamic economic unity that begs to be explored. The aim of this paper is twofold: firstly, I aim to examine the feasibility, viability, and sustainability of a union between the 56 nations of the Organization of the Islamic Conference (OIC). Secondly, I propose to analyze the role of innovation and authenticity of Islamic ideals in enabling the economic synergies that guarantee the union. Due to source constraints and the early stage of the research, my analysis will use the current developments in the union of Gulf Cooperation Council (GCC) currencies in a first instance to establish a baseline of understanding.

World leaders, industry analysts, and economists are realizing that in the new emerging global economy, the activities of all nations are directly or indirectly linked to an interoperable transnational network of finance made possible by advances in technologically-enabled infrastructure. Thus economic, monetary, trade, and fiscal policies that are developed under an isolationist philosophy effectively act to diminish the competitiveness of a nation on world markets. Within this emerging state of interdependence, Islamic finance is playing an integral role in reshaping the world's economic activity by acting as a new source of alternative financing for business, governments, and consumers.[9] The emerging economic conditions present Islamic nations

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[7] Multilateral Investment Guarantee Agency, "South-South FDI and Political Risk Insurance: Challenges and Opportunities," Working paper, World Bank Group, January 2008, p. 1.
[8] S. Rajan Ramkishen and Jose Kiran, "Will the greenback remain the world's reserve currency?" *Intereconomics,* May-June 2006, pp. 124–29.
[9] Her Majesty's Revenue and Customs (HMRC), *Impact Assessment of Sukuk (Islamic Bonds) Legislation*, June 26, 2008, p. 2.

with an opportunity to synchronize economic objectives in order to increase their interdependence while simultaneously creating conditions that will elevate the economies of all nations through trade and monetary collaboration.

That said, monetary collaboration and economic union consist of progressive degrees of economic synergies. These are complexes of economic behavior aggregated holistically, unpredicted by the separate behaviors of any single nation-state or group of nations.[10] Simply put, monetary unions are a series of complex relationships that demand a synchronization of monetary, fiscal, and economic policies across multiple nation-states. Under such unions, the economic behavior of each nation in the union is not always predictable when viewed holistically against a global marketplace. As transnational trade agreements become intertwined with economic policy, the ability to regulate economic activity is often neutralized by unseen forces and unpredictable economic events. Therefore, monetary union must be thought of as progressive layers of policies that resemble an onion; peal away each layer and one can develop a topology of how transnational policies interact.

The emerging global economy is a synergistic progression, a hierarchy of total complex economic behaviors entirely unpredicted by the successive national economic behaviors or collective sets of transnational economic collaborations. As economic interdependence is the new economic reality—one that the United States has yet to acknowledge—the Muslim world is realizing that their economies must no longer be solely dependent on petroleum production. It is through the rising diversification of Muslim national economies that the conditions for economic synergies are rapidly becoming the new reality.

Thus, the twenty-first-century global economy is emerging as one vast heterogeneous interlinked consumer-led financial market. In the new global economy, multinational companies, NGOs, banks, and other financial intermediaries are acting as market aggregators moving products and services across sovereign borders, exchanging capital and commodities seamlessly with lower costs made possible by technology. It is from this rising transnational activity that the concepts of economic and monetary union across the Muslim nations have taken root.

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[10] Adapted from the theory of synergistics by R. Buckminster Fuller, *Synergetics: Explorations in the Geometry of Thinking,* New York: Macmillan, 1975, p. 13.

Just as businesses in a fragmented marketplace realize that collaboration, cooperation, and coopetition provide an opportunity to achieve an economic vitality that is greater than the sum of its parts, Islamic nations are considering economic unions as a means to elevate their domestic economies. Unification through structural reforms and the harmonization of sectoral policies as a process to gain economic stability is dependent on developing a monetary union that has a broad diverse economic base.[11] According to A. A. Wane, diversifying the economic base of the West African Economic and Monetary Union (WAEMU) is the single biggest challenge in stabilizing a union's economic activities. As a result, economists, academics, politicians, and government ministers in Muslim states are pondering the concept of a unifying vision of economic integration that would create a monetary union of Islamic nations enabling a synergy in economic, fiscal, and monetary policies while preserving national sovereignty.

An historical analysis of monetary unions indicates that a common currency should be a by-product of economic collaboration, rather than a single inherent goal. Monetary policy synchronization must consider many factors in order to achieve a balance between fiscal policy objectives, economic goals, and monetary policy criteria. One of the key considerations in the devising of an IMU is the reduction in the possibilities to counteract fluctuations in productivity by monetary policy as labor prices and supply shift irrespective of national borders.[12] In 1992, the Islamic Development Bank (IDB) acknowledged that in the light of the then emerging European Union (EU), OIC member countries should develop a collective strategy in the development of bilateral agreements with the EU to reduce inefficiencies resulting from negotiations between individual nations.[13] As indicated by the IDB, policy coordination is complex and must occur at various levels establishing clear linkages between macroeconomic, industrial, and agricultural policies. Basically, the goal is twofold: increase trade and

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[11] Abdoul Aziz Wane, "West African Economic and Monetary Union (WAEMU) Countries," *International Monetary Fund Research Bulletin* 6.1, March 2005, p. 6.

[12] Mattias Erlandsson, "Nominal Wage Flexibility in a Monetary Union," *Working Paper in Economics*, Göteborg University, 80, September 23, 2002, p. 27.

[13] M. A. Mannan, *Key Issues and Economic Implications of a Unified European Market after 1992 for OIC Member Countries: Options and Response,* Jeddah: IDB, IRTI, 1992, pp. 53–59.

the flow of capital between OIC member nations while simultaneously acting as a single entity to negotiate bilateral agreements with non-OIC nations. Therefore, a key objective is to reduce the complexities of multi-level policy synchronization, which requires new approaches and an innovative process.

This leads us further into the idea of an IMU. The concept of Islamic economic unity is not new. Benjamin Cohen notes that GCC nations under the 1982 Unified Economic Agreement sought "to coordinate their financial, monetary and banking policies and enhance cooperation between monetary agencies and central banks, including an endeavor to establish a common currency" with varying degrees of political commitment over the past twenty-six years.[14] Although some major factors and conditions for Islamic integration do exist among Arab countries, for example, there are significant structural differences among them in terms of political regimes. Many nations in the region can trace their legal heritage to the Napoleonic code, the Ottoman Empire, and to British common law. However, even with structural differences, during the past five years a shift has occurred toward a common approach to financial interactions as seen in the rapid rise in Islamic (or *shari'a*-compliant) banking.

It is from this tapestry of past transnational interactions coupled with the fading influence of European and Ottoman political structures that one can see the common fabric of an economic union. Shared ideals represented in *shari'a* laws and a common need to modernize their economies to a world class standard requires a look at the feasibility of an IMU.

FEASIBILITY

In 2007, the Islamic banking industry experienced its largest annual growth rate of 29.7 percent representing $500 billion in assets (see Table 1). Although relatively small when contrasted against the $17 trillion in total assets of financial institutions worldwide, the industry is the fastest growing segment in the financial markets. The extraordinary growth has also created numerous economic opportunities for transnational finance as the movement of capital across the region is

[14] Benjamin J. Cohen, "Are Monetary Unions Inevitable?" *International Studies Perspectives* 4, 2003, p. 290.

demonstrating the need for greater interoperation between financial institutions, governments, and business.

Table 1: Valuation of Global Islamic Banking Industry

	Value (in millions US$)	Annual Growth Rate
GCC	178,129	39.35%
Non-GCC MENA	176,822	29.87%
Sub-Saharan Africa	4,707	54.90%
Asia	119,346	20.91%
Australia/Europe/America	21,475	5.79%
Global Total	500,481	29.70%

Source: The Banker Magazine & Maris Strategies

Although many OIC countries share a common belief in *shari'a* principles, the governmental structural differences between nations raise the question of whether monetary union has a greater advantage over a simpler currency union. According to George von Furstenberg, "MU [monetary union] is co-managed by its members through a mutually agreed process while CU [currency union] is achieved by unilateral adoption of another country's money and its policy."[15] Thus there are distinct advantages in a monetary union over a currency union for member nations of the OIC that have concerns about a loss of sovereignty represented by the issuance of national currency. That said, if currency union is a long-term goal, monetary union provides an interim step to establish viable economic controls across member nations. Over time, economic policy synchronization can be adapted to best serve the combined interest of members, setting the foundation for a single currency.

The rapid rise and commingling of Islamic and conventional financing activities across the globe is further witness to an acknowledgment of the importance of the role Muslim ideology will play in the twenty-first-century economy. The involvement of Islamic finance in global economic events is rooted deeply in the past,

[15] George M. von Furstenberg, "The Case for Monetary Union Re-examined with the Benefit of the Single Monetary Policy," Working Paper, Indiana University, 2003, p. 1.

beginning with trade and commerce that has spanned the centuries. In contrast to the economic renaissance happening across the Muslim world, during the course of the past few decades the sense of value and equity has changed as the world reinterprets free market capitalism in the early years of the new millennium. It appears that Adam Smith's invisible hand is about to turn a new page in economic history.

Islamic finance is emerging as a highly fragmented industry with distribution capabilities not currently aligned with the vast numbers of Muslim populations. What is needed at this stage of development is innovation, and yet there is a misconception in the industry about invention and innovation. Invention is the creation of something new; innovation is the application of financial instruments to the communities served. Innovation strives to create social financial cohesion, not simply by inventing new financial instruments but by applying existing products in new ways, to new markets and new segments of the population.

Innovation and authenticity are needed for a monetary union to be viable because unions are complex sets of interoperating obligations between nation-states formulated to better their respective societies, codified by constitutional principles, and implemented by rigorous adherence to economic objectives. Innovation is the glue that holds the industry together.

The Vision of an Islamic Monetary Union

During the October 2005 OIC meeting in Makkah, Saudi Arabia, the *OIC Ten-Year Programme of Action to Meet the Challenges Facing the Muslim Ummah in the 21st Century* was proposed to promote greater unity among Islamic nations, calling for economic cooperation between OIC member states in the form of an "Islamic Common Market" by establishing free trade areas between member states, the facilitation of the freedom of movement of business and investors across borders, imposition of a common external tariff system against third countries, and the promotion of electronic commerce. One of the expressed goals of the OIC ten-year plan is economic cooperation between Muslim nations: "priority must be given to enhancing economic cooperation, intra-OIC trade, alleviating poverty in OIC Member States, particularly in conflict-affected areas, and addressing issues related to globalization,

economic liberalization, environment, and science and technology."[16] Within the OIC plan, resolution I.1 calls for member states to ratify existing trade and economic agreements and to implement relevant provisions of the OIC Programme of Action to Strengthen Economic and Commercial Cooperation among Member States.[17]

Subsequently in December 2005, Pakistan's Prime Minster Shaukat Aziz put forth a vision to promote greater unity, social cohesion, and economic cooperation within the Muslim *umma*. These broadly defined visions of Islamic economic unity have set in motion more in-depth discussions on how to achieve policy synergies that would elevate local economies, increase cross-border trade, promote transnational finance, and protect member nations from asymmetric economic shocks.

During 2006 and 2007, the GCC made varying degrees of progress toward its objective of a single currency by 2010, realizing that monetary integration is a multifaceted process of monetary policy alignment affected by the economic ambitions of each nation coupled with a dynamically changing demand for petroleum products. Although media coverage of Islamic economic unity across the GCC and beyond to other nations may wax and wane, regional leaders, policymakers, and central bankers continue steadfastly to explore each issue toward a determined set of long-term goals.

Goals

The classic goal of monetary policy is to promote maximum output and employment while sustaining stable prices. The objective of Islamic economic unity is to address the root problems of cross border trade, to create economies less dependent on oil or any single commodity, to raise economic activity to levels on par with larger nations and to protect weaker members of the union from adverse economic conditions. In an Islamic context, the goal of monetary policy is to

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[16] OIC Summit: Ten-Year Strategic Action Plan, Public Statement: Royal Embassy of Saudi Arabia, Washington, D.C., December 8, 2005.
[17] Tan Sri Dr. Ahmed Mohamed Ali Al-Madani, "Progress and Achievements under the Organization of Islamic Conference Ten-Year Programme of Action," Paper presented at the International Forum on the Makkah Declaration: Implementing the Economic Agenda of the Muslim World, Kuala Lumpur, September 1–3, 2007.

maximize social welfare while maintaining a regime that encourages price stability and the efficient use of money.[18] The long-term goals of monetary policy and synchronization between Muslim states are twofold: the efficient spatial and inter-temporal allocation of resources and the creation of a foundation for real economic growth by controlling inflation. That said, the more dynamic aspect of monetary policy is to achieve the stabilization of nominal income during periods of asymmetric economic shocks. To address how monetary union can do this, first we must look at monetary union in a theoretical context, namely as a process of economic integration and policy synchronization between member countries.

Monetary policy seldom alters a nation's economic output, levels of employment, and pricing of goods and services directly. Central bankers act to influence indirectly the economic activity of a nation through the manipulation of interest rates. Thus, the question of an interest-based economy rises to the forefront of any discussion on IMU. Policymakers are asking if an IMU should be based on non-interest capitalism and, if so, whether such a form of capitalism can co-exist within an interoperating global economy. Even more importantly, with the absence of interest rates as a mechanism to influence the economy, they ask what other controls would need to exist to provide an appropriate set of tools for central bankers. Thus, an IMU can only be feasible if the member nations believe that monetary policy implementation will provide the tools to influence economic stability and offer protection against asymmetric economic shocks, regardless of whether the national economy is interest-based, non-interest-based, or in a transitional state converting from interest to non-interest-based, as we will see.

Monetary unions are a complex set of interoperating obligations between nation states formulated to better their respective societies, codified by constitutional principles and implemented by rigorous adherence to economic objectives. Simply, monetary unions are constructed by establishing a set of rules creating economic synergy between one or more nations whereby the coordination of political, monetary, and fiscal policy objectives creates an economic entity where the aggregated sum of economic activities has a value greater than the sum of the activities of the individual member nations. IMU is no exception to this premise. Discussions of IMU are not centered on a

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[18] Peter Bofinger, *Monetary Policy: Goals, Institutions, Strategies and Instruments,* Oxford: Oxford University Press, 2001, p. 128.

nostalgic search for past economic glory, nor are the underlying principles of Islamic finance as an economic system based on equitable exchange between parties solely a simple reaffirmation of a fundamental belief in Islam. IMU is about securing a future of Muslim societies in economic terms that ensures economic viability while preserving Muslim ideals. The establishment of an economic system unfettered by the same constraints that have evolved from conventional interest-based economies is one clear objective of an IMU.

The feasibility of an IMU brings forth two central questions: (1) can an economic system be constructed, operate, and achieve long-term viability without using conventional interest rate mechanisms as a prime tool to regulate economic activity; and (2) can national objectives be synchronized to serve the needs of individual nations while acting to simultaneously improve the diverse economic conditions of all nations?

Because national economies need a higher degree of policy synchronization to achieve monetary goals, central banks will need to redefine their roles to reduce the time between policy proposals and implementation of policy objectives. Paul Volcker (former chairman of the U.S. Federal Reserve) argued:

> We sometimes forget that central banking, as we know it today, is, in fact, largely an invention of the past hundred years or so, even though a few central banks can trace their ancestry back to the early nineteenth century or before. It is a sobering fact that the prominence of central banks in this [twentieth] century has coincided with a general tendency towards more inflation, not less. By and large, if the overriding objective is price stability, we did better with the nineteenth-century gold standard and passive central banks, with currency boards or even "free banking." The truly unique power of a central bank, after all, is the power to create money, and ultimately the power to create is the power to destroy. . .[19]

[19] Address by former Federal Reserve chairman Paul Volcker to a group of central bankers in July 1994, cited by J. Ernhart, "Paul Volker on the Reckless Inflationary Nature of Central Banks," *Vigilant Investor,* October 2006, available at http://www.ernharth.com/vi/2006/10/19/paul-volker-on-the-reckless-inflationary-nature-of-central-banks/ (accessed February 2009).

The central bank of the IMU (or a collection of central banks operating as one entity) must establish a baseline of value in which the new currency will be constructed. Then the conversation turns to gold, silver, or a commodity as a basis of a new regional currency. Historically no currency has ever survived long-term as an international currency when accompanied by high inflation. Moreover, one of the prime concerns of the IMU is establishing controls to regulate inflation through mechanisms that synchronize monetary, fiscal, and economic policies, making currency union a by-product of the unification process. Over the past 200 years, countries producing great currencies have avoided inflation by maintaining the gold or silver content, with devaluation or debasement a comparatively infrequent phenomenon. The lower the rate of inflation, the lower the cost of holding money balances and the more of them will be held.

The key point is that with gold or silver, currencies have a fall-back value if the state collapsed. Moreover, a monetary union under the right economic conditions can act as a catalyst for closer political union by creating a process that rapidly brings into focus any mounting economic crises. The goal of an IMU is predicated on predictability and consistency in monetary policy. Interoperation with conventional economies presents a clear dilemma for the basis of such a union: interest or non-interest.

Two Forms of Union

In the context of member states in the OIC, two distinctly different forms of monetary union must be considered: unilateral union (sometimes called dollarization) or multilateral union. In its early stages of union, unilateral monetary policy presents a higher degree of difficulty in gaining consensus between member states. Although unilateral union can be accompanied by an increase in the mobility of capital across member countries and new levels of monetary policy discipline, it can also reduce the effectiveness of inflation controls (as found in Latin American countries) by deflating the real value of public debt.[20] Therefore, multilateral monetary policy in a form similar to the EU provides a foundation for discussion on consensus building between member states. Regardless of their form, the technical

[20] Oya Celasun, "Inflation and Disinflation," *International Monetary Fund Research Bulletin* 6.1, March 2005, p. 2.

mechanisms needed for monetary union exist today, and they are well known. A growing body of knowledge from the European unification provides us with templates and decision criteria, which can be easily modified to accommodate the idiosyncrasies of transnational Islamic finance. European unification has demonstrated that although the goal of monetary policy is to make each member nation better off, achieving this symmetrically may not be possible due to variations in national incomes, debts, and other exogenous factors. Thus, in a union of Muslim nations, monetary policy must factor income instability and disproportionate income levels of single-commodity nations (oil production) in a way that provides a buffer to weaker members by protecting them from asymmetric economic shocks.

Conventional Union or Interest-free Union?

As far-reaching as an IMU may appear, the basic premise of an economic system free of interest should not be summarily dismissed. In the 1930s, John Maynard Keynes reviewed the work of finance theoretician Silvio Gesell, entitled *The Natural Economic Order*.[21] Among a series of debatable arguments, Gesell put forward a theory describing interest as belonging to the quality of money, being purely a monetary occurrence setting a limit on the growth rate of real capital. In Keynes's view, a non-interest-based economic system warranted closer examination.[22] This raises an important question for academics, *shari'a* scholars, and policymakers: is an Islamic monetary system the same as Gesell's proposal?

Gesell's evaluation of zero-interest economies advocated that money should be used to stimulate consumption rather than to earn interest. If one looks at the fundamental tenets of the Islamic value proposition, zero-interest is based on the idea that the time value of money (profit) is acceptable, but the monetary value of time (interest) is not. Margrit Kennedy examined Gesell's economic model, updating his ideas with factors more relevant to the emerging economic

[21] Silvio Gesell, *The Natural Economic Order,* Frankson, Texas: TGS Publishers, 2004 (reprint of 1920 edition).
[22] John Maynard Keynes, *The General Theory of Employment, Interest, and Money,* New York: Prometheus Books, 1997, pp. 353–58 (reprint of 1936 edition).

condition of the twenty-first century.[23] The most relevant aspect of their observations to the formation of an IMU is the correlation between the exponential growth of financial assets and debts and the environmentally-destructive "growth imperative" driving the real economy, along with suggestions for overcoming the growth imperative and efforts to combine land and monetary reform ideas with proposals for an ecologically-based tax system.

Feasibility over Time: A Six-Step Process

Economic integration is a process of establishing bidirectional agreements that can be expanded in scope and complexity to engage nations in higher degrees of economic synergies in a seven-step process, including preferential trade regimes, free trade areas, customs unions, common markets, monetary unions, and economic unions. The least complex agreement is a preferential trade system. During the past twenty years, Muslim states have been establishing various forms of agreements engaging trade partners through the reduction of tariffs and other protective measures in certain sectors or products. The OIC put forth an initiative to initiate a preferential trade regime among its member states by January 1, 2009. More recently, free trade areas such as in the Bahrain, Kuwait, Malaysia, Pakistan, Saudi Arabia, United Arab Emirates, and Yemen, to name a few, have been established, removing numerous barriers to trade (tariffs, quotas, other non-tariff barriers) and facilitating greater incentives for transnational transference of goods and services. However, to date, the prime beneficiaries of free trade areas appear to be Western multinational corporations with marginal increases in trans-Islamic trade.

Customs unions, which have been established in various Muslim states, on the other hand, require the implementation of a common external tariff system in addition to the removal of trade barriers. As the value of the US dollar wanes there is a resurgence of talks on additional development of the regional common market, which would add free movement of production and labor across member states, increasing the depth of customs unions. Recent discussions in the GCC center on monetary union and the implications of adoption of a common currency

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[23] Margrit Kennedy, *Interest and Inflation Free Money: Creating an Exchange Medium That Works for Everybody and Protects the Earth,* Okemos, Michigan: Seva International, 1995.

by 2010 across member states. One could argue that once implemented, the GCC monetary union could act as the foundation for a broader regional union or perhaps the start of the IMU.

Therefore, to achieve a truly transnational economic union across Muslim nations, the member states must adopt common fiscal, monetary, financial, and commercial policies and common rules of competition.

Evidence of fragmented movement toward Islamic economic unity can be seen by the rising number of economic agreements between Muslim nations such as the GCC's new Economic Agreement enhancing and strengthening economic ties among member states. During the first two decades of the GCC existence, the Supreme Council, during its annual meetings, approved resolutions to promote "joint economic actions such as the GCC customs union, the common market, development integration, and the economic and monetary union."[24]

Another consideration in the formation of an IMU is the mismatch between the relative economic size and voting rights of member nations in the early formation of the union and resolving the same inequalities with future members in the union. Achieving an optimal representation and voting rights in the process of setting policy will be a key point of discussion on the overall feasibility of the IMU. Voting rights in the IMU, as in other unions such as the Euro, will strive to insulate common monetary policy from the influence of a dominant member or members who may try to alter policy as a reaction or overreaction to any idiosyncratic national economic shocks.[25]

Therefore, the feasibility of an IMU centers on achieving consensus on the economic goals of the union and its interconnection with the rest of the world during the pursuit of objectives based on *shari'a* principles coupled with a monetary basis (interest or non-interest) on which the union is founded. As Islamic national economies become increasingly co-dependent, the need for monetary, economic, and fiscal policy synchronization moves from a theoretical daydream to

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[24] Abdulrahman bin Hamad al-Attiyah, *The Economic Agreement Between the GCC States*, The Cooperation Council for the Arab States of the Gulf (GCC) Secretariat General, 22nd Session, City of Muscat, Sultanate of Oman (December 31, 2001).

[25] Helge Berger and Till Mueller, "How Should Large and Small Countries Be Represented in a Currency Union?" *Public Choice* 132.3, September 2007, pp. 471-84.

a demand of modern economic survival. What is missing for economic unification is political will.

VIABILITY

IMU viability is based on participating nations meeting a stringent set of economic criteria. These include price stability (capped inflation rates), low government budget deficits (Euro 3 percent of GDP), a ceiling on national debt (Euro 60 percent of GDP), exchange rate stability (a precursor to union), and highly synchronized economic, fiscal, and monetary policies actively balancing a series of cross border economic factors. Unlike the EU, the convergence of interest rates in an IMU would take a significantly different path, as many countries operate under mixed Islamic/conventional systems. Therefore, interest rates would have to be engineered out of the system over time to achieve union without slowing down current economic growth.

An IMU, although not explicitly advocated by Prime Minister Shaukat Aziz, would act as a mechanism to give a sense of purpose, bringing Muslims together into an economic system in which a transnational fiat currency would reflect a diverse set of social values. If considered as a next step in a long process toward economic homogeneity, an IMU would elevate the GCC union to a larger regional economic agenda whereby nations with significant Muslim populations might find long-term monetary stability by participating in a wider economic base.

However, economists rightly argue that three key factors will act to undermine an IMU: little or no cross-border trade benefits, a feeling of loss of control on setting central monetary policy, and difficulty in integrating multiple political agendas that—if the Euro is a good example—have produced varying degrees of economic protectionism.[26] Transnational trade across Muslim nations must be significantly higher (perhaps 30–40 percent) to have any appreciable benefit for ultimate monetary union.

Kuwaiti economist Hajjaj Bukhdur observed that the slow transition toward GCC union has been a product of individual nations having “an unwillingness to relinquish even a part of their sovereignty

[26] Raymond J. Ahearn, “Trade Conflict and the U.S.-European Union Economic Relationship,” CRS Report for Congress, Document Number RL30732, April 11, 2007, p. 17.

which is essential for integration," which may act to dissipate any aspirations of an IMU.[27] Alternatives such as structuring the central bank as a board of governors that is hosted annually on a rotating basis can be explored to placate fears of a single nation dominating monetary policy with its own domestic objectives. Within a scheme where a virtual central bank would meet several times a year to set policy, existing central banks would remain intact to execute policy, monitor economic activities relative to transnational objectives, and assist in the synchronization of monetary policy to domestic fiscal and economic policy objectives. The key is to construct the central bank and other organizations to facilitate the transition to an IMU based on the best lessons learned from the United States and the Euro. Political implications and the sense of a "loss of sovereignty" may present an opportunity for organizations such as the OIC, the IDB, and others to play a new role in the redefinition of the rules for interchange within the IMU and the interoperation of the IMU with the conventional twenty-first-century economy.

Perhaps the most applicable lesson learned from the Euro in the establishment of an Islamic common market is the need for an establishment of clearly defined rules on the acceptable behaviors of member nations and the boundaries of unacceptable actions.[28] Thus, the harmonization of regulatory frameworks, legislation, and trading standards demand that a supranational law-making body is essential for IMU viability.

Simply put, monetary unions are constructed by establishing a set of rules creating economic synergy between nations whereby the coordination of political, monetary, and fiscal policy objectives creates an economic entity in which the aggregated sum of economic activities has a value greater than the sum of the activities of the individual member nations. The IMU is no exception to this premise.

The misalignment between the current Islamic financial capabilities and the centers of Islamic populations indicates a greater need for integration on the most basic economic activities such as

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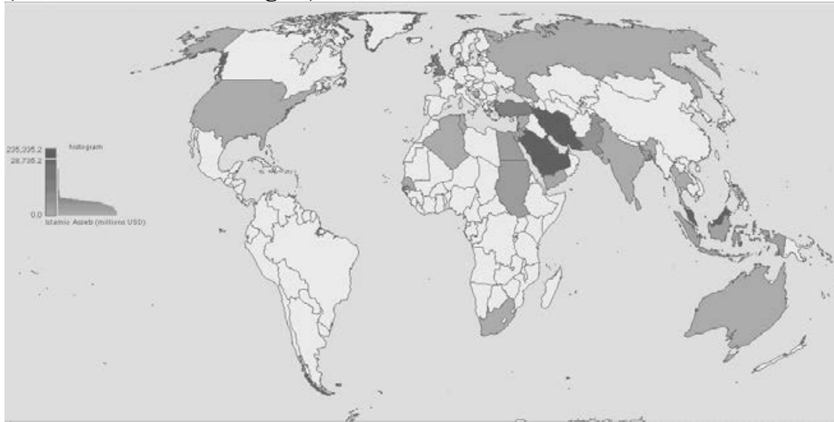
[27] "Rift over FTA could harm Gulf economic integration," *Khaleej Times,* December 23, 2004.

[28] W. Th. Douma and N. A. Mansourian, "Commercial and Political Impact of Globalisation on the OIC: The European Union Experience," Working paper, Asser Institute, Den Hague, The Netherlands, available at www.carsicm.ir/icmroot/public/Events/Tehran2000-9-27/Articles/2Teh6A.pdf (accessed February 2009).

commercial banking, migrant remittances, and transnational trade. Alignment will only come from innovation as institutions learn how best to deploy and apply the growing array of financial instruments.

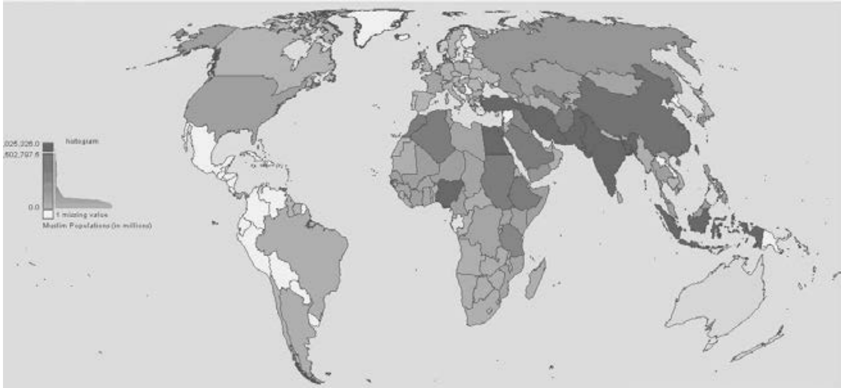
An examination of the distribution of *shari'a*-based banking services worldwide shows that although the Islamic finance industry is growing, the majority of the capabilities of the industry are not located in nations with dense Muslim populations, as illustrated in Figure 1.

Figure 1: Distribution of *Shari'a* Compliant Assets 2007 (Source: Maris Strategies)



When contrasted against the distribution of Muslim populations worldwide (illustrated in Figure 2), one can see that indeed there is a clear mismatch between Islamic finance capacity and serviceable populations. This can be attributed largely to the infancy of the industry and the need for more infrastructures throughout the regions.

Figure 2: Distribution of Worldwide Muslim populations (Source: Maris Strategies)



As the capabilities of the Islamic finance industry grow, an increasing share of the industry's capacity will be dedicated to facilitating cross-border activities. The need for Islamic economic synchronization is made clearer by evidence of rising transnational financial activity, for example in the Gulf with the rise in the number of GCC citizens owning real estate in other member states (see Table 2)

Table 2: Number of GCC Citizens Owning Real Estate in Other Member States in 2006 (Source: The Cooperation Council for the Arab States of the Gulf–Secretariat General).
* 2005, ** 2004

	Total	Kuwa-iti	Qatari	Omani	Saudi	Bahraini	Emir-ati
UAE*	**2,113**	**855**	**144**	**123**	**704**	**287**	
Bahrain	**975**	**487**	**105**	**18**	**262**		**103**
Saudi Arabia	**256**	**221**	**9**	**0**		**21**	**5**
Oman	**2,944**	**1,008**	**66**		**22**	**895**	**953**
Qatar**	**115**	**63**		**3**	**4**	**30**	**15**
Kuwait	**217**		**1**	**0**	**191**	**15**	**10**
Total	**6,620**	**2,634**	**325**	**144**	**1,183**	**1,248**	**1,086**

Further evidence of the growing need for transnational facilitation under a common set of economic policies can be seen in the rising number of licenses granted to GCC citizens to practice economic activities in other member states—as illustrated in Figure 3—and the steady rise in intra-GCC trade, which has increased steadily since 1990, illustrated in Figure 4.

Figure 3: Number of Licenses Granted to GCC Citizens to Practice Economic Activities in Other Member States
(Source: The Cooperation Council for the Arab States of the Gulf – Secretariat General)

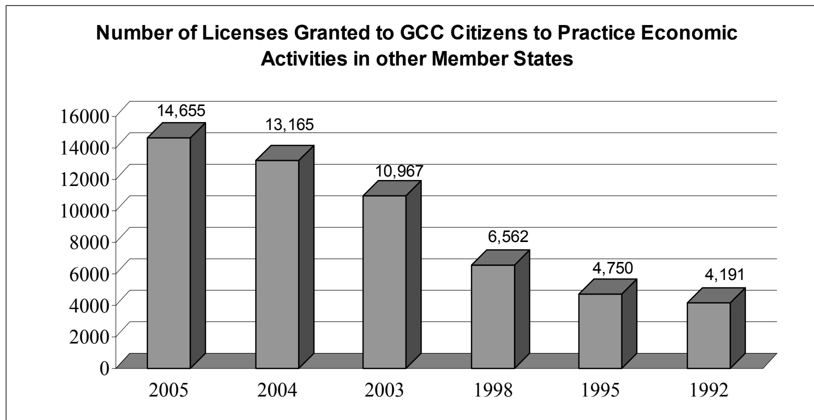
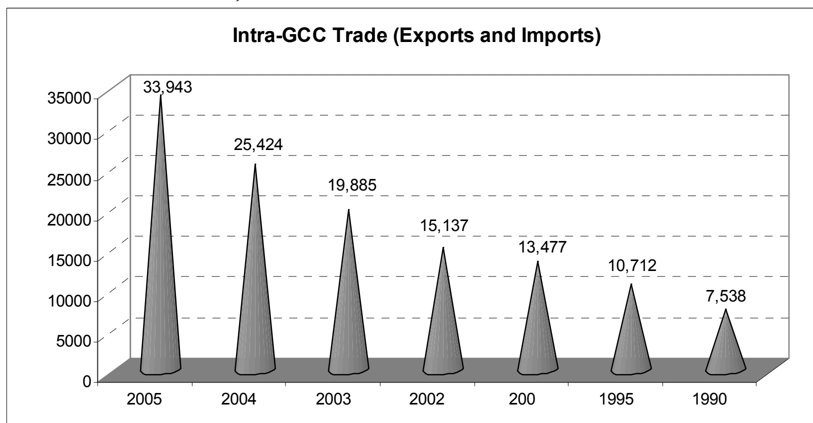


Figure 4: Intra-GCC Trade (Exports and Imports)
(Source: The Cooperation Council for the Arab States of the Gulf – Secretariat General)



As one can see from the previous figures, transnational trade in the GCC is still far below a level that would make even a Gulf-centric IMU sustainable under ideal conditions. Transnational trade across Muslim nations must be significantly higher, perhaps 30-40 percent, to be viable and to have any appreciable benefit for ultimate monetary union. Countering the feeling of loss of control can be addressed through the

experimentation of new forms of structural agreements that engage members instead of creating a sense of economic isolation because of domestic protectionism.

That said, the synchronization of multiple political agendas, agreements, and policies seems extraordinarily complex, and indeed it needs to be factored when examining the feasibility of monetary union. The relationships between different nation states in the union are factored against the degrees of political difficulty and the time and duration in which they are engaged between member states, as illustrated in Figure 5. What the figure shows is that at each stage of interaction between member nations, the degree of complexity rises due to numerous agreements involving multiple nations. As the integration of economic, fiscal, and monetary policy objectives become more synchronized, the total number of aggregate agreements is reduced. Simply put, each nation will have similarly-constructed agreements with each other and with key external non-IMU nations that will act over time to consolidate the total number of independent relationships requiring an agreement. That said, perhaps we are already on the journey toward unification as the emerging global economy unfolds as a synergistic progression of relationships between member nations. One can see in Table 3 below that between GCC nations, the process of policy alignment has been occurring over a long period.

Figure 5: Layers of Economic Collaborative Complexity (Source: Maris Strategies)

Table 3 - Implemented Steps and Agreed Objectives (Source: Khalfan M. Al Barwani)

1983	Established a free trade zone
1999	Agreement on custom union
2000	Agreement is concluded to adopt a common peg as a step toward creating a unified currency in 2010
2001	Accord reached on a joint custom tariff of 5 percent
2002	US dollar is selected as intermediate peg to the six currencies
2003	Joint custom tariff of 5 percent is implemented
2004	Formal adoption of the US dollar as intermediate peg; Agree in "principle" on key convergence criteria: size of budget deficit, inflation rate, interest rates, foreign reserves, and ratio of public debt to GDP
2007	Envisages a common market
2010	Projected implementation of a unified currency

However, monetary unification has challenges such as the requirement of a diverse set of national economies not currently found in the homogeneous petroleum-based economies of the Gulf. As economic interdependence is the new economic reality, the GCC is realizing that creating diversified economies is a basic requirement for synergistic policy coordination.

Therefore, viability is accomplished in two ways: (1) by innovation in how Islamic finance is applied to Muslim communities; and (2) by establishing the proper control mechanisms and refining them over time. Viability of the union in the context of how common economic objectives will unify member nations must be focused on the relative economic stability of each member state as their economies mature and become increasing more interdependent.[29]

SUSTAINABILITY

Now let us turn to sustainability, a much more controversial aspect of any monetary union. Sustainability depends on many factors, as an IMU engages in an increasingly more complex number of agreements between member nations and non-IMU nation-states, as illustrated in Figure 6.

To make the IMU truly sustainable long-term, Muslim nations must overcome several fundamental problems found in monetary unions. These range from the accountability of the central bank to any single national legislature, to how to synchronize fiscal policies to ensure regional stability, and agreements on technical issues such as the size of budget deficits and the maturity profile of public debt.[30]

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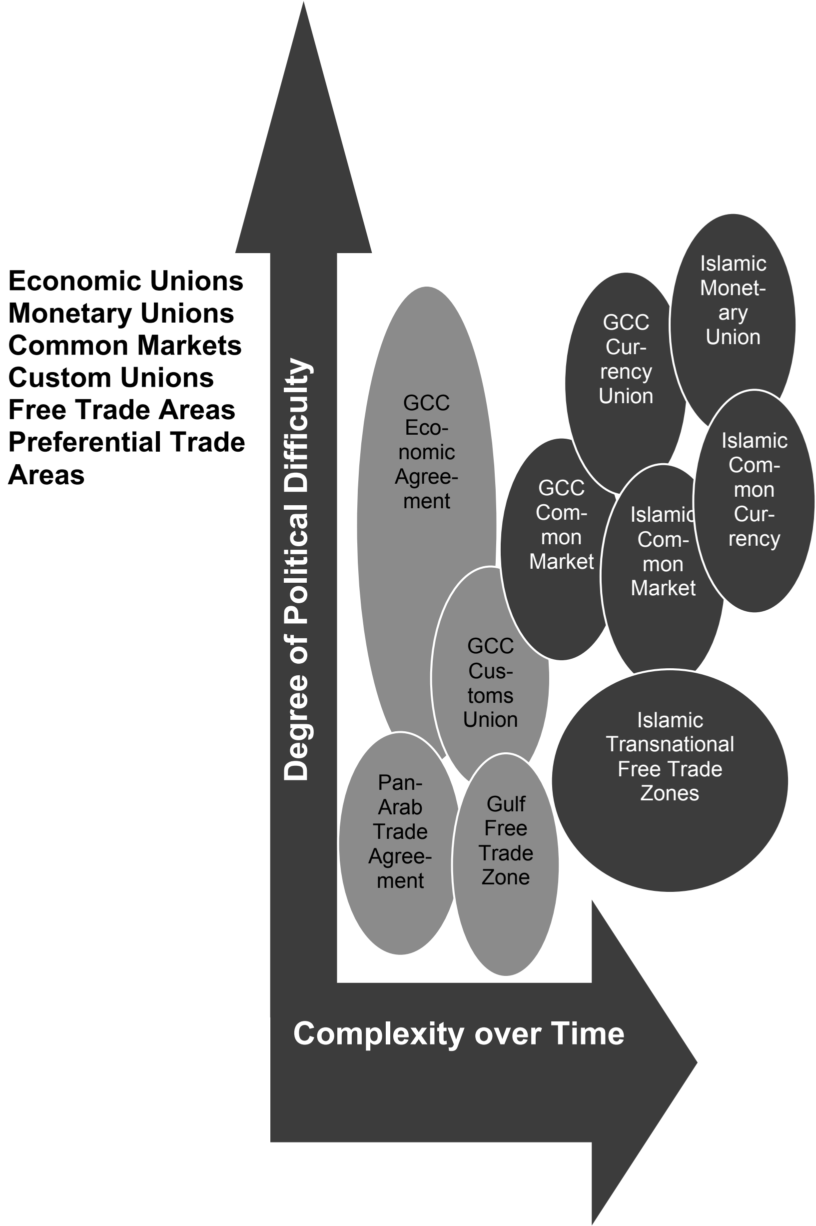
[29] Berger and Mueller, “How Should Large and Small Countries Be Represented in a Currency Union?” p. 471.

[30] Tim Congdon, “EMU: Can Monetary Union Work Without Political Union?” Open Lecture, University of Edinburgh, November 16, 2000.

Figure 6: Future Stages of IMU Development (Source: Maris Strategies)



The classic goal of monetary policy is to promote maximum output and employment while sustaining stable prices. The objective of Islamic economic unity is to address the root problems of cross-border trade, establishing economies less dependent on oil or any single commodity, raising economic activity to levels on par with larger nations, and to protect weaker member of the union from adverse economic conditions. In an Islamic context, the goal of monetary policy is to maximize social welfare while maintaining a regime that encourages price stability and the efficient use of money. The long-term goals of monetary policy synchronization between Muslim states are to create a foundation for real economic growth by controlling inflation. That said, the more dynamic aspect of monetary policy is to achieve the stabilization of nominal income during periods of asymmetric economic shocks. The key lesson to learn from other monetary unions is to develop a process that balances the overreaction to economic shocks, which are typically voiced by national authorities (due to re-election worries) in an effort to shape policy favoring their domestic agendas at the expense of the common needs of the union, with sound policy and mechanisms that lead to stabilization quickly. Bottazzi and Manasse argue that central monetary policy should overreact to large symmetric shocks (multi-nation) and underreact to small asymmetric shocks (domestic single country).[31]

In a theoretical context, monetary policy seldom alters a nation's economic output, levels of employment, and pricing of goods and services directly. Central bankers act to influence indirectly the economic activity of a nation through the manipulation of interest rates. Thus, the question of an interest-based economy rises to the forefront of any discussion on IMU. As said above, policymakers are asking if an IMU should be based on a form of non-interest-based capitalism and whether such a form of capitalism can coexist within an interoperating global economy. Even more importantly, with the absence of interest rates as a mechanism to influence the economy, they ask what other controls would need to exist to provide an appropriate set of tools for central bankers.

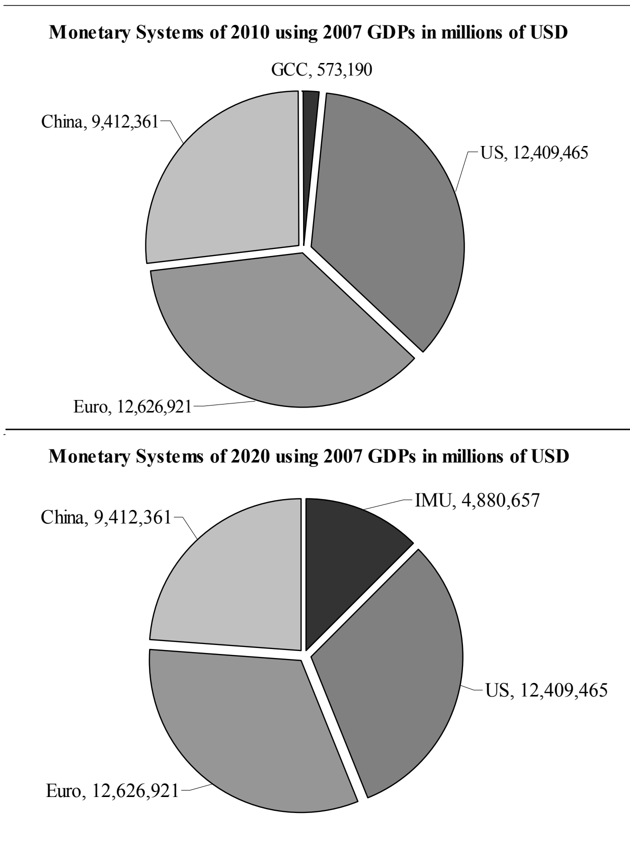
Sustainability becomes more complex as economic integration is a process of establishing bidirectional agreements that can be expanded in scope and complexity to engage nations in higher degrees of

[31] L. Bottazzi and P. Manasse, "Asymmetric Information and Monetary Policy in Common Currency Areas," Working Papers Series 217, Milan, Innocenzo Gasparini Institute for Economic Research, July 2002, p. 17.

economic synergies. Evidence relative to the GCC indicates that the rising number of transnational agreements in the form of preferential trade areas, free trade areas, and customs unions is already laying the foundation for long-term sustainability. However, to date, the prime beneficiaries of free trade areas appear to be western multinational corporations with only marginal increases in trans-Islamic trade.

Assessing the theoretical aspects of the IMU in the context of the developing GCC monetary union and the future state of unification across the OIC member nations, one can see in relative terms the impact of an IMU in world markets, as illustrated in Figure 7.

Figure 7: Theoretical Impact of IMU (using 2007 GDP figures as a baseline) (Source: Maris Strategies)



Using 2007 GDP figures as a baseline to understand the relative strength of a theoretical IMU on today's world markets, Figure 7 represents the relative impact of the 2020 IMU if it existed today. As the value of the US dollar wanes, there is a resurgence of talks on the development of the regional common market, which would add free movement of production and labor across member states, increasing the depth of customs unions. Recent discussions in the GCC focus on monetary union and the implications of adoption of a common currency by 2010 across member states. Since the GCC nations share a common economic export (oil) and international oil trade is largely dollar-denominated, the initial currency will try to maintain a close peg to the U.S. dollar; however, as GCC economies become more diversified, a more flexible exchange rate policy will be required.[32] According to Rose and Engel, members of a currency union tend to have more highly synchronized business cycles as a direct result of increases in trade between member nations.[33] One could argue that, once implemented and as the Gulf economies diversify, the GCC monetary union could act as the foundation for a broader regional union or perhaps the start of the IMU.

Evidence of movement toward Islamic economic unity can be seen in the rising number of economic agreements between Muslim nations. What is needed for sustainability, I argue—somewhat against the current—is authenticity, a clear distinction of the inherent value of Islamic finance beyond simply enabling Muslims to practice their faith.[34] Authenticity is a reaffirmation of Islamic ideals manifested in a socioeconomic system that demonstrates to the world a viable sustainable alternative to the incumbent financial system. Socioeconomic systems like socialism and capitalism are sustained or fail based on an underlying ideology. The degree of success within a socioeconomic system (its sustainability) is manifested by the trustworthiness of the economic activity within the systems, and based

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[32] George T. Abed, S. Nuri Erbas, and Behrouz Guerami, "The GCC Monetary Union: Some Considerations for the Exchange Rate Regime," Working Paper, International Monetary Fund, WP/03/66, April 2003, pp. 4–6.

[33] Andrew K. Rose and Charles Engel, "Currency Unions and International Integration," *Journal of Money Credit and Banking* 34.3, August 2002, pp. 821–22.

[34] Iraj Toutounchian, *Islamic Money and Banking: Integrating Money in Capital Theory,* Singapore: John Wiley and Sons, 2009, is a good study of the issues involving Islamic banking and Islamic ethics that go beyond the remit of religious morality per se.

on how the systems interoperate in external global market conditions. In short, markets and economies are sustained when people and businesses have faith in their socioeconomic system. The sustainability of an Islamic Monetary Union will be the result of a steadfast adhesion to Islamic ideals, which in turn establishes market fidelity. Thus, if the authenticity of Islamic ideals is maintained, the fidelity of the market will be sustained because the people within the socioeconomic system have faith and trust in the execution of market activities.

If I were asked to draw a picture of where we are today in the process of economic unification, the image of a lone tower crane in the desert symbolizes that we are building the foundation of an economic entity that we have yet to define. Nonetheless, history is littered with failed monetary unions.

Even loosely constructed, monetary unions will work while economic activity is experiencing steady growth. At the same time, history also points out that monetary unions fail if they do not achieve political union and a high degree of economic convergence.

CONCLUSIONS

In conclusion, monetary unions are a complex set of interoperating obligations between nation-states formulated to better their respective societies, codified by constitutional principles, and implemented by rigorous adherence to economic objectives.

Discussion about an IMU has largely been the intellectual pursuit of academics, *shari'a* scholars, bankers, and a few policymakers, with the sceptics outnumbering supporters by a vast majority. Talk of Keynesian economic theories, interest-free monetary systems and synchronizing fiscal and monetary policies to interoperate all seem insurmountable obstacles to the IMU. However, the "equitable exchange of value" between parties as a fundamental tenet of *shari'a* principles may be a prescription to redress the vast inequalities created in the current global economic conditions.

An IMU is feasible because the technical mechanisms required exist today. What is missing is political determination to make it work. Fiscal, economic, and monetary policy synchronization is difficult but not impossible. Viability, on the other hand, demands innovation, a fundamental rethinking of how Islamic institutions engage the communities in which they serve, and the establishment of control mechanisms that build consumer confidence and market quality. The

sustainability of an IMU will be determined by the authenticity stemming from the industry's ability to maintain the fidelity of Islamic values and *shari'a* principles.

An IMU is not a nostalgic search for past economic glory, nor are the underlying principles of Islamic finance as an economic system based on equitable exchange between parties solely a reaffirmation of a fundamental belief in Islam. An IMU is about securing a future of Muslim societies in economic terms that ensures economic viability while preserving Muslim ideals. The IMU is not a clash of ideological constructs that is determined to usurp the incumbent financial systems; it is rather a process that re-evaluates the nature of exchange within a broader context of fairness between social classes. The IMU is part of a political resolve that determines the acceleration or diminution of economic unification between Muslim states. In the final analysis, one could make the case that perhaps if monetary policy synchronization already existed, political differences between Muslim states would lessen over time.

Conceivably the IMU—or at least the discussion of economic unity—acts as a catalyst to bring a new level of global economic power to the nations that are willing to operate within a new set of interoperating objectives. Initiatives such as the GCC monetary union and the dream of an IMU give Muslims a concrete vision of a possible economic future.

Global Legislation and Regulations on Islamic Banking: Innovation and Authenticity Implications

Huma Sodher[1]

ISLAMIC LEGAL SYSTEM IN CONTEMPORARY TIMES

Appropriate laws, regulations, and legal infrastructure have played a key role in the development of the conventional banking industry. The majority of legal systems throughout the globe are based on the principles of one or both of the two well-known legal systems, civil law and common law systems. These Western legal systems have spread around the globe through colonization and replication. The majority of Muslim countries have adopted these two Western legal systems, especially in the development of corporate and commercial legal frameworks.[2] Though Islamic legal tradition has a long history, commercial law related to the contemporary Islamic banking industry is at the developing stage.

The absence of a comprehensive Islamic legal system for a long time has resulted in the lack of legal infrastructure that can support the use of Islamic commercial law in contemporary times. Since the inception of Islamic finance, Islamic financial contracts have been used, but this is being done in an alien legal environment. Even if individuals agree to use Islamic contracts, the laws and courts may not be there to interpret and enforce the form of these contracts in their true

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[2] Habib Ahmed, "Islamic Law, Adaptability and Financial Development," *Islamic Economic Studies* 13(2), 2006, pp. 79–101.

spirit. The successful application of Islamic law to contemporary financial transactions requires appropriate supporting legal infrastructure institutions.

Today, Islamic banks face an unusual set of challenges. On one hand, the Islamic banking sector is growing at an extremely rapid pace; on the other hand, Islamic banks are forced to conform to a regulatory environment that has traditionally catered to a deep-rooted, interest-based banking system. Given the principle of permissibility, Islamic commercial law can evolve as long as the limits imposed by *shari'a* are not traversed. Contemporary *shari'a* scholars and jurists have carried out the admirable and painstaking task of modifying the classical contracts into contemporary financial contracts. But there still remains a lot of work to be carried out for development of Islamic commercial law in order to make it more relevant to modern day needs. Though Islamic law can evolve based on a rich body of legal theory and rulings, other elements and attributes of the Islamic legal system—including dispute settlement institutions—are still weak and are yet to be developed. Given the universality of Islamic law and specific injunctions on financial dealings, its evolution can help produce an alternative financial system that can benefit not only Muslims but humanity at large.

Now, I will attempt to discuss both selected existing legislation and desirable characteristics of prospective legislation on Islamic banking and their corresponding innovation and authenticity implications for the industry. In my opinion, here the term legislation should not be confined only to commercial laws but should include accounting, auditing, reporting, and supervisory guidelines where appropriate.

UNIFORM REGULATORY AND LEGAL FRAMEWORK

A uniform regulatory and legal framework that is supportive of an Islamic financial system has not yet been developed. Existing banking regulations both in Islamic and non-Islamic countries are based on the western banking model. This is why Islamic financial institutions face

difficulties in operating not only in non-Islamic countries but also in Islamic countries.[3]

Legal Framework

As an outcome of globalization and cross-border investments, sometimes bankers end up in huge deals that entail financing of a project through Islamic modes of finance by both conventional and Islamic financial institutions. In such instances, the conventional financial institutions are not interested in the *shari'a* compliance of the transaction; however, they are always concerned about ascertaining the enforceability of underlying contracts of the deal and legal recourse available to them in case of any future disagreement. Investors and stakeholders prefer to choose English or New York law as governing law even for Islamic banking transactions over *shari'a* law or the law of any country based on *shari'a* principles.

Unfortunately, there is a lack of harmony and standardization in the application and interpretation of *shari'a* law even among Muslim countries. It is applied and interpreted differently[4] among different Muslim jurisdictions. This lack of standardization of *shari'a* law has promoted uncertainty among investors and professionals, when dealing in *shari'a*-complaint transactions, as to their specific rights and obligations in case of any future dispute and disagreement between parties to the contract.[5]

Shari'a law may be applied either directly as the common law of a country where there is no fully developed codified legal system, indirectly through the application of statutes based fully or partly on Islamic law, or as a source of law to fill legislative gaps when a

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[3] Tarek S. Zaher and M. Kabir Hassan, "Islamic Law: A Comparative Literature Survey of Islamic Finance and Banking," *Financial Markets, Institutions & Instruments* 10(4), 2001, pp.187–188.

[4] Mahmood Faruqui, Vice Chairman, Institute of Islamic Banking & Insurance, UK, "Islamic Finance – An Overview," Speech at International Bar Association 2007 Meeting, Singapore, October 16, 2007 (manuscript on file with author). Faruqui is of the view that "there are variations amongst GCC countries, even where *Shari'a* is 'the source,' 'the principal source,' [or] 'a source' of law."

[5] Ibid.

particular statute lacks the necessary provisions.[6] For instance, in Saudi Arabia where there is no civil code, *shari'a* operates and applies directly as the common law of the country, both in commercial courts and courts of personal matters. However, in other Arab countries where there are civil legal systems in place, *shari'a* plays a lesser role and applies mainly in the field of family law such as marriage and inheritance. The following is a short survey of specific provisions of the constitutions and the civil codes of some Arab countries that have dealt with the application of the *shari'a*.

Egypt

Article 2 of the amended Egyptian Constitution, which was amended in 1980, states that: "The principles of the *shari'a* are THE main source legislation in the Arab Republic of Egypt. . ."

In 1985, the rector of Al Azhar filed a case against the president and the Egyptian parliament and others contending that the provisions of the Egyptian Civil Code—for instance, Article 226 of the Egyptian Civil Code—permitting interest were unconstitutional in view of the amended Article 2 of the constitution declaring *shari'a* as the main source of legislation. The court rejected this contention and decided that the amended Article 2 had no retrospective effect as to render existing laws unconstitutional. However, they also ruled that the amended Article 2 has imposed an obligation on the legislature to bring all future laws in conformity with the *shari'a*.[7]

Kuwait

Article 2 of the Kuwait Constitution stipulates that: "The religion of the state is Islam and the Islamic *shari'a* is a principal source legislation. ."

It should be noted that according to this article, *shari'a* is "a principal source," and not "the source" of legislation.

Kuwaiti courts also followed the footsteps of Egyptian courts when an argument asserting that the Kuwait Civil Procedure Code was

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[6] Saleh Majid and Faris Lenzen, "Worldwide: Application of Islamic Law in the Middle East," December 7, 2007, available at http://mondaq.com/article.asp?articleid=52976 (accessed March 2008).

[7] Ibid. Saleh and Faris, while discussing the legal system of Egypt, referred to Dr. Ahmed Mahmoud Saad, *Delay Interests, Comparative Study with Islamic Law* (in Arabic), Cairo, 1986, pp. 15–32.

unconstitutional was brought before them. In 1992, the Kuwaiti Constitutional Court dismissed a claim that the Kuwait Civil Code, which permits interest, was unconstitutional and contrary to Article 2 of the constitution. The Court explained that Article 2 of the Kuwait Constitution is a political directive to the legislators to adopt provisions of *shari'a* as far as possible. Furthermore, *shari'a* is a source, not the sole source, and there is nothing to prevent the legislature from applying sources other than *shari'a*.[8]

United Arab Emirates (UAE)

In the UAE, the matter is even more complex and vague because, on the one hand, Article 7 of the UAE Constitution states the *shari'a* is "a principal source" of legislation, while on the other hand, Article 75 of the Law of the Union Supreme Court of 1973 provides that the Supreme Court shall first apply *shari'a* and other laws in force if conforming to the *shari'a* principles. It may also apply customs if such custom does not conflict with the principles of the *shari'a*.

In contrast with those constitutional provisions, the provisions of the UAE Civil Code provide that *shari'a* is "the main source of law." Articles 1, 3 and 27 of the said Code explicitly establish this fact.

Article 1 of the Civil Code refers to *shari'a* as the first source of law in the absence of any legislative provision. Article 3 of the Code also stipulates that public policy rules are those which are not contrary to the basic principles of *shari'a*. Furthermore, Article 27 of the Civil Code provides that in cases of conflicts of law, no law contrary to *shari'a* can be applied, and public policy and morals are applicable.

Hence in the UAE, the constitution recognizes *shari'a* as "a source of law," while the Civil Code and the law of the Supreme Court of 1973 consider *shari'a* as *the* source of law. Thus the constitution, being the supreme law of the country, recognizes *shari'a* as "a source of law" instead of the main and only source of law, and all the other laws of a country are subordinate to the constitution. This inter-statutory contradiction in the UAE weakens the case for application of *shari'a* law as "the main source of law." The UAE statute and provisions notwithstanding, when the issue relating to the extent of *shari'a* application was raised before the highest court of appeal in the UAE,

[8] Ibid. The authors, while discussing the legal system of Kuwait, referred to W. M. Ballantyne, *Essays and Addresses on Arab Laws*, Richmond, UK: Curzon, 2000, pp. 60–64.

the court ruled that the *shari'a* is the principal source of law and above all other laws. However, the Court also ruled that it is for the legislature to implement when enacting new legislation.[9]

Saudi Arabia

In Saudi Arabia, the Basic Law of 1992 ruled that the Quran and *hadith* are the sole sources of law and that all laws and regulations must conform to *shari'a* as *shari'a* law is the common law of the country. Hence, neither any foreign judgment nor a contractual provision contrary to *shari'a* injunctions may be enforced in the Kingdom of Saudi Arabia.

The foregoing survey and review signifies the complexity of the matter and the uncertainty in the application of law in relation to *shari'a*, especially when vital issues like the validity of legal provisions relating to interest are involved. However, there is a growing assertion of *shari'a* and Islamic identity in Middle Eastern society. This may in turn invite Western lawyers to make themselves familiar with the principles of *shari'a* with the aim of finding bridges and similarities instead of pointing only to differences and diversities. In the Muslim and Arab world, it remains a desire that a unified legislation or civil code may one day apply to all Arab countries, based mainly on the principles of *shari'a,* as the *Majella*, the civil code of the Ottoman Empire, did before the First World War.[10]

Presently, most Islamic contracts are governed by English law, and a few by New York law.[11] The officials of the Financial Services Authority, UK, have deliberated the matter and have analyzed one of the famous cases in contemporary case law: The English Court of Appeal EC (2004) EWCA Civil 19:[12]

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[9] Ibid. The authors, while discussing the legal system of the UAE, referred to Saad, *Delay Interests, Comparative Study with Islamic Law,* pp. 15–32.
[10] Ibid.
[11] Michael Ainley, Ali Mashayekhi, Robert Hicks, Arshadur Rahman, and Ali Ravalia, "Financial Services Authority—Islamic Finance in the UK: Regulation and Challenges," 2007, available at http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf (last accessed on January 24, 2009).
[12] EC (2004) EWCA Civil 19 Judgment at www.hmcourts-service.gov.uk/judgmentsfiles/j2232/beximco-v-shamil.htm (accessed January 24, 2009).

> When the Court of Appeal ruled that it was not possible for the case to be considered based on principles of *shari'a* law, there were two main reasons. First, there is no provision for the choice or application of a non-national system of law, such as *shari'a*. Second, because the application of *shari'a* principles was a matter of debate, even in Muslim countries.[13]

Certain scholars and practitioners have also referred to this precedent and concurred with the findings of the case. Some of them are of the view that legal practitioners should be very careful while drafting Islamic finance contracts, as usage of Arabic terms referring to an Islamic finance product and *shari'a* generally may lead to obfuscation and difficulties in proper implementation of the contract. Hence, instead of using and referring generally to the principles of *shari'a*, the *shari'a* rules governing the contract or transaction should be clearly spelled out and explicated in the contract per se. This judgment is a milestone judgment in Islamic banking legal history, as it has provided guidance on "further refinements in drafting clauses relating to representations, choice of law & situs of forum, and the governing law of the contract."[14]

The Right Honorable Jack Straw MP, Lord Chancellor and Secretary of State for Justice, has also emphasized the supremacy of English law over *shari'a* law in his speech at the Islamic Finance and Trade Conference in London on October 30, 2008, by clarifying that:

> Given the fact that speculation abounds on this point, let me say once again: There is nothing whatever in English law that prevents people abiding by *shari'a* principles if they wish to, provided they do not come into conflict with English law. There is no question about that. But English law will always remain supreme, and religious councils subservient to it.[15]

Hence, the use of English or New York law and legal infrastructure for resolution of disputes relating to the Islamic banking industry may not be considered as a permanent alternative for Islamic

[13] Ainley et. al., "Financial Services Authority."
[14] Faruqui, "Islamic Finance," p. 4.
[15] Jack Straw, speech at Islamic Finance and Trade Conference, October 30, 2008, available at http://www.justice.gov.uk/news/sp301008a.htm (accessed January 24, 2009).

banking industry. The development of a distinct regulatory and legal framework for Islamic banking industry will not lead to limitation of choices available to the industry. Rather, it is the right time to realize that the Islamic banking industry as a specialized industry requires specialized legal and regulatory framework in order to address the exigencies of the industry in a proper manner. Furthermore, it will ensure the enforceability of Islamic banking contracts in their true spirit by introducing constitutional provisions, at least in all Muslim jurisdictions, guaranteeing the application of *shari'a* law for Islamic finance transactions. Ideally, the *Shari'a* Standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)[16] should form part of Islamic banking law. However, if any Muslim jurisdiction amends the standards in accordance with its prevalent Islamic sect/school of thought, the amendment should be permitted. Hence, distinct legislation is as inevitable for the Islamic banking industry as specialized standards and laws are for the conventional banking and insurance industry in order to ensure the smooth functioning and development of the industry.

Regulatory Framework

Currently, central banks are trying to play a leading role in the development of a regulatory framework for the Islamic banking industry. The State Bank of Pakistan, Central Bank of Bahrain, and Central Bank of Qatar are among those central banks that have issued various directives and circulars with the objective of developing an effective regulatory framework for Islamic banks. Despite all these developments, regulatory authorities and legislators of different jurisdictions have a long way to go to develop the specialized regulatory and legal frameworks needed. This fact is evident from the existing state of regulatory frameworks in different Muslim countries.

[16] The Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) is an international standard setting organization that issues accounting, governance, auditing, and *shari'a* standards for Islamic financial institutions. Further details are available at www.aaoifi.com.

Table A[17] provides a summary of salient features of Islamic banking and supervisory regimes in selected Muslim countries.

Table A: Salient Features of Islamic Banking Supervisory & Regulatory Systems in Muslim World

Country	Features	Country	Features
Bahrain	• Regulated by Central Bank of Bahrain (CBB). • Basel capital requirements and core principles adopted for both groups. • International Accounting Standards have been adopted. • Each Islamic bank should have a *shari'a* board. • AAOIFI Standards are required to be complied with.[18] • Islamic banks are supervised by special directives of CBB.	**Kuwait**	• Regulated by Central Bank of Kuwait (CBK). • Basel capital requirements and supervisory standards adopted. • International Accounting Standards have been adopted. • Islamic banks are governed by Section 10 of CBK Law No. 321, 1968. • Each Islamic bank should have a *shari'a* board.
Qatar	• Regulated by the Central Bank of Qatar (CBQ). • Separate Islamic banking law does not exist. • Basel capital requirements and supervisory standards adopted. • International Accounting Standards have been adopted. • Islamic banks are supervised by special directives of CBQ. • Each Islamic bank should have a *shari'á* board	**UAE**	• Regulated by the Central Bank of UAE. • Basel capital requirements and supervisory standards adopted. • International Accounting Standards adopted. • Islamic banks are governed by Islamic banking law, i.e., Federal Law No. (6) of 1985 regarding Islamic Banks, Financial Institutions and Investment Companies. • Each Islamic bank should have a *shari'a* board.

[17] Table A has been compiled from the information provided in Table 8 of Zaher and Hassan, "Islamic Law," and websites of some central banks. Zaher and Hassan note the sources of Table 8 at p. 187 in their article.

[18] Central Bank of Bahrain, *Rule Book,* Volume 2–*Islamic Banks*, Clause AU-4.1.1, Part A, Kingdom of Bahrain. According to this clause, Islamic bank licensees must comply with Financial Accounting Standards (FAS) issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). For products and activities not covered by the AAOIFI, International Financial Reporting Standards (IFRS) / International Accounting Standards (IAS) are required to be followed.

Country	Regulation	Country	Regulation
Iran	• Regulated by the Central Bank of Iran (Bank Jamhuri Islami Iran). • Recent policy orientation toward adopting the Basel capital and supervisory standards and International Accounting Standards. • Onsite and offsite supervisory methods. • Bank regulation and supervision is strongly affected by monetary as well as fiscal and other government policies. • Single (Islamic) banking system operating under the Usury Free Banking Act of 1983. Modes of finance are defined by this Law. • No separate *shari'a* board for individual banks.	Indonesia	• Regulated by the Central Bank of Indonesia (Bank Central Republic Indonesia-BSRI). • Separate Islamic banking does not exist. Islamic *shari'a* banking is covered by added section in the banking law (Act No. 10 of 1998 and Act No. 23 of 1999). • Basel capital requirements and core principles adopted for both groups. • International Accounting Standards adopted. • Each Islamic bank should have a *shari'a* board.
Malaysia	• Regulated by the Central Bank of Malaysia (Bank Negara Malaysia-BNM). • Ministry of Finance closely associated with supervision of Islamic banks. • Onsite and offsite supervision well defined with clear objectives. • Basel capital requirements and supervisory standards adopted. • International Accounting Standards adopted. • Islamic banks are governed by Islamic banking law, i.e., Islamic Banking Act, 1983 • Separate *shari'a* boards at institutional level in the BNM and Securities Exchange Commission. Each Islamic bank should also have a *shari'a* committee.	Pakistan	• Regulated by the Central Bank of Pakistan (State Bank of Pakistan-SBP). • Concept of onsite and offsite supervision exists. • Basel capital requirements and supervisory standards adopted. • International Accounting Standards adopted. • Separate Islamic banking law does not exist. Governed by Banking Companies Ordinance, 1962 and Policies for Islamic Banking in 2001 and 2003. However, *mudaraba* Companies law exists. • Some special provisions in relation to banks carrying on business based on *shari'a* principles have been specified in Sections 27-32, Part IV of Draft Banking Act, 2006. • Each Islamic bank should have a *shari'a* board. The State Bank of Pakistan also has a *Shari'a* Supervisory Board.
Sudan	• Regulated by the Central Bank of Sudan (CBS). • Single (Islamic) banking system. • Islamic banking law in place. • Each Islamic bank should have a *shari'a* board. Furthermore, the Central Bank also has a *Shari'a* Supervisory Board. • AAOIFI Standards are required to be complied with.		

It is evident from the perusal of Table A that the essential specialized regulations for risk management, financial reporting, and product development for Islamic banking have not been enforced on

full-fledged Islamic banks or Islamic window operations of conventional banks. It is of vital importance that *shari'a*, accounting, auditing, and governance standards issued by the AAOIFI should be enforced on a mandatory basis for all those institutions carrying out Islamic banking transactions. These standards have been developed after consultation with scholars from all schools of thought in Islam, bankers, and other stakeholders from throughout the world. The implementation of the AAOIFI *Shari'a* Standards and their mandatory use for product development purposes will promote authenticity of Islamic banking, while the promulgation of the AAOIFI standards on accounting, auditing, and governance will ensure transparency and comparability of financial information, and good governance within Islamic banking industry.

As far as the development of a supervisory framework is concerned, the Islamic Financial Services Board (IFSB) has formulated various standards and guidelines on the matter, including guidance on key elements in the supervisory review process of institutions offering Islamic financial services (excluding Islamic insurance (*takaful*) institutions and Islamic mutual funds), issued in December 2007.[19]

Now there is a need to consolidate the guidance contributed by the experts of the industry as well as international organizations like the IFSB and the AAOIFI in order to develop a regulatory framework addressing the product development, risk management, governance, financial reporting, and operational issues of the industry, which should be enforced by the regulators including central banks. Furthermore, the AAOIFI and the IFSB standards should be developed and amended, if required, to provide a basis for the consolidated international regulatory framework for Islamic banking. Mere development of a consolidated international regulatory framework will not serve the purpose until it is enforced and adopted by the central banks and regulatory authorities across the globe, where Islamic banking is being practiced. This framework can be promulgated in the same way as the International Financial Reporting Standards (IFRS), regulations of BASEL II, and other international guidelines that are applied and enforced throughout the world.

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[19] The Islamic Financial Services Board (IFSB), Malaysia. Information obtained from website of IFSB, www.ifsb.org (accessed in March 2008). IFSB is an international standard-setting body that issues global prudential standards and guiding principles for the Islamic finance industry.

The development and enforcement of such a regulatory framework will ensure authenticity not only in structuring but also in the operational aspects of Islamic financial products. It will also ensure that adequate risk management policies and practices are in place in Islamic financial institutions (IFIs), which aim to address and mitigate the peculiar risks arising out of Islamic finance transactions. Furthermore, recording and reporting of Islamic finance transactions in accordance with an internationally accepted and standardized Islamic financial reporting framework will promote transparency and comparability of financial statements of IFIs across the globe.

In my opinion, the development and enforcement of regulatory frameworks, which would address the transparency and comparability issues specific to Islamic institutions, would not only further enhance the integration of Islamic markets and international financial markets but could also endorse the authenticity of Islamic financial products and contracts. For instance, IFIs are subject to different conventional financial reporting and governance frameworks. IFIs reporting under conventional standards (e.g., the IFRS regime) may not represent the true spirit of Islamic finance products and transactions. If Islamic finance contracts are drafted without giving due regard to *shari'a* principles and the financial results of such contracts are also reported in accordance with the conventional accounting standards, the authenticity of such Islamic products and contracts would be endangered and subject to suspicions. Lack of regulatory supervision of structuring and reporting of Islamic finance products also puts them in a weak position in the eyes of stakeholders as compared to their conventional counterparts, which are being properly regulated in order to ensure the fairness, robustness, and transparency of the conventional financial system.

On the other hand, a uniform regulatory and legal framework that is developed and enforced in a meticulous and rigid manner may not be suitable for each and every market and specific business environment. It will instead inhibit the development of industry. Though an arduous task, it will be a milestone in the history of Islamic banking industry if accomplished properly by the scholars, legislators, regulators, and industry experts.

DEVELOPMENT AND ENFORCEMENT OF ISLAMIC FINANCIAL STATUTES

Legal systems of most of the Muslim countries do not have specific laws or statutes that can support the unique features of Islamic financial products.[20] As discussed earlier, most Muslim countries currently either do not have specialized Islamic statutes or have Islamic statutes that are inconsistent with the constitution or other laws in force in those countries. This gives rise to an uncertainty regarding the enforceability of Islamic banking transactions in their true spirit.

For countries and jurisdictions having a civil law regime, it would be difficult to have Islamic financing unless new specialized Islamic banking laws are enacted. In these countries and jurisdictions, the existing rules and regulations are usually geared toward conventional banking. Hence, it would be mandatory to enact specialized Islamic banking legislation in such jurisdictions to serve as a legal foundation for Islamic banking and financial dealings and provide a level playing field for the Islamic banking industry. The Islamic banking laws passed in civil law countries like Indonesia and Pakistan, however, are worded in general terms and lack details of the different Islamic modes of financing. While Bank Indonesia is trying to fill some of the gaps through some regulations,[21] these may not hold in the courts of law. Examples of such omissions in Indonesian law include the prohibition of trading and taking equity positions and the absence of resolutions of the double taxation in Islamic financial transactions. It is necessary for Islamic banking law or law containing provisions on Islamic finance to stipulate explicitly the constituents of permissible Islamic finance products and the penalties to be imposed for noncompliance.

At this point in time, it will not suffice if the specialized banking statutes only grant permission to Islamic banks or windows of conventional banks undertaking Islamic banking transactions to undertake trading activities by way of *murabaha*. Rather, the details of permissible forms of *murabaha* also need to be specified; for instance, a *murabaha* transaction cannot take place until the asset in question is acquired by the Islamic bank. Hence, if a dispute on a *murabaha*

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[20] Ahmed, "Islamic Law, Adaptability and Financial Development."

[21] Reza Adirahman Djojosugito, "Relative Stability of Civil and Common Law Regimes for Islamic Banking," Paper presented at the International Conference on Islamic Banking: Risk Management, Regulation, and Supervision, Jakarta, Indonesia, September 30–October 2, 2003.

transaction is brought before the court, the statute should provide ample guidance as to what constitutes a valid *murabaha* transaction in order to enable courts to decide the matter appropriately as per the law. Thus, there is a need for detailed codification of the law that would include the Islamic principles for financial transactions and the administrative procedures for carrying out these activities. Uncertainty and incompleteness of laws related to Islamic banking, if left to continue, will put Islamic banks in a disadvantageous legal position compared to the conventional banks.

As far as countries having a common law regime are concerned, Islamic contracts and transactions may have problems of interpretation because not enough precedents on these activities exist. Promulgation of law in this system may not be as effective as in civil law regimes because the judges have liberty to deviate from the statutes in order to meet the ends of justice. Some scholars believe that common law regimes may provide more predictable results under legal documentation for Islamic finance transactions compared to the civil law system, since the common law system will consider the provisions in a legal document with more weight irrespective of other considerations, like materiality or fairness. Consequently, there may be lower legal risk involved for Islamic banking instruments under a common law regime.[22]

Taking into account the current state of affairs of the Islamic banking industry, in my opinion it is necessary that concerted endeavors should be made—particularly by Islamic countries—not only to legislate but also to enforce specialized Islamic financial and commercial law. The legislation so formulated and enforced will regulate the industry and will create a feeling among the stakeholders of the industry that an appropriate and enforceable system is available to ensure the rights and obligations of all the concerned parties. Furthermore, it will do away with the uncertainty among the stakeholders of the industry regarding the enforcement of their rights merely because of absence of relevant, well-defined laws and appropriate enforcement institutions. It will not only reduce the excessive dependency on other legal system (for instance, English and American legal systems) but will also cater to the specific needs of the industry that are not being catered to by other legal systems because those systems were not principally developed to cover the legal issues emanating from the specialized transactions of the Islamic banking

[22] Ahmed, "Islamic Law, Adaptability and Financial Development."

industry. The initiative for development of comprehensive specialized Islamic banking and financial laws taken by the Muslim countries will also facilitate the formulation of specialized laws, rules, and regulations for ensuring the legal remedies of the stakeholders of the industry in non-Muslim jurisdictions.

Appropriate measures for the development and enforcement of specialized statutes for the Islamic banking industry, if taken now and on a high-priority basis, will provide authenticity and stability to an industry appearing to be in doldrums of suspicions regarding the enforceability of existing and upcoming Islamic financial products. Specialized legal frameworks will ensure that the structuring and development of Islamic financial products are in compliance with the specialized Islamic financial law and include the features of valid Islamic financial contracts used for the development of various products. In addition, it will also ease all the uncertainty and doubts regarding the lustrous future and growth of the industry.

DEVELOPMENT OF LEGAL INFRASTRUCTURE INSTITUTIONS FOR THE ISLAMIC BANKING INDUSTRY

The lack of Islamic commercial/banking courts in most Muslim countries that can enforce Islamic financial contracts increases the legal risks of using these contracts. It has been observed that parties to Islamic finance transactions avoid using Islamic law in order to avoid the "impracticalities or the uncertainty of applying classical Islamic law." In an environment with no Islamic banking courts, Islamic financial contracts include choice-of-law and dispute settlement clauses.[23]

The implications of using the alternative of the existing legal system for dispute resolution for Islamic financial contracts depend on the type of legal system in place in the relevant jurisdiction. In civil law–based jurisdictions, laws applicable for Islamic banking transactions would have to be detailed and specific. However, even in most jurisdictions where something identified as Islamic banking law is in place, these laws mostly give general features of Islamic banking and leave the interpretation thereof to the courts. This increases legal risks and creates uncertainty as the Islamic banks define and develop Islamic

[23] Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return*, Boston: Kluwer Law International, 1998.

financial products and instruments themselves without being subject to any standardized statutory criteria. The problem is aggravated due to the absence of specialized courts that deal with Islamic banking matters.

On the other hand, the situation in common law jurisdictions is not that different. As discussed above, the use of English common law as the governing law for Islamic finance transactions also does not solve the problems; English law prevails over the principles of *shari'a* since *shari'a* is a non-national law and has diversified interpretations.

Serious efforts are being made in different parts of the globe to develop an effective and efficient legal system including a dispute resolution system for the Islamic services industry. In this regard, the International Islamic Center for Reconciliation and Arbitration (IICRA) has been established in the United Arab Emirates with an objective of making up the deficiency in the international dispute resolution forum for the Islamic financial services industry. Furthermore, Malaysia has taken several steps to build some legal infrastructure institutions for the Islamic financial industry.[24] Malaysia has not only enacted special Islamic banking statutes but also attempted to establish special benches in the High Court to deal with matters pertaining to Islamic banks. In the Commercial Division of the Kuala Lumpur High Court,[25] all Islamic banking (*muamalat*) cases are heard by a judge in this division, who also hears other commercial cases including those related to insurance, companies winding-up, agency, banking, intellectual property, and Specific Relief Act cases. Furthermore, to complement the court system, the Kuala Lumpur Regional Center for Arbitration (KLRCA) has been established to deal with disputes in Islamic banking and finance for both domestic and international cases. In the KLRCA, disputes arising out of any *shari'a* related financial transactions are resolved using the guidelines set out in the Rules for Arbitration of Kuala Lumpur Regional Center for Arbitration (Islamic Banking & Financial Services) — the KLRCA IBFS Rules.[26] These rules cover

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[24] Zeti Akhtar Aziz, "Current Issues and Developments in Islamic Banking and Finance," Keynote Address at ASLI's Conference on Developing Islamic Banking and Capital Markets, Kuala Lumpur, Malaysia, 25 August, 2004.

[25] Laman Web Mahkamah Malaysia – Malaysian Court website, http://www.kehakiman.gov.my/courts/judicialEN.shtml#thc (accessed March 2008).

[26] Islamic Banking & Financial Services, *Rules for Arbitration of Kuala Lumpur Regional Center for Arbitration*, Kuala Lumpur Regional Center for

Islamic banking, Islamic finance, Islamic development finance, *takaful,* and Islamic capital market products.

However, it is a matter of concern that despite all these measures taken in the jurisdiction of Malaysia, including the Islamic Banking Act, 1983, ambiguity prevails regarding the role of the court in Islamic banking matters. The Malaysian High Court observed in *Arab-Malaysian Finance Bhd v. Taman Ihsan Jaya Sdn Bhd & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party)-(Abdul Wahab Patail J)* that:

> When dealing with cases involving Islamic financing facilities, the civil court functions strictly as a civil court and does not become a *Shari'a* Court. The civil court's function, in this regard, is to render a judicially considered decision before it according to law and not apply Islamic law as if it were a *Shari'a* Court. [27]

The development of specialized courts for the Islamic financial services sector without establishing comprehensive, corresponding laws may not be of much use. Besides legislating the specialized laws for governing the conduct of Islamic banking industry, rules relating to composition of Islamic banking courts and those governing the conduct of legal proceedings in such courts should also be framed by appropriate legislating authorities. Furthermore, appropriate amendments should also be made in the other applicable general statutes (for instance, amendments resulting in non-applicability of interest granting clauses of civil procedure codes and banking laws to Islamic finance transactions and contracts).

The existing courts may find it difficult to interpret and apply specialized Islamic banking law in its true spirit due to various reasons, including the absence of adequate precedents and laws on the subject and *shari'a* knowledge to understand the intricate product structures used by the Islamic finance industry. Hence, there is a need to establish specialized dispute settlement institutions or Islamic banking courts

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Arbitration, Malaysia, available at http://www.rcakl.org.my/GUI/pdf/Rules-for-arbitration-10.pdf (accessed March 2008).

[27] *Arab-Malaysian Finance Bhd v. Taman Ihsan Jaya Sdn Bhd & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party)* Judgment [2008] 5 MLJ 631-660 (Abdul Wahab Patail, J).

that understand the form of the contracts so that the contracts can be interpreted and enforced accordingly. These Islamic banking courts or specialized benches of courts should be presided over by a team of judges having expertise in banking matters and *shari'a* scholars having expertise in banking matters. The specialized nature of the industry demands the inclusion of legal and religious professionals in the special courts in order to enable the courts to understand the substance of intricate and peculiar transactions in their true spirit and to decide the dispute based on the merits of the case. Hence, I reiterate that delivery of justice to the stakeholders of the Islamic finance industry can only be ensured through specialized laws and their implementation by specialized legal infrastructure.

It should be noted that the development of specialized legal institutions does not necessarily mean that a separate court or alternate dispute resolution system must be established, since the underlying objective of establishing a specialized legal system may also be well served through the establishment of Islamic banking benches of courts with the aforementioned composition and the promulgation of specialized Islamic banking substantive and procedural laws. These specialized benches of courts are recommended mainly for two reasons. First, appropriately qualified legal and *shari'a* experts will be available to understand the specialized nature and intricacy of Islamic banking transactions. Second, it will ensure the delivery of speedy justice to the Islamic banking industry as these specialized cases will not be buried under the heap of pending cases before the ordinary courts. It is vital for IFIs to have access to speedy justice since, unlike conventional banks, IFIs cannot earn interest and penalties on delayed payments from their customers. Hence, these courts will also serve as a deterrent to those customers involved in deliberate default with the intention of exploiting the inability of Islamic banks to recover interest on delayed payments.

The development of legal infrastructure institutions along with the required specialized laws and the harmonization of differences throughout the globe with regard to the establishment of a legal system for the industry will ensure the soundness and stability of the Islamic financial system. The fast-paced innovation and growth taking place in the industry without the establishment of the required legal infrastructure may lead to the collapse or downfall of the industry, as it is similar to constructing a skyscraper without laying a deep and sound foundation for the building. Taking into account the peculiarities of the industry, it cannot be handed over permanently to alien legal systems

like the American or English systems, which were not primarily designed and established to cater to the needs of the Islamic banking industry. No doubt, the reduced number of disputes arising out of Islamic banking transactions is good, but the reduction of disputes merely because of the absence of a proper redress system is not a good sign for the Islamic financial services industry. The absence of a required legal infrastructure might also be one of the causes of the high cost of Islamic financial products as compared to their conventional counterparts because of the inclusion of a premium for legal risk in the price of Islamic products. Hence, in order to ensure the competitiveness and soundness of the industry and to authenticate the existing as well as upcoming innovated products, appropriate legal infrastructure institutions should first be developed and then used by the industry for settlement of disagreements or disputes.

STANDARDIZATION AND HARMONIZATION OF *SHARI'A* RULES AND APPLICATION THEREOF

Although the day-by-day increasing market share of the Islamic banking service industry is indicative of a bright future for the industry, lack of uniformity in the application of *shari'a* principles in Islamic countries and more particularly in the Islamic banking industry is an obstacle in the development of the industry. The diversity provided by different schools of thought on the same issue at times creates confusion in the general public, but if properly harmonized across the globe, it can become a great strength for Islamic financial services industry by offering different options suitable to the varying needs of customers.[28]

The long history of development of *fiqh* under various schools of thought has led to a multitude of legal opinions. Though this diversity of traditional legal opinions constitutes a vast body of knowledge from which new laws can be developed and derived, the variety of rules related to economic transactions may introduce legal risks and can affect the growth of the Islamic financial industry.[29] Hence,

[28] Dr. Shamshad Akhtar, "Shariah Compliant Corporate Governance," Keynote Address at Annual Corporate Governance Conference, Dubai, 27 November, 2006.
[29] Ahmed, "Islamic Law, Adaptability and Financial Development."

standardization of *shari'a* principles will also help the interface of Islamic banking with conventional financial institutions.[30]

The regulations or guidelines governing Islamic finance, including local laws or regulations and AAOIFI standards, require Islamic banks to establish *shari'a* boards and to obtain approval for every Islamic finance product offered by the bank. However, there is no internationally-accepted, central Islamic religious authority, and the *shari'a* boards of Islamic banks are not bound to follow any *shari'a* standards; therefore, sometimes the authenticity of new products becomes doubtful merely on account of lack of harmonization and standardization of *shari'a* rules across the globe. Hence, it may happen that a given Islamic finance product may not be acceptable in all jurisdictions on account of differences in interpretation of Islamic principles by different schools of thought. The harmonization of *shari'a* rules does not mean promulgation of *shari'a* rules of one school of thought, across the globe and disregarding all the others. Rather, the *shari'a* rules prescribed by any one school of thought should at least be standardized throughout the globe irrespective of the jurisdiction where they are being implemented.

It should be noted that basic rulings for all the Islamic modes of finance do not contradict each other. Rather, the secondary rulings may differ from one school of thought to another. For instance, it is mandatory to acquire the ownership of an asset before its sale to any other party in *murabaha* transactions and all schools of thought agree on this principle. However, rules relating to the mode and manner of acquisition of ownership may differ. As discussed earlier, such differences can play a vital role in the expansion of the clientele of Islamic banking industry through the innovation of new products to meet varying needs of customers belonging to different schools of thought.

The standardization of *shari'a* rules should take place both at the national and international level.[31] The harmonization of *shari'a* rules within the national borders only, however, will not solve the problems of global Islamic financial transactions. On the international level, the standardization of *shari'a* rules can be carried out through the consolidation and harmonization of *shari'a* rules from all schools of

[30] M. Fahim Khan and Layachi Feddad, "The Growth of Islamic Financial Industry: Need for Setting Standards for *Shari'a* Application," Paper presented at the 6th Harvard University Forum in Islamic Finance, May 8–9, 2004.
[31] Ahmed, "Islamic Law, Adaptability and Financial Development."

thought and enforcing them in the form of unanimously agreed upon international standards. This job has already been carried out by the AAOIFI through the issuance of *Shari'a* Standards. Besides the issuance of *shari'a* standards, the AAOIFI has also issued standards on accounting, auditing, governance, and ethics. The AAOIFI develops these standards through its two boards, the *Shari'a* Board and the Accounting & Auditing Standards Board. Since these boards are composed of members and experts of the fields from throughout the world, their standards are considered to be a consensus of experts from the field. Hence, these standards may be used for standardization and harmonization of practices of Islamic finance and banking throughout the world.[32] Specifically, the AAOIFI's *Shari'a* Board includes world-renowned scholars from all schools of thought and is well known and recognized throughout the world for its well-researched and harmonized *shari'a* standards that have endorsements from renowned scholars of every school of thought from diversified parts of the world. The Islamic *Fiqh* Academy of the Organization of Islamic Countries has also played a key role for standardization of *shari'a* rulings and *fatawa*.

The issue of harmonization and standardization is not solved just through the development of standards unless their implementation both in letter and spirit is ensured. Islamic financial institutions use the AAOIFI *Shari'a* Standards either in total or in part irrespective of their mandatory enforceability and promulgation throughout the world. Some countries have already recognized these standards in their regulatory framework, and the adoption of these standards in other countries would pave the way not only for *shari'a* compliance but also product innovation.

The endeavors made by the AAOIFI can be made more worthwhile and beneficial for the Islamic industry if the standards issued by the AAOIFI are made mandatory in all the jurisdictions involved in Islamic finance transactions by the relevant national regulatory authorities. In addition, further standards should be issued by AAOIFI to provide guidance on all ambiguous and complicated contemporary issues encountered by the Islamic banking industry. Furthermore, the participation of stakeholders, including industry players and *shari'a* scholars from different schools of thought, from as many countries as possible, should be ensured in order to enhance the

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[32] Omar Mustafa Ansari, "Building Reliance on Islamic Finance and Banking-II," available at www.ibp.org.pk (accessed March 2008).

credibility, adaptability, and enforceability of the AAOIFI *Shari'a* Standards. Furthermore, the *fatawa* pertaining to Islamic banking industry issued by renowned *shari'a* boards, international organizations like the International Islamic *Fiqh* Academy, and distinguished *shari'a* scholars should be discussed, and if no AAOIFI standard exists on the issues underlying that *fatwa*, then a standard should be issued thereon. This measure is suggested in order to do away with contradictory *shari'a* rulings on the same subject matter in the Islamic banking industry.

On the national level, this objective can also be achieved through the establishment of national *shari'a* boards or councils for the Islamic finance industry. This board should not only be made responsible for the issuance of rulings but also for the codification of standards for application. Examples of national-level *shari'a* boards and authorities exist in Sudan and Malaysia. Presently, these countries are ahead of other countries in their efforts for standardization of *shari'a* rules on the national level. Other countries like Pakistan are also endeavoring to promote *shari'a* standardization through issuance of model agreements, active participation for issuance of local Islamic standards, and enhancement of the role of the *shari'a* advisory board at the central bank level.[33]

From the above details, it is established that a great deal is left to be done by regulators, the legislatures, *shari'a* scholars, and international Islamic organizations to ensure that a conducive environment exists for the promotion of Islamic banking. Particular attention should be given to *shari'a* harmonization and standardization both on the national and international levels in order to build public reliance on these products and institutions. Furthermore, vigorous measures should be taken by the regulatory authorities of the jurisdictions where Islamic banking business is being carried out to ensure the compliance with such standardized *shari'a* rules in their letter and spirit. Last but not least, standardization and harmonization of *shari'a* rules applicable to the Islamic banking industry would only be useful if their application is made mandatory in all the jurisdictions carrying on Islamic banking business throughout the globe.

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[33] Ahmed,"Islamic Law, Adaptability and Financial Development."

ENFORCEMENT OF *SHARI'A* LAW THROUGH COMPLIANCE ASSURANCE

Shari'a compliance assurance is one of the core contemporary challenges faced by the Islamic banks that must be tackled effectively. The success of an Islamic financial system is based on stakeholders' belief that the system is *shari'a* compliant. This very reason and the potential for reputational risk for Islamic financial institutions accentuates the need for *shari'a* compliance to ensure that the faith of stakeholders is not compromised and the system sustains and grows smoothly.[34]

There is no doubt that even the formulation, harmonization, and standardization of *shari'a* rules may not lend stability to the Islamic financial system unless and until an effective network of checks and balances is established to ensure compliance with the system in letter and spirit. *Shari'a* compliance cannot be ensured merely on the basis of the approval of products by *shari'a* supervisory boards and *shari'a* advisors of IFIs. Hence, there is an exigency to develop and implement the framework for *shari'a* compliance assurance both on the national and international levels. This framework may be developed by consolidating the guidance provided in the relevant governance and auditing standards issued by the AAOIFI. Besides other crucial matters of interest, the following matters should be properly addressed through this framework.

Role of Dedicated and *Shari'a*-Literate Directors

Nowadays, Islamic banks, being incorporated as banking companies, carry out business in accordance with the licensing conditions imposed by their respective central banks. Most corporate laws require that a board of directors (BOD) should be entrusted with the management of an Islamic bank. Hence, the BOD is responsible for running the bank in a profitable manner and ensuring compliance with all applicable laws and regulations. *Shari'a* compliance may become the supreme objective of an Islamic bank if the directors are not only *shari'a*-literate but also committed to ensure *shari'a* compliance. It is only then that they develop the policies, procedures, and systems to ensure that the

[34] Akhtar, "Current Issues and Developments in Islamic Banking and Finance."

fatawa and rulings of the *shari'a* board are implemented according to their letter and spirit at the operational and transactional levels. Therefore the possibility of *shari'a* non-compliance is ruled out or reduced to the minimum, which in turn helps reduce the reputational risk arising out of *shari'a* non-compliance.

Therefore, central banks and regulatory authorities issuing licenses to institutions for carrying out Islamic finance business should ensure that the directors, sponsors, and promoters of the Islamic financial institution are adequately *shari'a* literate, have relevant experience, and are capable and committed to conducting the business in compliance with *shari'a* rules.[35]

Segregation of Duties

Akin to the segregation of responsibility and accountability in a conventional bank between the BOD and the management, the issue of demarcation is essential between the role and functions of the *shari'a* advisor or board (as the case may be) and the management and BOD. First and foremost, the step to be taken in this regard is to ensure the independence of *shari'a* advisors from the management or BOD. This may be ensured through explicit provisions in the applicable statutes regarding the appointment, removal, reporting, and independence requirements for *shari'a* advisors of IFIs. Central banks of various countries where Islamic banking is being practiced have issued regulations, rules, and circulars to address these issues. For instance, the State Bank of Pakistan has issued IBD Circular No. 2 on March 25, 2008, which includes provisions relating to *shari'a* advisors and *shari'a* compliance. Both the AAOIFI and the IFSB have issued governance standards and guidelines that lay down the key principles and concepts relevant to governance in IFIs. The governance principles are founded on the need for structures to enhance compliance, transparency, accountability, fairness, and the equitable treatment of stakeholders.[36]

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[35] Ibid.

[36] Accounting and Auditing Organisation for Islamic Financial Institutions, *Governance Standard for Islamic Financial Institutions No. 6: Statement on Governance Principles for Islamic Financial Institutions*, Bahrain, 2008, Para 9 at p. 53. For further details, also refer to: Islamic Financial Services Board (IFSB), *Guiding Principles on Corporate Governance for Institutions Offering*

Hence, the governance guidance available in AAOIFI and IFSB standards should be consolidated and promulgated in all the jurisdictions involved in Islamic finance business. The guidance available in these standards and guidelines is extensive and comprehensive; therefore, it can ensure that minimum requirements as to good corporate governance—including the segregation and independence of the *shari'a* board—are complied with by all the IFIs or relevant conventional financial institutions throughout the globe.

Role of *Shari'a* Board

The appointment of a *shari'a* board should be made mandatory through the inclusion of this requirement either in the specific Islamic banking law or under the special provisions embodied in a general banking law. However, mere appointment of a *shari'a* board at each IFI will not by itself contribute to the resolution of the issue in question; the roles and responsibilities of such *shari'a* advisors and boards should also be clearly explicated in the statute. Such responsibilities should include, besides their regular functions, the issuance of a *shari'a* compliance review report to all the stakeholders after carrying out the *shari'a* compliance review of the IFI in a proper manner prescribed by the regulatory authorities or statute.

Due to the faith-based nature of the Islamic banking business, it is evident that the *shari'a* advisor will review most aspects of the business. However, the involvement may vary and he may focus on the approval of the basic structure of products and other special activities rather than monitoring the day-to-day operations of the business. Hence, it is recommended that the role of *shari'a* advisors should be expanded and their extensive involvement into daily affairs of Islamic financial institutions should be ensured in order to achieve a high level of assurance as to *shari'a* compliance.

To perform these extensive responsibilities and functions effectively, there is a need to enhance the pool and capacities of *shari'a* scholars in financial businesses, as currently the most experienced *shari'a* scholars serve on *shari'a* boards of multiple institutions. The State Bank of Pakistan has taken a lead in this direction by requiring that a *shari'a* scholar should not be part of the *shari'a* board of more

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Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds), Malaysia, 2007.

than one bank in accordance with the requirements stipulated in the Fit and Proper Criteria.[37] As a result, all the eighteen licensed Islamic banking institutions have appointed their own *shari'a* advisors and new institutions are appointing new *shari'a* advisors. This policy also ensures full time availability of these advisors to guide and monitor the banks on a daily basis.[38]

Shari'a Compliance Review

It should be ensured that the *shari'a* review report issued by the *shari'a* board is based on a formal comprehensive review conducted by a competent team reporting to the *shari'a* board. The reviewing team should be comprised of *shari'a* professionals having substantial knowledge and experience relating to the application of *shari'a*, accounting, and auditing principles to Islamic financial services. If *shari'a* professionals having knowledge of these principles are unavailable due to the scarcity of such professionals, then the *shari'a* compliance review team should be comprised of both the *shari'a* professionals and banking professionals/auditors who, besides having sound knowledge of *shari'a*, have strong academic credentials, practical knowledge of banking, and strong auditing skills.

If internal *shari'a* compliance review at the financial institution level is not conducted in a proper, professional, and systematic manner by the appropriate professionals, then it is likely that compliance reviews will remain limited to the assurance of the legal form of transactions, while vetting of agreements and the operational aspects of the transaction—the substance—may remain unaudited and unchecked. This might ultimately lead to the *shari'a* board being unaware of non-compliance at the operational level. Hence in my view, reliance (if made) on the representations and disclosures made by the management regarding *shari'a* compliance does not absolve the *shari'a* board

[37] State Bank of Pakistan, *IBD Circular 2 of 2007*, Pakistan, 2007, available at http://www.sbp.org.pk/ibd/2007/C2_FP_Criteria.pdf (accessed in March 2008). It has prescribed Fit and Proper Criteria for *Shari'a* Advisors, vide Annexure-IV to IBD Circular No. 2 of 2004, which was revised vide IBD Circular 2 of 2007.

[38] Akhtar, "Current Issues and Developments in Islamic Banking and Finance."

members of their duty to ensure *shari'a* compliance at all levels of the Islamic financial transactions execution.

Besides ensuring the expertise and professional qualifications of the compliance review team, their independence should also be ensured. Furthermore, sufficient numbers of qualified professionals and ample time should be allocated for *shari'a* compliance review in order to reap the maximum benefits of this exercise. In order to systemize the review process and to ensure transparency therein, central banks should come forward and ensure that internal *shari'a* compliance review is being properly carried out by the IFIs. In this regard, the AAOIFI has issued two governance standards on *shari'a* review with the aim of providing guidance to and facilitating both the *shari'a* advisors and internal *shari'a* audit department of IFIs in discharging their responsibility to ensure the conduct of business in conformity with *shari'a* rules and principles. These standards should either be adopted (preferred option) or used as a guideline by the central banks across the globe and made enforceable in their respective jurisdictions. The compliance with this framework may also be ensured by central banks through appropriate supervision methodologies including the inspection of IFIs after pre-defined intervals of time.

In a nutshell, it is necessary to ensure the conduct of *shari'a* compliance review in a proper, professional manner in order to avoid subsequent confusion regarding the novel products introduced by the industry. Such systematic, comprehensive, and transparent screening of Islamic financial products and transactions will lend an ipso facto authenticity to the industry.

Potential Role of External Islamic Financial Services Auditors

External auditors of the Islamic financial institutions can also play a vital role by providing services of *shari'a* compliance review and assurance to the Islamic financial services industry. The external auditors may be assigned with the task of performing *shari'a* compliance audits within a pre-defined scope. This may be considered a viable option for independent assurance of compliance with the *shari'a* terms. However, this option may have two basic weaknesses. First, if the external auditor, who is also entrusted with the task of performing a *shari'a* compliance audit, is not equipped with the necessary skills and knowledge, the output of the assignment might not be as good as may be expected from an experienced and appropriately

qualified auditor. Second, as the scope of audit is pre-defined and the matter of permissibility of a transaction is generally subject to opinions and perspectives of the *shari'a* supervisory board or the *shari'a* advisor, the independence of exercise, to some extent, remains in jeopardy.

In this regard, the AAOIFI has made commendable endeavors through issuing Auditing Standards and a Code of Ethics for Accountants and Auditors of Islamic Financial Institutions. Besides other Auditing Standards, the AAOIFI has also issued a standard on "Testing for Compliance with *Shari'a* Rules and Principles by an External Auditor." The standard provides guidance on the testing for compliance with *shari'a* rules and principles by an external auditor in connection with the audit of financial statements of a financial institution that conducts business in conformity with Islamic *shari'a* rules and principles.[39]

In view of the above, it is proposed that a framework for *shari'a* compliance audits of Islamic financial institutions should be developed by consolidating the guidance issued by the AAOIFI from time to time on the subject. During the process of formulating such a framework, participation of regulators, audit firms, *shari'a* scholars, and industry experts from different parts of the globe and multiple jurisdictions should be ensured. Once this framework is developed, it should be enforced by the legislators in their respective jurisdictions in order to ensure not only *shari'a* compliance but also transparency, objectivity, and professionalism in the process of conducting *shari'a* compliance audits or reviews by the auditors.

Hence, besides ensuring the proper functioning of internal *shari'a* review departments, the regulators should also issue explicit mandatory directions to IFIs for the conduct of either stand-alone *shari'a* compliance audits or for the inclusion of *shari'a* audits into the scope of their regular audits conducted by external auditors, depending upon the volume and intricacy of Islamic banking transactions undertaken by IFIs.

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[39] Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), *Auditing Standard No. 4- Testing for Compliance with Shari'a Rules and Principles by an External Auditor,* 2003–4, pp. 35–41.

Potential Role of Islamic Rating Agencies

Islamic rating agencies can also lend further credibility to Islamic financial institutions through the issuance of *shari'a* quality ratings. In this regard, the Islamic International Rating Agency (IIRA) has made a remarkable contribution. The IIRA, besides providing other services to the Islamic banking industry, issues *shari'a* quality ratings and consequently is playing an active role in promoting and ensuring *shari'a* compliance.

The *shari'a* rating aims to provide information and independent assessments regarding the *shari'a* compliance of Islamic financial institutions or conventional institutions providing Islamic banking or financial services, as well as of Islamic financial products such as *sukuk*. *Shari'a* ratings provide independent opinions on *shari'a* compliance quality for financial institutions, securities, or financial products.

The major element characterizing Islamic financial institutions and products is that they are based on morality and religious philosophy. People prefer Islamic financial products over conventional products because of their religious legitimacy and in order to avoid *haram* (what is forbidden by the *shari'a*). Therefore, this element of religious compliance has to be measurable, and there has to be a way to evaluate such institutions or products according to the extent to which they adhere to and respect this element of legitimacy. The *shari'a* ratings aim to evaluate and determine the *shari'a* quality of IFIs and their products. Such evaluation will ultimately lead to improvement of *shari'a* quality. One of the major benefits of the availability of ratings as a marketing tool is to make sure that competition among the IFIs and issuers of Islamic financial products, for maintaining and enhancing *shari'a* compliance, will lend the required credibility and authenticity to Islamic financial institutions. *Shari'a* rating also provides a mechanism for assessing *shari'a* quality and disclosing it to the public.[40]

Currently, besides the IIRA, other rating agencies are also providing rating services to the Islamic finance industry. However, the *shari'a* quality rating service provided by the IIRA is unique as

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[40] Islamic International Rating Agency, *Methodology for Shari'a Quality Ratings*, Kingdom of Bahrain, May 2006, available at http://www.iirating.com/methodologies/sharia_methd_eng.pdf (accessed March 2008).

compared to the services provided by its conventional counterparts because the IIRA has been specifically established to meet the needs of the Islamic finance industry. However, the propriety of the role played by Islamic rating agencies or conventional rating agencies offering rating services for Islamic banking and finance industry should be ensured by the regulators through the issuance and enforcement of rules governing these agencies.

Role of Supervisory/Regulatory Bodies

The role of a supervisory body is as critical in ensuring the smooth functioning of the Islamic banking system as it is for ensuring the smooth functioning of the conventional banking system. The regulators or central banks (whichever the case may be) can play an effective and leading role in ensuring *shari'a* compliance. The regulator/supervisor can do so through various ways, including the issuance of regulations, the enforcement of regulations, and on-site supervision methods such as *shari'a* compliance inspection. Few central banks have used any or all of these methodologies to ensure *shari'a* compliance in the banks licensed as fully Islamic banks or Islamic windows of conventional banks.

The key element of *shari'a* supervision is a mechanism that ensures that the Islamic financial system continues to remain viable and growing without compromising the principles of *shari'a*. The central banks of Malaysia (Bank Negara) and Pakistan (State Bank of Pakistan) are two of those few central banks that are endeavoring to ensure *shari'a* compliance of Islamic banking products and transactions in their jurisdictions. Pakistan has adopted a three-tiered *shari'a* compliance approach to ensure a deeper and extensive *shari'a* compliance supervision.[41] First, the State Bank of Pakistan has issued guidelines and regulations whereby all IFIs are required to have a *shari'a* board discharging duties in due course, including those required by the State Bank of Pakistan. Second, a centralized *shari'a* board has been established at the central bank level to ensure *shari'a* compliance and standardization. Finally, *shari'a* compliance inspection procedures and teams are being established to perform on-site supervision to ensure *shari'a* compliance.

[41] Akhtar, "Current Issues and Developments in Islamic Banking and Finance."

Hence, all the regulatory authorities and central banks in jurisdictions where Islamic financial products are offered by the banks, should establish effective supervisory frameworks to ensure *shari'a* compliance. This is not required merely for promotion of a faith-based banking system; it will also protect Islamic banking customers and stakeholders (regardless of their religious allegiance) from all possible malpractices by Islamic bankers or financial engineers. The *shari'a*, which is the base of this faith-based banking system, never permits the exploitation of any stakeholder involved in Islamic finance transactions; hence, ensuring *shari'a* compliance will result in a just and transparent financial system and better economic conditions, which are some of the core objectives of a central bank.

STANDARDIZATION OF DOCUMENTATION

The documentation of contracts made in a specific and explicit manner is one of the key determinants of growth and stability in financial markets. The benefits accruing from standardized and lacunae-free documentation for financial contracts have been highlighted by various experts.[42] Standardized documentation enhances predictability and certainty about the characteristics of the financial contracts. It may enable the parties to the contract to comprehend and enforce their rights and obligations under the contract, which results in enhanced confidence to enter the market and transact. The whole process of negotiating different aspects of a transaction becomes more simplified and streamlined. Negotiations are more specific on the issues that are unique and specific to the particular transaction rather than on the general and common aspects of the contract. This in turn helps the parties to the contract to focus on the prospective risks of the transaction and to include provisions in the contract to mitigate the risk. Furthermore, the administration and execution of a contract becomes easy due to standardization.

The manifest virtues of standardized documentation are cost reduction, enhanced protection against legal risk, and guidance in interpretation from reported precedents. Some argue against standardization as it would dent the "sovereignty" of the individual *fiqhi* schools, leading to a dilution of heritage and of identity itself. Furthermore, some also consider the phenomenon of standardization as

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[42] Ahmed, "Islamic Law, Adaptability and Financial Development."

an obstacle to innovation in the industry. This is not limited to *shari'a* scholars, as regulators also wish to have their exclusive regulatory mechanism for Islamic institutions and products and to compete for regulatory arbitrage regionally and internationally.[43] Bankers and lawyers are no exception to it. However, the situation has started changing gradually now as standardization of *sukuk* and other vital general banking documentation is being promoted on the international level.

Internationally, efforts for standardization of trading agreements between interbank participants are currently being carried out by the International Islamic Financial Market (IIFM). The principal objective of the IIFM is to encourage self-regulation for the development and promotion of the Islamic capital and money market sector.[44] The IIFM objectives also include the issuance of trading guidelines, best practice procedures, and standardization of financial contracts leading to swift authentic product innovation and infrastructure development. In this regard, the IIFM has recently developed milestone documents like the Master *Murabaha* Agreement and the Master Agency Agreement for purchase of commodities.

In a nutshell, it is the duty of all the stakeholders of the industry and especially the regulators and professionals (i.e., lawyers, *shari'a* scholars, and bankers) to endeavor to maintain a balance between innovation and authenticity in the development of the Islamic banking industry. Appropriate precautions should be taken to ensure that standardized contracts should not get entrenched and rigid; rather, they should be flexible enough to adjust to changing businesses and environments. The flexibility is desirable at both the transactional and market levels.

STANDARDIZATION OF ACCOUNTING AND REPORTING REQUIREMENTS

The rapid expansion of the Islamic financial services industry that started in the 1970s was not initially accompanied by the creation of a set of internationally recognized accounting rules. As a result, Islamic financial institutions started accounting for Islamic finance products

[43] Faruqui, "Islamic Finance—An Overview."
[44] International Islamic Financial Market (IIFM), Kingdom of Bahrain, 2008. Information obtained from http://www.iifm.net/ (accessed March 2008).

according to their own interpretations and accounting solutions mainly based on the best accounting practices. These varied accounting and reporting practices resulted in less transparent and noncomparable financial statements within the same industry. The stakeholders of the industry realized that development of well established and recognized sound accounting procedures and standards consistent with Islamic laws was inevitable for the Islamic banking industry. Hence, the AAOIFI was established to standardize and develop the accounting and financial reporting practices best suited to Islamic finance products.[45] Western accounting procedures were inadequate due to differences in the nature of Islamic financial products. Well-defined procedures and standards are necessary not only for information disclosure, building investors' confidence, and monitoring, but also for integration of Islamic markets with the international markets.[46] However again, the development of these standards alone will not solve the problem; enforcement is mandatory to achieve these objectives.

Therefore the application of already tested accounting and auditing standards (i.e., AAOIFI Standards) should be enforced and encouraged in the jurisdictions where Islamic banking is practiced. The standards can alleviate the burden on regulators facing the peculiar supervisory challenges imposed by Islamic banking. However, these standards should be revised and developed in a manner that should not eliminate the liberty of industry players to innovate and develop the industry while prescribing the boundaries for the industry. In addition, the participation by stakeholders in this industry in the development of standards should be increased in order to ensure and promote the flexibility, comprehensiveness, and effectiveness of Islamic standards.

CONCLUSION

Islamic banking is not only growing rapidly, it is also gaining international recognition day by day. Even non-Muslim jurisdictions

[45]Juan Solé, "Introducing Islamic Banks into Conventional Banking Systems," IMF Working Paper, WP/07/175, Monetary and Capital Markets Department, International Monetary Fund, 2007. Available at http://www.imf.org/external/pubs/ft/wp/2007/wp07175.pdf (accessed March 2008).

[46] Zaher and Hassan, "Islamic Law: A Comparative Literature Survey of Islamic Finance and Banking."

have started taking an interest in this banking system. However, the industry is still in its nascent stages of growth as compared to the conventional banking industry; hence, the challenges encountered by the industry are also high as compared to those faced by the conventional banking industry. Though the rapid growth of the industry is a positive indication, it also simultaneously poses great risks for the long-term sustenance of the industry. Hence, there is a need for the appropriate and timely identification and resolution of core issues in the industry. One of the greatest challenges encountered by the industry is the preservation of the originality and authenticity of the Islamic banking industry. Unfortunately, there are instances where the Islamic banking industry is mirror-imaging conventional banking products that are altered to be *shari'a* compliant. These sorts of practices, if undertaken improperly and incautiously, put questions on the authenticity of Islamic banking products. Furthermore, the IFIs and their clientele appear to be in a situation where they do not have any specific forum having special expertise for the resolution of disputes arising out of Islamic banking transactions/deals.

In this regard, commendable endeavors have been made by *shari'a* scholars, industry experts and international organizations like the Islamic *Fiqh* Academy of the OIC. Now all the stakeholders of the industry are required to join hands and make concerted endeavors to resolve the core challenges of the industry, including the harmonization and standardization of *shari'a* rules and the development and enforcement of regulatory and legal frameworks specific to the Islamic banking industry. These challenges can only be properly addressed if the regulators and legislators come forward and play a vital role in the development and enforcement of specialized statutes, regulations, and legal infrastructure institutions. As far as the guidance on the subject is concerned, it is available not only in the form of researches and *fatawa* issued by the experts but also in the form of guidelines and standards issued by organizations like the AAOIFI and the IFSB.

What is required now is that all these guidelines, researches, *fatawa,* and standards be consolidated, if required, and agreed to by the regulators and legislators across the globe. The consensus on regulatory and legal frameworks and standards should permit the regulators and legislators to cater to the specific economic and legal needs of their respective jurisdictions while simultaneously promoting the standardization of *shari'a*, legal, and supervisory guidelines across the globe. The development and enforcement of specialized statutes and the establishment of legal infrastructure institutions will lend a level of

comfort to the stakeholders by reducing the legal risks encountered by the industry, and it may ultimately enable the IFIs to offer Islamic banking products at competitive prices. In a nutshell, if legal and regulatory issues encountered by the industry are addressed in a proper manner and resolved on a priority basis, it will not only guarantee the long term sustenance and rapid growth of the industry but will also support the ongoing product innovation in the industry by providing assurances to the stakeholders as to the *shari'a* compliance and legal enforceability of Islamic banking products.

Part III

Sukuk Issues

Purchase Undertakings in Recent *Sukuk* Issuances: Different Objectives and Approaches

Andrew Coats and Habib Motani[1]

In February 2008, the *Shari'a* Committee of the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) issued a statement[2] (the AAOIFI Statement) on *sukuk* transactions, which provides certain rules that should be adhered to in structuring *sukuk* transactions. One particular rule (the "Fourth Rule"), which restricts purchase undertakings in *sukuk* transactions, states in part that "[i]t is not permissible for the *mudarib* (investment manager), *sharik* (partner), or *wakil* (investment agent) to agree to purchase assets from *Sukuk* holders or from whoever represents them for a nominal value of those assets at the time the *Sukuk* are extinguished at the end of their tenors."[3] This paper examines the structure and use of purchase undertakings in a number of recent *sukuk* transactions that originated in Gulf Cooperation Council ("GCC") countries, considers the commercial objectives underlying these transactions, and evaluates their adherence to the Fourth Rule. We will seek to demonstrate that there is a certain variety in the structures adopted, which reflects the varying commercial objectives of the transactions in question, and that current transactions appear to adhere to the Fourth Rule in varying degrees. We will look at three categories of transaction structures and briefly examine the way in which rating agencies approach their analysis for these types of transactions. While the *shari'a*-based evaluation of the transactions (and how they should be considered in light of the Fourth Rule) is ultimately a matter of judgment by Islamic

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[1] Partners, Clifford Chance LLP, United Kingdom.

[2] Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), "Statement in Relation to *Sukuk*," February 2008.

[3] Ibid.

scholars, we nonetheless hope that our analysis of the transactions as professional lawyers may help to clarify the structures used and add to the discourse surrounding *sukuk* transactions.

PURCHASE UNDERTAKINGS IN *SUKUK-AL-MUSHARAKA*

The first category of transaction structure that we wish to examine is the *sukuk-al-musharaka*. This structure has been adopted in a significant number of recent large *sukuk* issues originated by corporations in the GCC region, including the US $3.5 billion issue of Trust Certificates by PCFC Development FZCO ("DP World") in 2006,[4] and the AED 7.5 billion issue of Trust Certificates by JAFZ *Sukuk* Limited (Jebel Ali Free Zone) in 2007.[5] The main objective of these transactions has been fund-raising, often for corporate acquisitions, or major development or infrastructure projects.

Before examining the purchase undertakings themselves, it is important to have an understanding of the context in which they are used. Therefore, we set out below a brief description of the *sukuk-al-musharaka* structure as a whole.

A *musharaka* is a partnership. In a typical *sukuk-al-musharaka* structure, the two partners would be the sponsor or originator of the transaction (and the party raising the financing) (the "Originator") on the one hand, and a special purpose company (SPV) (the "*Sukuk* Issuer") on the other. The *Sukuk* Issuer contributes cash to the partnership (*musharaka*), which it raises through the issuance of *sukuk*, and the Originator contributes assets in kind. Units in the *musharaka* ("Units") are issued to the *Sukuk* Issuer and the Originator in relation to their respective contributions. The *Sukuk* Issuer and the Originator, as parties in the *musharaka*, will typically also draw up a business plan regarding the employment of the *musharaka*'s assets and appoint a managing agent to act on behalf of the *musharaka*. (In practice this managing agent will often be the Originator.)

During the life of the transaction, the *musharaka*'s assets will generate income or profit and this will be paid to the Originator and the *Sukuk* Issuer in pre-agreed proportions, with the *Sukuk* Issuer typically

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[4] PCFC Development FZCO, Offering Circular relating to U.S.$ 3.5 billion Trust Certificates due 2008, January 20, 2006.

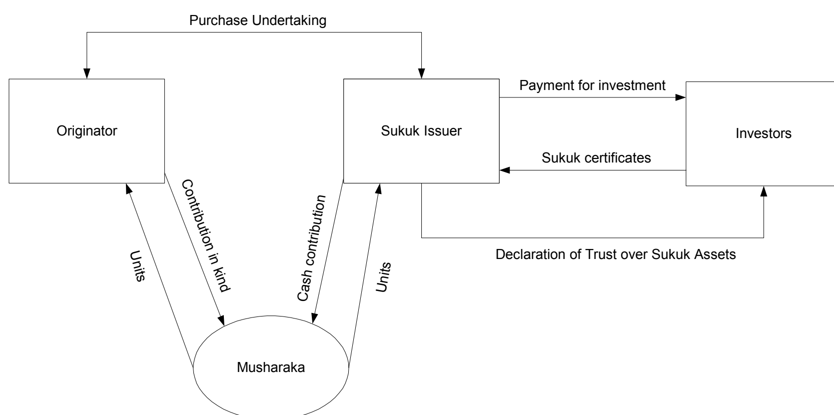
[5] JAFZ *Sukuk* Limited, Prospectus relating to AED 7,500,000,000 Trust Certificates due 2012, November 21, 2007.

being entitled to receive out of such income a pre-set amount determined by reference to, say, a particular interest rate. Such amounts are often termed "Periodic Distribution Amounts."

In these structures it is usually the case that a purchase undertaking is entered into by the Originator in favour of the *Sukuk* Issuer. This will generally be a full recourse undertaking by the Originator to purchase from the *Sukuk* Issuer its Units in the *musharaka*, normally at their original book value (which matches the face or principal amount of *sukuk* in issue).

The *Sukuk* Issuer will in turn then establish the *sukuk* by declaring itself trustee over the *sukuk* assets in a trust instrument and issuing certificates (*sukuk*) to investors representing undivided shares in the *sukuk* assets. Note that in this structure the *sukuk* assets are not the assets contributed to the *musharaka*, but rather the *Sukuk* Issuer's Units and its rights under the purchase undertaking. Accordingly, investors are effectively put in the position of having direct recourse against the Originator through the purchase undertaking. As we shall see, this is a key element of the structure and is of particular importance in terms of how these transactions are analyzed by rating agencies.

The above transaction structure is illustrated in the following diagram:



Although other circumstances are at times also included, purchase undertakings are generally exercisable in these transactions by the *Sukuk* Issuer at least (a) at scheduled maturity, and (b) following the occurrence of events and circumstances (collectively, "Dissolution Events") set out in the terms and conditions of *sukuk* under which the

trust that is the subject of the *sukuk* may be dissolved early (i.e., accelerated) at the option of the *sukuk*-holders. Generally speaking, the ability to exercise purchase undertakings following the occurrence of Dissolution Events serves the same purpose as events of default in a loan agreement or bond issue. Dissolution Events will commonly include, among other things, non-payment and insolvency of the *Sukuk* Issuer (which is invariably a bankruptcy-remote special purpose company, and so in practice these are of little importance), but also, and most important, events of default under the purchase undertaking itself. These latter events of default will normally relate to the Originator and may include a full set of corporate loan or bond-style events of default, including cross-default provisions and breaches of covenant by the Obligor.

There are thus two main purposes for purchase undertakings in these structures. First, it provides for a relatively straightforward mechanism for unwinding the *musharaka* at the scheduled maturity of the *sukuk*. Second, it provides for a means to accelerate and unwind the structure prior to the final maturity in circumstances where there has been an event of default or similar such event affecting the Originator or else some other change in circumstances that entitles investors to terminate their investment early. In each case, there will typically be full recourse to the Originator, and thus it also provides a contractual obligation that rating agencies are able to assess and effectively treat as the underlying credit in the transaction. Such purchase undertakings also usually provide for the price at which the units are purchased from the *Sukuk* Issuer to be a price fixed at the outset rather than a price established by reference to market prices at the time that the units are repurchased or otherwise established by reference to prevailing circumstances at such time. As mentioned above, this is normally equal to the outstanding nominal amount of the *sukuk* and sometimes also includes any prior shortfalls in Periodic Distribution Amounts to the extent that there was insufficient income generated by the *sukuk* assets to cover such amounts.

The overall effect of this is that the purchase undertaking amounts to a direct undertaking given to the *Sukuk* Issuer by the Originator, under which an event of default in relation to, or breach of covenant by, the Originator will potentially lead to an obligation on the part of the Originator to buy the *Sukuk* Issuer's units at par. While such obligation is not given directly in favor of investors, but rather to the *Sukuk* Issuer as their trustee, it is not difficult to see how similar the position of

sukuk-holders in this structure is to that of holders of regular corporate bonds with the benefit of a guarantee from the Originator.

That said, there are a number of important differences between a purchase undertaking and a bond guarantee, even where the purchase undertaking is structured in this manner. An English law euro-bond guarantee is usually written as a guarantee and indemnity, giving investors an immediate right to sue for payment of a liquidated sum equal to any due and unpaid principal and interest. A purchase undertaking, on the other hand, is an executory contract for the sale and purchase of an asset, either automatically exercisable or exercisable on the instructions of *sukuk*-holders. Under English law, a failure by the Originator to comply with its obligations under the purchase undertaking would not automatically entitle the *Sukuk* Issuer to sue for a liquidated sum. Instead the *Sukuk* Issuer would need to petition the court for specific performance of the purchase obligation and, if that petition was not successful, it would only be entitled to a claim in damages for the difference between the contractual price specified in the purchase undertaking for the *sukuk* assets and their market price as of the date that the purchase obligation matured. As the award of specific performance is discretionary for an English court, the *Sukuk* Issuer (and thus investors) is in a less advantageous position than where there is a guarantee (properly so-called).

From a technical legal perspective, at least, it is accordingly misleading to describe purchase undertakings as guarantees.

Jebel Ali Free Zone *Sukuk* Issue

The Jebel Ali Free Zone ("JAFZ") *Sukuk* issue is a good example of the use of a purchase undertaking in this type of structure. In this transaction, Jebel Ali Free Zone FZE (the Company) entered into a *musharaka* with JAFZ *Sukuk* Limited, as *Sukuk* Issuer, under which the *Sukuk* Issuer contributed the proceeds of the *Sukuk* and the Company contributed certain assets in kind.

The Company also entered into a purchase undertaking as obligor in favor of the *Sukuk* Issuer. The terms of this purchase undertaking included an undertaking restricting the giving of security by the Company and its subsidiaries and also a covenant requiring asset sales to be for fair market value. In addition, the purchase undertaking included the following events of default:

- non-payment
- breach of other obligations
- cross-acceleration
- enforcement proceedings
- security enforced
- insolvency
- winding-up
- authorization and consents
- illegality

This package of covenants and events of default is very similar to what one would commonly find in a conventional interest-bearing euro-bond issued by an issuer in the GCC region.

The purchase undertaking in the JAFZ transaction is exercisable by the *Sukuk* Issuer at scheduled maturity, in the event of a change of control in the Company, and upon the occurrence of a "Dissolution Event." The latter includes the occurrence of any of the above-listed events of default under the purchase undertaking. All payments by the Company under the purchase undertaking are also required to be grossed-up for any withholding taxes levied on payments by the Company, and the Company also agrees in the transaction documents to pay the *Sukuk* Issuer additional amounts to cover any required withholdings or deductions to payments under the *sukuk* themselves.

The overall effect of these arrangements is to give investors recourse to the Company that is similar, but not identical, to what they would have in a conventional bond issue (not identical, as a purchase undertaking is not a guarantee, for the reasons discussed above). This degree of recourse and linkage to the underlying originator also allows rating agencies to give ratings to *sukuk* structured in this manner at the same level as the ratings that apply to an originator's senior unsecured debt (see further below).

While the *shari'a*-based evaluation of such transactions (and how they should be considered in light of the Fourth Rule) is ultimately a matter of judgement by Islamic scholars, at first impression, the aforementioned structure appears to contravene the Fourth Rule since the obligor under the purchase undertaking is often the same entity as the partner in the *musharaka* and the purchase price for the *Sukuk* Issuers Units will typically be their original face value.

SECURITIZATION STRUCTURES

At the other end of the spectrum are transactions that are closer to securitizations in their structure and degree of recourse to the Originator. Such transactions may properly be described as asset-backed, whereas the first category of *sukuk* we have examined might more accurately be described as asset-based. To date, there have been relatively few such transactions in GCC countries, partly because of perceived local law difficulties relating to the certainty of transfers of property rights and other issues relating to enforcement.

A common goal of securitization transactions where the originator is a financial institution is to remove the assets that are the subject of the securitization from the balance sheet of the originator from an accounting and/or a regulatory capital perspective. This typically requires the relevant assets to be sold outright by means of a "true sale." The features of what is treated as a true sale may vary depending on the jurisdiction of the originator and the location of the assets in question. However, it is generally accepted in English law that the answers to the following questions are all relevant considerations, namely:

(a) Does the purchaser have recourse to the seller in the event that the asset purchased is worth less than the amount he paid to the seller?
(b) Conversely, is the purchaser required to account to the seller for any profit he makes on a sale of the assets?
(c) Does the seller have the right to get back the subject matter of the sale by returning to the purchaser the money that has passed between them?

Similar considerations often apply in other jurisdictions.

Another way of expressing the first of these considerations is to say that in a true sale the purchaser typically runs a significant degree of risk on the assets and generally speaking the assets will be the primary source of repayment, whereas in a loan financing transaction secured on the same assets there will be full recourse to the borrower if the assets do not generate sufficient funds to repay the financing.

With that said, it is nonetheless common to find a degree of recourse to the originator even in true sale securitisations. However, depending on the jurisdiction, this is often limited to circumstances

where the assets that are the subject of the securitization fail to meet certain pre-agreed criteria or other pre-defined standards relating to the origination of the assets are not met. In the case of a securitisation of, say, real estate mortgage loans, these criteria would normally fall short of prospectively requiring full repayment of the loans by the underlying borrowers; to allow recourse to the originator in these circumstances would be tantamount to the originator guaranteeing full repayment of the loans, which in turn will generally have the effect of placing the mortgage loans back on the originator's balance sheet, whether from an accounting or a regulatory perspective, as the originator would remain "on risk." (Note, however, that, under English law, at least, such a guarantee of receivables would not necessarily result in a transaction being characterized as a loan financing secured on receivables rather than a financing by way of a sale of receivables.) In essence, the purchaser may have a limited right to put back to the originator defective assets, but only where they differ *at the time of purchase* from the assets that the purchaser has bargained for.

It should accordingly come as no surprise that the function and features of a purchase undertaking in a securitization-type asset-backed transaction is quite different from that of a purchase undertaking in the first category of transactions. So as not to jeopardize the true sale analysis and the attendant regulatory and accounting benefits, one would expect the circumstances in which the purchase undertaking could be exercised to be much more limited.

Tamweel

The US $210 million issue of Floating Rate Notes due 2037 by Tamweel Residential ABS CI (1) Ltd ("Tamweel") in 2007 is a good example of the use of a purchase undertaking in this type of asset-backed transaction. (The Tamweel transaction represents a number of "firsts" for the GCC region, being not only arguably the first true securitization, but also the first such transaction to provide for differently ranking classes of securities.)

In this transaction, the Originator was Tamweel PJSC, a UAE company whose principal business consists of providing *shari'a*-compliant home financing solutions to real estate buyers and end-users in the UAE. While the details of the transaction are somewhat complex (as is any residential mortgage-backed securitization (RMBS)), in essence the transaction consisted of the Originator selling to a DIFC-

incorporated special purpose company, Tamweel Properties (1) Ltd ("TPL"), its interests in a portfolio of properties and the related financing and leasing arrangements (collectively, the "Assets"). TPL in turn declared a trust over such Assets in favour of a Cayman Islands incorporated Company (the "Issuer"), which issued securities to investors.[6]

In the sale documentation relating to the transfer of the Assets to TPL, the Originator gave TPL a large number of representations and warranties relating to the Assets (collectively, the "Tamweel Warranties"). These cover a comprehensive list of factual matters, ranging from the Originator having good title to the Assets, to whether there is access to the relevant properties over public roads or whether any of the underlying borrowers/lessees were materially in default under the financing arrangements. Importantly, however, these representations and warranties are given only at the time of, or immediately prior to, the sale of the relevant Assets to TPL. So long as such representations and warranties were true at the time they were given, neither TPL nor the Issuer will have recourse to the Originator if circumstances subsequently change so that they would no longer be true if they were repeated. Accordingly, under these representations and warranties TPL (and ultimately investors) bears the risk of subsequent changes in circumstances relating to the Assets, such as a deterioration in the ability of the underlying borrowers/lessees to pay.

The transaction also includes a purchase undertaking entered into by the Originator (as obligor) in favor of TPL (as promisee). However, the scope of this purchase undertaking is relatively limited. It may only be invoked if either (a) one of the Tamweel Warranties was untrue when given and remains unremedied when repeated 30 days after written notice to Tamweel (i.e., there is a 30 day cure period), or (b) a borrower/lessee does not consent or otherwise objects within a specified timeframe to the relevant property being transferred into the securitization. Upon exercise of the purchase undertaking the Originator is required to repurchase from TPL its rights to the relevant property and related arrangements at a pre-defined repurchase price.

The following diagram sets out a simplified overview of the elements of the Tamweel transaction structure discussed in this paper.

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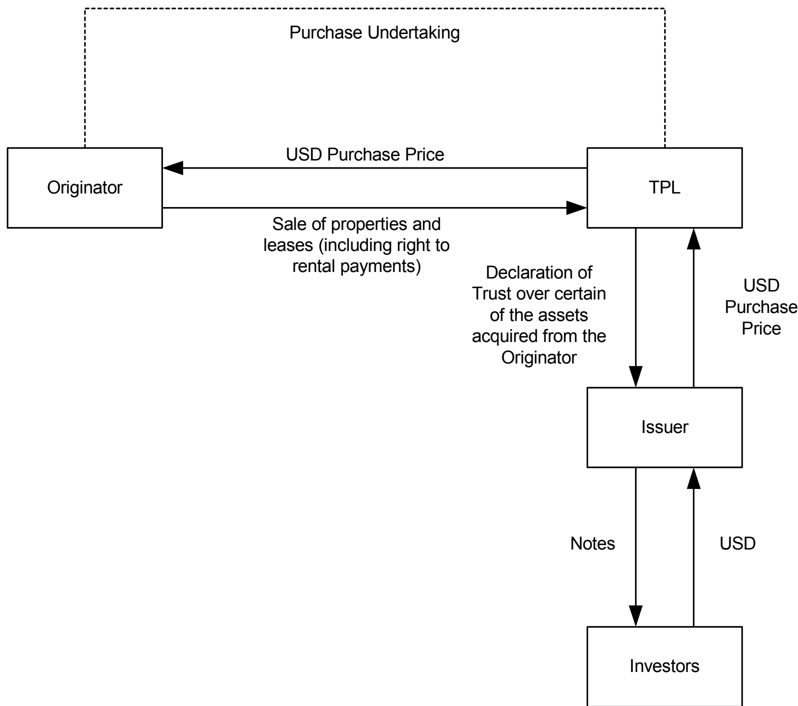
[6] Tamweel Residential ABS CI (1) Ltd, Prospectus relating to US$210,000,000 Floating Rate Secured Notes due 2037, July 19, 2007. In Tamweel, the securities are termed Floating Rate Notes rather than the more usual trust certificate.

The Tamweel transaction is very different from the *sukuk-al-musharaka* transactions discussed above, both in its overall structure and in its use of the purchase undertaking.



For our purposes, the primary difference is in the degree of recourse to the Originator through the purchase undertaking. In particular:

- Whereas in the *sukuk-al-musharaka* structures the purchase undertaking provides the mechanism by which the *Sukuk* Issuer disposes of its Units and thereby generates the funds necessary to redeem the *sukuk* at their face amount, in the Tamweel transaction, the cash flows from the underlying Assets (namely the properties and related rights) generate the redemption proceeds.
- In the *sukuk-al-musharaka* structures, the purchase undertakings include a large number of events of default and covenants that are designed to protect the creditworthiness of the Originator and/or

allow the *Sukuk* Issuer/investors to unwind the transaction upon signs of a deterioration in the Originator's ability to meet its payment obligations. Such provisions are entirely absent from the Tamweel purchase undertaking.

- In the Tamweel transaction the trigger events that allow an exercise of the purchase undertaking relate to the Assets and not to the Originator. Moreover, they only cover misrepresentations as to the nature of the Assets actually purchased as of the time of their transfer or the situation where there is a doubt as to their transferability in the first place.

In light of the different commercial objectives of the two types of transactions, none of this should be surprising. In the first category, the transaction, while asset-based, is also largely supported by the Originator. In the second type of transaction, the transaction is fully asset-backed and it is a primary goal that investors have recourse to the underlying assets but not to the Originator so long as the initial criteria for eligibility of the Assets were met.

The Tamweel transaction also appears to fit in more readily with the Fourth Rule set out in the AAOIFI Statement. Although, as described above, repurchases of assets at nominal value are not generally permitted, there is an exception in the Fourth Rule that would appear to apply to the limited circumstances in which the Tamweel purchase undertaking can be triggered: "It should be understood that the *sukuk* manager acts as guarantor of [investor] capital at its nominal value in cases of negligence or mala fides or non-compliance with stated conditions, regardless of whether the manager is a *sharik* (partner), *wakil* (agent) or *mudarib* (investment manager)."[7]

SEC AND SABIC — AN INTERMEDIATE CLASS OF TRANSACTION?

The two types of transaction we have so far examined are at either end of the spectrum in terms of the risks covered by the purchase undertaking, ranging from more debt-like asset-backed structures on the one hand to pure true sale asset-backed securitizations on the other.

However, there are also transactions that fall somewhere between these two extremes and involve investors taking a degree of risk on the

[7] AAOIFI, *Statement in Relation to Sukuk*, February 2008.

underlying assets while retaining, in many circumstances, a significant amount of recourse to the originator.

Two transactions that we consider fall into this category are Saudi Electricity Company's SAR5 billion *Sukuk* expiring 2027 and Saudi Basic Industries Corporation's SAR3 billion *Sukuk* expiring 2026[8] completed in July 2007 and July 2006, respectively.

We consider it worthwhile looking at these transactions in some detail, as they arguably succeed in meeting some of the criticisms levelled at the more debt-like structures while potentially still being treated in a manner similar to debt by rating agencies and investors.

Saudi Electricity Company ("SEC")

Saudi Electricity Company ("SEC"), as an integrated electricity generation, transmission, and distribution company, is a primary supplier of electricity in Saudi Arabia. The issue of the *sukuk* was part of SEC's strategy to diversify its sources of funding, with a particular focus on obtaining longer-term funding. The use of proceeds of the *sukuk* is described as being "general corporate purposes, including meeting working capital requirements, refinancing existing financial obligations and capital expenditure and the making of other investments."[9]

SEC is regulated by various Saudi laws relating to the electricity industry. The assets (the "*Sukuk* Assets") that are the subject of SEC's *sukuk* issue comprise SEC's rights under Council of Ministers' Resolution No. 169 and related legislation and its distribution and retail supply license granted by the Saudi Electricity and Co-generation Regulatory Authority (ECRA) (a) to read and maintain electricity consumption meters at its customers' premises, (b) to prepare, issue, and distribute bills, and (c) its entitlement to levy and receive charges in relation to (a) and (b) above.[10] These charges essentially consist of a periodic fixed tariff for the provision of metering and billing services, depending on the size of the relevant meter. For the purposes of the *sukuk* issue, SEC identified meters relating to certain of its residential

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[8] SABIC's July 2007 SAR7 billion transaction was largely a repeat of this transaction.
[9] Saudi Electricity Company (SEC), Offering Circular relating to *Sukuk* expiring 2027, June 25, 2007.
[10] Ibid.

and commercial customers, and then transferred the above rights in relation to such meters to *Sukuk* Electricity Company, a newly created SEC subsidiary that was appointed as custodian for the holders of the *sukuk*.

The *sukuk* were issued by SEC itself, each of them representing an undivided beneficial ownership interest in the *Sukuk* Assets described above. They differed from the transactions previously discussed in that the *sukuk* were issued directly to investors by the Originator.

So as to deal with the day-to-day administration and management of the *Sukuk* Assets, SEC was also irrevocably engaged as *sukuk* administrator to perform the meter reading and billing services in relation to the relevant customers and meters, including invoicing for the meter reading tariff and collecting the related payments.

SEC, as *sukuk* administrator, is required to keep records of all income received in relation to the *Sukuk* Assets and, after deducting certain allowable costs, to transfer the net amount to *sukuk*-holders on a quarterly basis, up to a Periodic Distribution Amount determined by reference to Saudi interbank deposit rates ("SIBOR"). Amounts recovered in excess of this amount are credited to a reserve book-entry account maintained by SEC (Reserve) and are available to cover future shortfalls of Periodic Distribution Amounts and, on each five-year anniversary of the issue date, a potential "Extra Amount" payment equal to up to 10 percent of the face value of the *sukuk*. Accordingly, if the net income recovered from the *Sukuk* Assets was sufficient, an investor who retained its investment in the *sukuk* for the full twenty years stood to receive 40 percent of the *sukuk* face amount in payments of Extra Amounts.

In addition, holders of the *sukuk* have the right under a purchase undertaking to require the *sukuk* to be repurchased from them on each five year anniversary of the issue date, at 90 percent of their face amount at 5 years, 60 percent of their face amount at 10 years, and 30 percent of their face amount at 15 years. Note that the structure of this purchase undertaking differs from those previously described in that it is an undertaking to purchase the *sukuk* themselves rather than the *Sukuk* Assets.

An investor who exercised such right at five years would have received, subject to there having been sufficient income from the *Sukuk* Assets, a SIBOR-based quarterly return on its investment and a return of 100 percent of its capital. Put in this way, the payment profile is very much like that of a regular bond.

At first glance, as well as covering the optional repurchase right described above, the purchase undertaking appears to be similar to that in the archetypal *sukuk-al-musharaka* transactions described above in that it is potentially exercisable by or on behalf of *sukuk*-holders upon the occurrence of a fairly lengthy list of events of default consisting of the following:

- Default resulting in non-payment of Periodic Distribution Amount or Extra Amount
- Breach of other obligation
- Cross-default of *Sukuk* Administrator
- Unsatisfied judgment
- Insolvency
- Winding up
- Distribution Sector Restructuring Event
- Failure to take action
- Unlawfulness
- Non-effectiveness of *Sukuk* Assets

This list is very similar to that for the JAFZ transaction described above. However, on more careful examination one discovers that the structure of the purchase undertaking in the SEC transaction falls somewhere between the two structures previously examined, and as a result investors do run a certain amount of risk on the underlying *Sukuk* Assets.

More specifically, a shortfall in net income resulting in a failure to pay the full amount of any Periodic Distribution Amount or Extra Amount only constitutes an event of default under “Default resulting in non-payment of Periodic Distribution Amount or Extra Amount” if it occurs as a direct result of SEC’s default or negligence in performing its obligations under the transaction documents.

Accordingly, if such shortfalls were attributable, say, purely to the failure by SEC’s customers to pay their bills on a timely basis, then, absent SEC’s default or negligence, *sukuk*-holders would suffer the shortfall without recourse to SEC. (In practice, the risk of this occurring appears to be low based on historic customer delinquency rates and SEC’s ultimate sanction of disconnection, but the risk is far from being completely theoretical.)

This is also consistent with the Fourth Rule in the AAOIFI Statement described above in that it falls within the exception for "negligence or mala fides or non-compliance with stated conditions."[11]

In addition, although the occurrence of an Event of Default entitles investors to have their *sukuk* (and their entitlement to the underlying *Sukuk* Assets) repurchased by SEC, the price at which SEC repurchases them declines over the twenty-year life of the *sukuk*, being set at 100 percent for the first four years and then declining over the life of the issue to just 5 percent in the year before the *sukuk* expire.

The list of events of default is also something of a mixture of bond-like credit events relating to SEC and other events relating more to the *Sukuk* Assets. The Distribution Sector Restructuring Event, in particular, provides for an early termination of the transaction in circumstances where SEC concludes that a government-led restructuring of the electricity sector makes continued servicing of the *Sukuk* Assets impracticable. (This might be the case if, for example, the distribution sector of the industry were restructured so that SEC was no longer generally responsible for billing consumers.) If the *Sukuk* Assets were merely incidental to the structure, then this would be of little importance.

The SEC transaction, while retaining a number of debt-like features, also exhibits a number of more asset-backed elements and the structure of the purchase undertaking reflects this. Investors run credit-risk on SEC's customers and this is accordingly disclosed as a risk factor in the Offering Circular. Conversely, it is not intended that investors should run additional risks arising out of the potential restructuring of the Saudi electricity industry by the Saudi government, and the commercial solution is to enable the investors to exit the transaction if this occurs, potentially receiving a full return of their capital so long as this occurs during the first four years of the transaction.

A further example of risk allocation relating to the *Sukuk* Assets is the "Top-Up of Reserve" provision. This requires SEC to pay additional amounts into the Reserve to cover any shortfalls arising out of either (1) the meter reading tariff and related legislation being amended or revoked or (2) any of the customers whose meters are the subject of the transaction changing their electricity supplier.

The risk of the latter occurring was thought to be relatively low, as residential and commercial electricity consumers in Saudi Arabia do

[11] AAOIFI, *Statement in Relation to Sukuk*, February 2008.

not now generally have a free choice of electricity supplier. Likewise, no change in the tariff structure affecting meter reading was expected at the time of the issue. However, given the final maturity of the *sukuk* (20 years) and the first date at which they could be repurchased (5 years), it is not inconceivable that the electricity sector in Saudi Arabia and the tariff structure could be restructured while the *sukuk* were outstanding. This essentially political risk is hard to quantify, and potential investors might legitimately consider that it was not one that was reasonable for them to bear. Accordingly, the solution here is to allocate these particular risks to SEC, which is in a much stronger position in terms of evaluating these risks and potentially influencing the political outcome.

Again, this illustrates the hybrid nature of the SEC transaction. The transaction is asset-backed, in that investors do run genuine risk on the *Sukuk* Assets, but not all risks relating to the *Sukuk* Assets are borne by investors.

Saudi Basic Industries Corporation ("SABIC")

Saudi Basic Industries Corporation's ("SABIC's") July 2006 SAR3 billion *sukuk* issue was the first such transaction publicly offered in Saudi Arabia under the Capital Market Law. In many ways, it was the precursor of the SEC issue discussed above, and there are many similarities in the overall transaction structure.

SABIC is the Saudi holding company for the SABIC Group, one of the largest petrochemical companies in the world. While SABIC Group's products are produced by various SABIC affiliates and subsidiaries, SABIC itself is primarily responsible for conducting marketing and sales activities for most of its affiliates and subsidiaries incorporated in Saudi Arabia. SABIC receives marketing fees for these activities, which are the subject of various marketing agreements, and the *Sukuk* Assets in the SABIC *sukuk* issue consist of a specified percentage share of SABIC's rights and obligations under these marketing agreements.

SABIC itself issued the *sukuk* directly to investors and transferred the *Sukuk* Assets to a newly incorporated subsidiary to act as custodian for investors. SABIC was then irrevocably engaged by the custodian to act as administrator of the *Sukuk* Assets on behalf of investors.

This appointment is in many ways analogous to the appointment of an originator of receivables as servicer in a receivables securitization. As administrator, SABIC is required to devote the same

degree of skill, care, and diligence as it does in performing its own rights and obligations under the marketing agreements.

The cash flows and financial terms in the SABIC transaction are similar to those in the SEC transaction and we will not set them out in full in this paper. However, the key feature that we will highlight (and which distinguishes these transactions from the *sukuk-al-musharaka* structures discussed above) is that the purchase undertaking is not activated in all circumstances in which investors suffer shortfalls in Periodic Distribution Amounts or return of their capital.

In particular, while non-payment of the full amount of any Periodic Distribution Amount or Extra Amount is potentially an event of default, it will only be an actual event of default entitling investors to have their *sukuk* repurchased by SABIC if the relevant shortfall occurred as a direct result of SABIC's default or negligence in performing its obligations as administrator of the *Sukuk* Assets. Accordingly, investors run both a performance risk on the SABIC Group's continuing to produce products to market under the marketing agreements and a credit risk on group companies in terms of their paying the related marketing fees. This falls some way short of the protection that a typical bond guarantee offers investors and instead provides a degree of recourse similar, in this respect at least, to that in a securitization where the originator defaults in its obligations as servicer.

On the other hand, a full list of corporate bond-style events of default, including cross-default and insolvency-type events, are included in the *sukuk*, all of which trigger an investor right under the purchase undertaking to have their *sukuk* repurchased by SABIC. However, as in the SEC *sukuk* the repurchase price declines over the life of the transaction, falling to 5 percent of the face value of the *sukuk* in the final year before maturity.

This is again illustrative of a hybrid instrument under which investors bear some risk on the *Sukuk* Assets, but not in all circumstances.

APPROACHES OF RATING AGENCIES

Rating agencies generally approach the rating of *sukuk* with purchase undertakings or originator guarantees in a different manner from *sukuk* without such features. We discuss below the published approach of Fitch Ratings ("Fitch") to rating *sukuk*; we understand that broadly

similar considerations are taken into account by the other major rating agencies.

There is no single approach covering all *sukuk*, which is hardly surprising given the range of structures and different credit-enhancement techniques (including purchase undertakings) used.

That said, Fitch categorises *sukuk* issues as being either "originator-backed *sukuk*" or "asset-backed *sukuk* (securitizations)."[12] The first category includes those with purchase undertakings to repurchase the *sukuk* assets at a predetermined price (thereby avoiding valuation risk) and any outstanding periodic distribution amounts.

Fitch comments in relation to these types of transaction:

> [A]lthough *sukuk* are asset-based, the originator's contractual obligations—whether represented by a guarantee or not—clearly determine that the credit risk of the *sukuk* reflects that of the originator rather than the underlying assets. The *sukuk's* Long-Term Rating cannot therefore exceed the Issuer Default Rating (IDR) of the originator, and would ordinarily be in line with the originator's IDR.[13]

Additional risk factors, among other things, may lead Fitch to notch down from the IDR, if appropriate. Notching up would only generally be possible if there were tangible assets that could increase the recovery prospects and where Fitch can be satisfied that the transaction is genuinely secured on such assets.

Local legal factors relating to enforceability of purchase undertakings are relevant, but will often not result in a purchase undertaking supported *sukuk* having a lower rating than the originator's IDR, even where there may be significant potential difficulties in enforcing a purchase undertaking in the originator's jurisdiction. (Although purchase undertakings are frequently governed by English law, there are often uncertainties in GCC jurisdictions regarding both enforceability of English judgments and English law agreements in the local courts.) The reason for this is that similar considerations also apply to conventional bonds issued in the same jurisdiction, and hence these risks will normally already be reflected in the originator's IDR.

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[12] FitchRatings, "Fitch's Approach to Rating *Sukuk*," *Corporate Finance: Criteria Report,* March 5, 2007, pp. 1–4.
[13] Ibid.

Conversely, Fitch would apply more conventional securitization rating methodologies for rating true asset-backed *sukuk*, potentially resulting in a rating higher than the originator's IDR.[14] However, in order for it to do so, the transaction would need to represent a true sale, with investors having first priority over the underlying assets, without any risk of the sale subsequently being overturned by local courts. In many GCC jurisdictions, local legal uncertainties may make it difficult to satisfy these criteria.

CONCLUSIONS

This paper has demonstrated that existing *sukuk* transactions adhere to the Fourth Rule in varying degrees. Asset-based *sukuk* transactions, as exemplified by the JAFZ transaction, do not appear to comply with the Fourth Rule since the obligation for the purchase undertaking is often the same entity as the partner in the *musharaka* and the purchase price for the *Sukuk* Issuer's Units will typically be their original face value. On the other end of the spectrum, asset-backed transactions, as exemplified by the Tamweel transaction, appear to comply with the Fourth Rule, since the purchase undertaking is limited to circumstances that fall within the exception in the Fourth Rule that the *sukuk* manager acts as a guarantor in cases of negligence or mala fides or non-compliance with stated conditions. Transactions that appear to fall in between those ends of the spectrum, as exemplified by the SEC and SABIC transactions, are less clear in their adherence to the Fourth Rule.

It is currently too early for a consensus to have developed as to how best to take into account the AAOIFI Statement in structuring *sukuk* transactions going forward and, in particular, how purchase undertakings may be used. However, while commercial objectives and credit ratings will continue to have a large impact on these transactions, adherence to the Fourth Rule will likely be influential in the structuring of *sukuk* transactions. Nevertheless, given the variety of *sukuk* transactions that have thus far been adopted, particularly those such as the SEC and SABIC transactions that appear to fall in the middle of the spectrum of compliance with the Fourth Rule, transaction parties will continue to have a wide variety of options to structure their transactions and seek to comply with AAOIFI's Statement.

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[14] Ibid.

Standardization and Authenticity in the Global *Sukuk* Market

Armen V. Papazian[1]

INTRODUCTION

While the *sukuk* market was not spared by the recent global financial crisis, its track record in preceding years has been unique. Indeed, between 2001 and 2007, the growth rates experienced in the Islamic finance industry and the *sukuk* industry in particular have been impressive. From 2005 to 2007, the growth in issuance value was 204 percent. As an Islamic alternative to the conventional bond, *sukuk* provide a unique tool of financing for Islamic as well as non-Islamic entities.

With high growth rates in the recent past and a solid potential for further growth, the *sukuk* industry has many challenges to overcome. Lack of standardization, higher costs, and structuring complexities are some of the key issues addressed in this paper. The immediate implication of these challenges is the relative absence of small and medium sized enterprises (SMEs) in the growing list of players within the industry. This is true both on the issuance side as well as the investment side. Indeed, if the *sukuk* market could somehow embrace SMEs, it could make a leap into becoming a mass market. *Sukuk* could then become an instrument accessible to retail investors and a popular and widely used financing instrument for the wide range of family businesses that dominate the business scene in the Islamic world.

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[1] This paper was completed while the author was a Senior Vice President responsible for Innovation and Development at the Dubai International Financial Exchange (Nasdaq Dubai), UAE. An acknowledgment of feedback and support is due to Dr. Nazim Ali, Sheikh Hussein Hamad Hassan, and Sohail Zubairi.

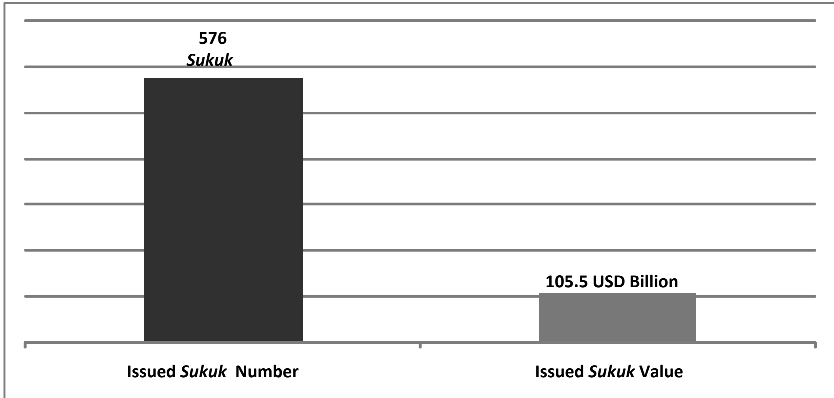
This paper proposes a model for standardization in the *sukuk* market that also addresses authenticity issues in *sukuk* structures. More specifically, it addresses the common practice of using orphan special purpose vehicles (SPVs) as third parties to facilitate *shari'a* compliance. Indeed, the standardization model presented here is based on the creation of an authentic third party that acts as an Islamic clearing agent of sorts and fulfills the role of an independent central Islamic trustee that could be used by many issuers.

The paper is divided into four sections. Section one provides a snapshot of the global *sukuk* market. The database uses data providers such as Islamic Financial Information Service (IFIS) and Zawya and complements the information through direct reference to stock exchanges, securities commissions, and other relevant sources such as lead managers and when necessary issuers. The period covered extends from 2001 to 2007. Section two describes and develops a theoretical framework, which I believe is important in justifying the focus on standardization and the necessity of innovation to achieve it. Section three explores in detail the proposed standardization solution for *sukuk*. Section four concludes the paper.

THE GLOBAL *SUKUK* MARKET: A SNAPSHOT

During the last couple of years, *sukuk* have emerged as a unique asset class. The market has been growing steadily over the past seven years and has witnessed phenomenal growth, particularly in 2006 and 2007. Charts 1 to 7 describe this market as it stands by the end of 2007. As of 2007, a total of 576 *sukuk* had been issued globally, representing an issuance value of US$105.524 billion.

Chart 1: Global *Sukuk* Issuances, Number and Value, 2001- 2007



The number of *sukuk* issuances has been rising steadily over the past seven years. As shown below in Chart 2, 140 *sukuk* were issued in 2007 as compared to 31 in 2001. The number of *sukuk* issuances has grown at a compounded annual growth rate (CAGR) of 52 percent. The rise in the values of *sukuk* issued has been even more significant. Chart-3 reveals the yearly *sukuk* issuance in terms of values. In 2007, the total value of *sukuk* issued was US$41.24 billion compared to US$4.7 billion in 2001. The value of *sukuk* issuances has been growing at a CAGR of 56 percent.

Chart 2: Yearly *Sukuk* Issuance, Number, 2001–2007

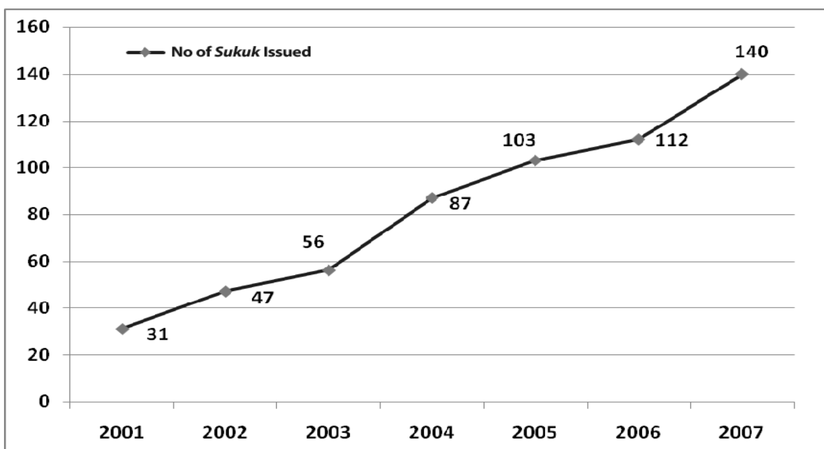


Chart 3: Yearly *Sukuk* Issuance, Value in USD Millions, 2001–2007

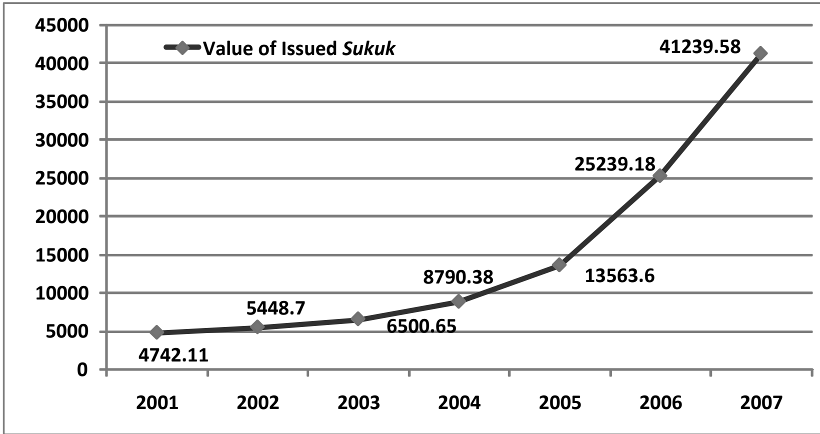
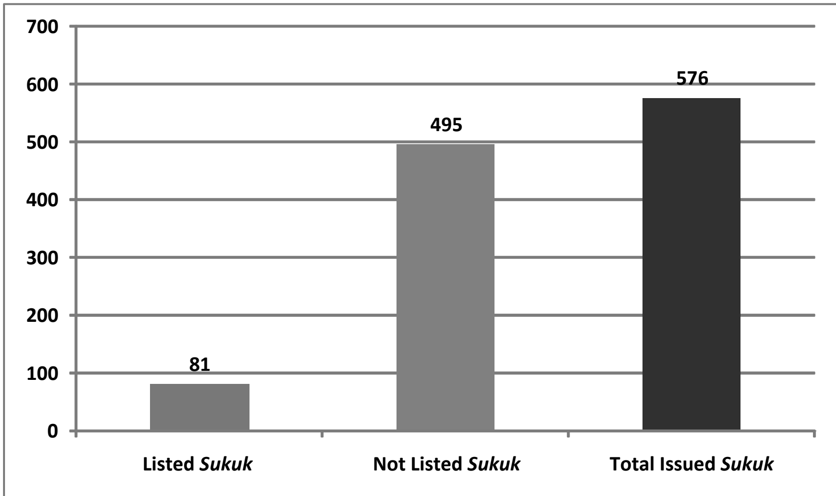


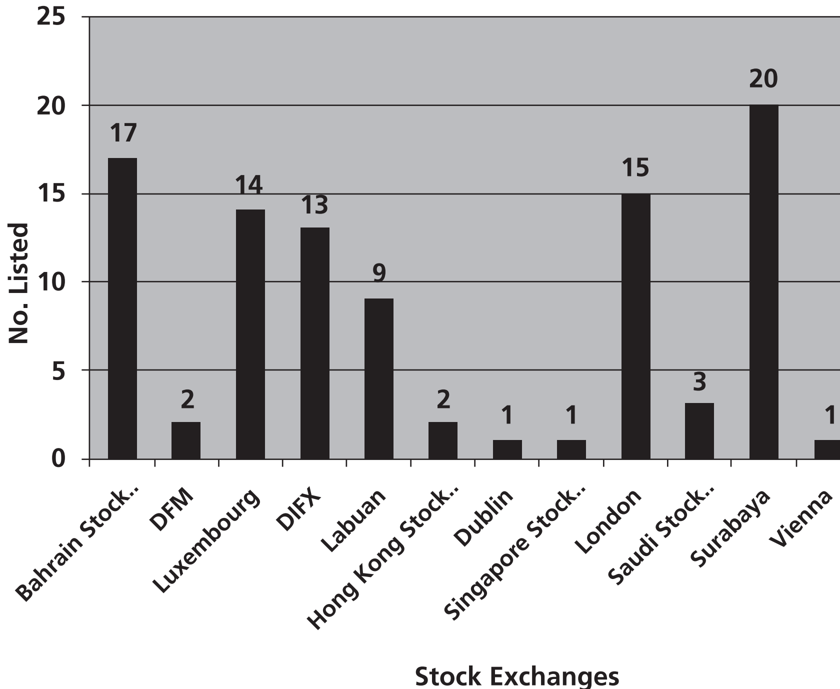
Chart 4: Number of *Sukuk* Issued and Listed on Exchanges, 2001–2007



Several *sukuk* have been listed on stock exchanges across the world to generate investor demand and facilitate further liquidity and trading. Chart 4 reveals that 14 percent of the 576 *sukuk* issued between 2001 and 2007, i.e., 81 *sukuk*, have been listed on stock exchanges. Chart 5 reveals the exchanges where *sukuk* have been listed and their

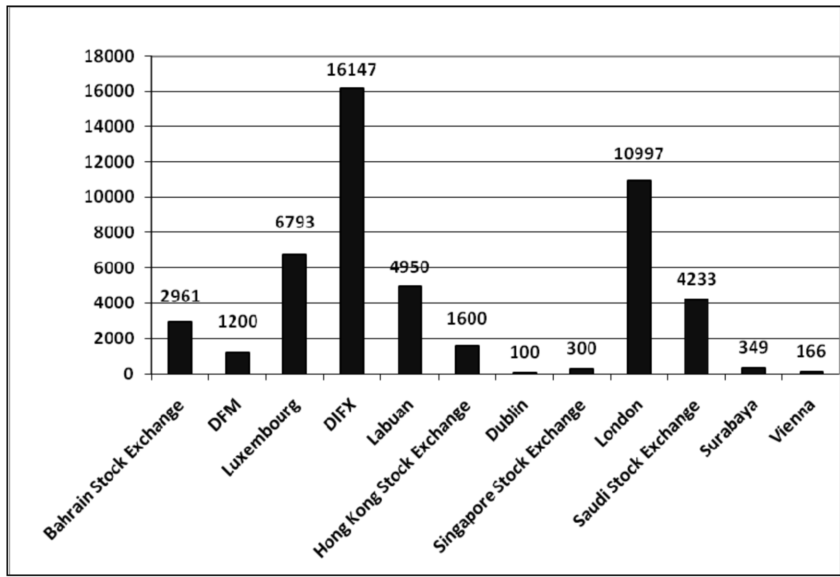
numbers. It should be noted that due to cross-listings the total exceeds 81.

Chart 5: Number of Listed *Sukuk* per Exchange, 2001–2007



Eighty-one *sukuk* have been listed on twelve stock exchanges throughout the world, including major global hubs such as the DIFX (Nasdaq Dubai) and the LSE. The Indonesian Surabaya Stock Exchange has had 20 *sukuk* listed and is host to 20.4 percent, the highest number of listed *sukuk*. The Bahrain Stock Exchange and London Stock Exchange have 17 and 15 *sukuk* listed, respectively. Other stock exchanges with a high number of listed *sukuk* include the Luxembourg Stock Exchange with 14, the DIFX with 13, and Labuan Malaysian Stock Exchange with 9 *sukuk*. GCC stock exchanges including DIFX, DFM, Bahrain, and Saudi Tadawul account for 35 *sukuk* or 35.7 percent of the total number of listed *sukuk* between 2001 and 2007.

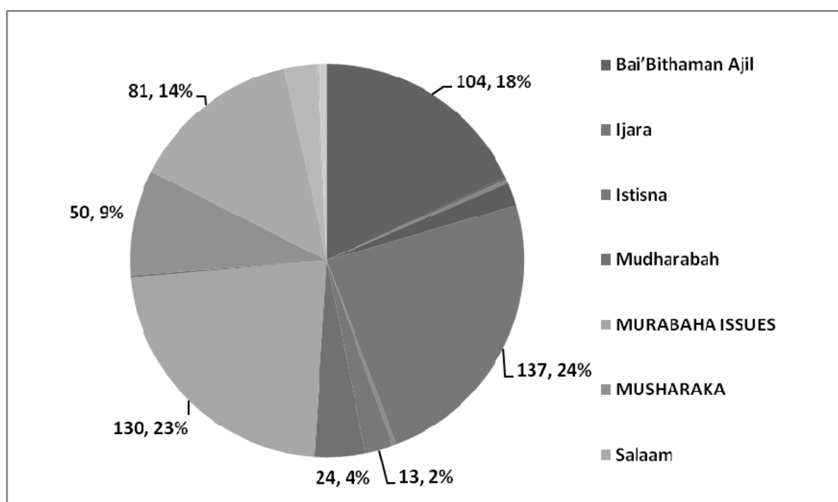
Chart 6: Value of Listed *Sukuk* per Exchange, in USD Millions, 2001–2007



By 2007, the total value of listed *sukuk* across all exchanges amounts to US$49.7 billion. DIFX had the highest value of *sukuk* listed at US$16.14 billion. This represented 32 percent of the total value of *sukuk* listings. The London Stock Exchange had approximately US$ 10.9 billion worth of *sukuk* listed, which represents 21 percent of the total. It should be noted that the value figures should only be used as indicative descriptions due to double-counting given cross listings across exchanges.

Looking at the major types of *sukuk* structures used, Chart-7 below reveals that 137 *Ijara sukuk* have been issued between 2001 and 2007. These account for 24 percent and the largest of all *sukuk* instruments issued. *Murabaha* issues account for 23 percent of all global *sukuk* issuances. One hundred four *Bai' Bithaman Ajil sukuk* have been issued, particularly in the early years in Malaysia, representing 18 percent of total *sukuk* issued. *Salam sukuk*, most commonly issued as short-term *sukuk* by the Central Bank of Bahrain, rank fourth and account for 14 percent of all *sukuk*. Other relatively sizeable *sukuk* instruments include *musharaka* and *mudaraba*, which account for 9 percent and 4 percent of all *sukuk* respectively.

Chart 7: Global *Sukuk* Instrument Breakdown, 2001–2007



The above discussion is a snapshot of the global *sukuk* market as it stood by the end of 2007. The figures reveal a fast growing industry that is still in its early stages of evolution, with tremendous potential for innovation and further development. Indeed, the *sukuk* industry has not been spared by the credit freeze across conventional markets. Based on a recent Standard and Poor's report, global *sukuk* issuance dropped to US$15 billion in 2008.[2] While the slowdown has been significant, the potential of *sukuk* as a unique asset class remains unchallenged.

The next section discusses a framework for the future, addressing strategic and tactical issues relevant to the ongoing process of self-definition experienced by this young and growing industry.

A FRAMEWORK FOR THE FUTURE

The rapid growth of Islamic finance and the *sukuk* market have spread excitement and anticipation among all players. Whether governments,[3] exchanges, banks, law firms, or other institutions, the benefits of taking

[2] Standard and Poor's, "*Sukuk* Market Declined Sharply in 2008, But Long-Term Prospects Remain Strong," 2009.
[3] For growing Islamic and non-Islamic interest in this developing industry, see HM Treasury, *Government Sterling SukukIissuance:A Cconsultation,* 2007.

part and contributing to this infant and fast growing industry have been obvious.[4] In parallel, many conferences and seminars have been organized to address the many pressing issues. Indeed, this young industry is seeking to find itself, to invent itself according to the principles of the *shari'a*. This self exploration and invention is a powerful process that without any doubt will determine the future course of development of the *sukuk* market.

The framework proposed here suggests that all players in the Islamic finance field are faced with a number of key strategic decisions (figure 1). The first and most important strategic decision concerns an entity's position vis-à-vis form and substance. In other words, to what extent does an entity seek to achieve authentic Islamic solutions? Naturally, given the pluralistic nature of Islam, and the nature of *ijtihad*,[5] there could be many interpretations of what is truly and authentically Islamic finance and what is not. All in all, the first strategic decision concerns the pursuit of form or substance, or both in balance. Do we dedicate resources to "appear" Islamic, or do we dedicate resources to "be" Islamic (always allowing for multiple interpretations)?

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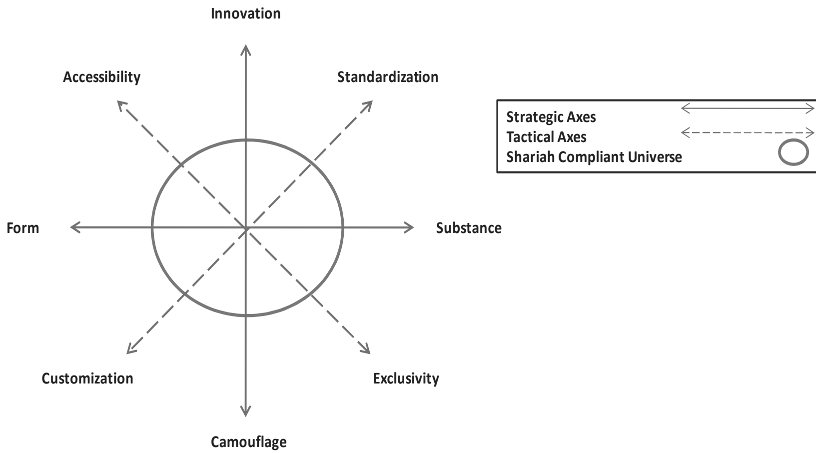
[4] For additional material on the recent momentum and future prospects of Islamic finance and the *sukuk* market see: Zamir Iqbal, "Islamic Financial Systems," *Finance and Development*, IMF, 2007, Volume 34, No. 9, 42–45; Zamir Iqbal and Hiroshi Tsubota, *Emerging Islamic Capital Markets: A Quickening Pace and Potential*, Euromony Handbook DCM, 2006, The World Bank, 5–11; Ahmed A. El Waleed, "Sukuk–A Sharia Advisory Perspective," *Islamic Finance News,* 2007, Vol. 4, Issue 29, 1–4; Global Investment House, *Sukuk–A New Dawn of Islamic Finance Era,* 2008.

[5] *Ijtihad* refers to the process of independent effort and interpretation that is applied by Islamic scholars.

Figure 1: Framework for the Future



The second strategic decision, which is a direct result of the first, concerns the position of an entity vis-à-vis innovation and/or camouflage. In other words, depending on what an entity's purpose is, it will dedicate resources to innovation, which is far more costly and much riskier, or to camouflage, which consists of transforming the appearance of what is already available in order to blend in with the environment and meet the general requirements of the principles.

Depending on where we position ourselves on these two strategic axes, we also determine what type and how much resources we dedicate to our Islamic finance initiatives and thus we determine the impact and extent of our contribution to this unique and promising industry.

In parallel, firms and players in the Islamic finance arena are faced with broad tactical decisions: (1) the decision to pursue exclusivity vs. accessibility, and (2) the decision to seek standardization vs. customization.[6] These decisions, which are highly dependent on the nature of the institution concerned, determine the nature, extent, and focus of the Islamic finance initiatives that companies undertake. For example, a law firm, a bank, and an exchange would most definitely be inclined to adopt very different positions when it comes to standardization and accessibility. Indeed, the nature and size of the companies in question could be a crucial variable. All in all, depending

[6] A. Papazian, *The Global Sukuk Market: Developments and Prospects*, 2007.

on a firm's position vis-à-vis these two axes, an entity determines the type of projects and objectives it seeks to implement.

While the future of the industry and Islamic finance in general will be determined through the ongoing and future projects and negotiations of all the players, the development of a mass market in *sukuk* will depend on more standardization and more accessibility.

The next section proposes a model for standardization in the *sukuk* market.

CENTRAL ISLAMIC TRUSTEE (CIT): A STANDARDIZATION SOLUTION FOR *SUKUK*

At the heart of all the *sukuk* structures is a Special Purpose Vehicle (SPV).[7] The very objective of such a company is to have an entity that will hold the *sukuk* assets on trust or as agent for and on behalf of *sukuk* holders. SPVs are usually owned by a charitable trust. The share capital of such SPVs is set at the minimum possible depending on the jurisdiction of incorporation. An SPV's board of directors generally consists of nominee directors who represent *sukuk* holders or initial investors. The board operates in accordance with the instructions of *sukuk* holders. All relevant details are set out in clear terms in the declaration of trust and offering circulars or terms and conditions of the *sukuk*.

The SPV enters into various transaction documents (almost all transaction documents and capital market documents necessary for the issuance, listing, and redemption of *sukuk*) for and on behalf of *sukuk* holders, issues the *sukuk*, and holds the *sukuk* assets in trust for the benefit of the *sukuk* holders. An SPV, in its capacity as issuer and trustee, invests the proceeds of the *sukuk* in the project identified in the business plan of the underlying *sukuk* structure.

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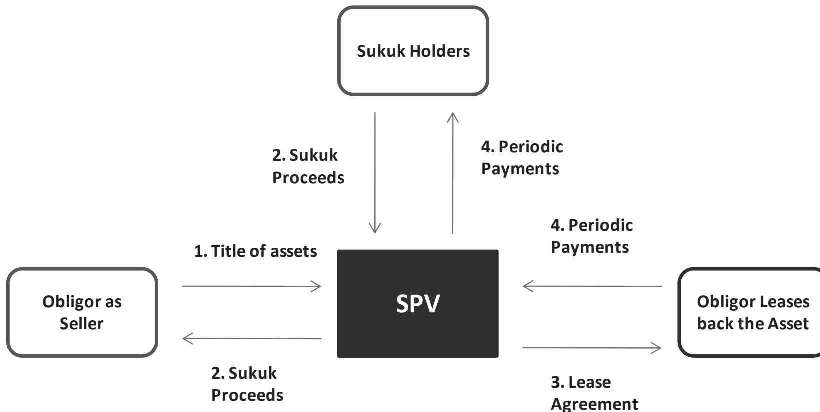
[7] For additional and background discussion on *sukuk* please see Muhammad al-Bashir Muhammad Al-Amine, "The Islamic Bonds Market: Possibilities and Challenges," *International Journal of Islamic Financial Services*, 2001, Vol. 3, p. 1; Dar Al Istithmar, *Sukuk: An Iintroduction to the Underlying Principles and Structure,* 2006; Abdulkader Thomas, *Structural Challenges Impeding Growth of the Sukuk Market*, August 2006; Abdulkader Thomas and Sh. Muhamed Becic, *Debt or Equity in the Sukuk Market,* June 2007; Thomas and Becic, *Are Sukuk Islamic? The Sukuk Market,* December 2007; Rodney Wilson, *Innovation in the Structuring of Islamic Sukuk Securities,* 2006.

To visualize the role of SPVs, figure 2 provides an example of a *sukuk* structure where the central role played by the SPV is revealed.

Figure 2: *Ijara Sukuk* Structure



In the case of a simple *ijara sukuk* (lease *sukuk*), for example, the role of the SPV (acting as agent and/or trustee) is to purchase the underlying asset from the primary obligor (by utilizing the *sukuk* proceeds) and then to lease the asset back to the obligor (receiving rentals that become the payments to *sukuk* holders). However, as an entity, it is neither responsible for the payments, nor guarantees the payments. The SPV is a trustee that acts as a legal conduit to a *shari'a* compliant *sukuk* structure.

When a *sukuk* is brought to listing on an exchange, the legal issuer is the SPV. However, regulators look through the SPV and consider the primary obligor as the reporting entity. Indeed, this is common practice across many jurisdictions and regulators. The SPVs have no financial or reporting responsibilities. Their function is to be a legal entity that buys/rents the underlying asset from the primary obligor, legally acts as the issuer of the *sukuk*, and appoints (legally) the relevant entities to manage and administer the transaction. It does not itself manage cash or responsibilities.

Acting as an issuer/trustee/agent in a *sukuk* structure, the specific functions of an SPV are:

1. *Core Transaction Documents:* Enters into and executes all Core Transaction Documents in relation to the underlying

sukuk structure (for example, *musharaka* agreement, asset purchase agreement, lease, undertakings, *mudaraba* investment agency agreement, *istisna'*, management agreement, etc.).

2. *Capital Market Documents:* Appoints (legally) the mandated lead arrangers, arrangers, underwriters (subscribers), paying agent, collection agent, security agent, transaction administrator, book runners and publisher for the printing of offering circular, etc.

At the core of the standardization model proposed in this paper is an entity that I call the Central Islamic Trustee (CIT). The mission of the Central Islamic Trustee is envisaged to be that of a facilitator and a source of standardized *sukuk* contracts. Moreover, the CIT is expected to provide the market with a genuine third party that would be in a better position to safeguard and pursue the interests and rights of *sukuk* holders. The existence of such an entity will give more meaning and authenticity to the SPVs and their role in *sukuk* structures.

The Central Islamic Trustee must be organized as a charitable trust that will serve the industry through the provision of standardized *sukuk* blueprints. It will create SPVs (Figure 3) and provide administrative services to them, thus standardizing incorporation documents and other related transaction documents. The Central Islamic Trustee will establish an SPV (on the request of an originator/arranger of a *sukuk* issue), monitor it, and facilitate the appointment of or enter into different relationships by the trustee/issuer with other concerned parties for the purpose of the issuance of a *sukuk* (Figure 4).

Figure 3: CIT Structure

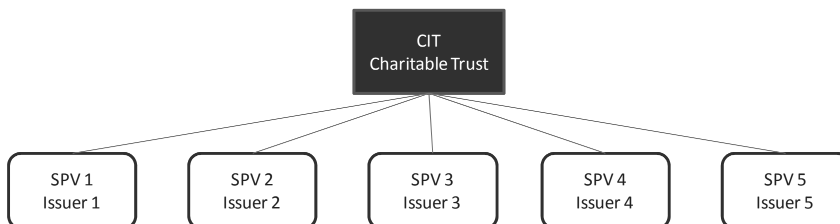
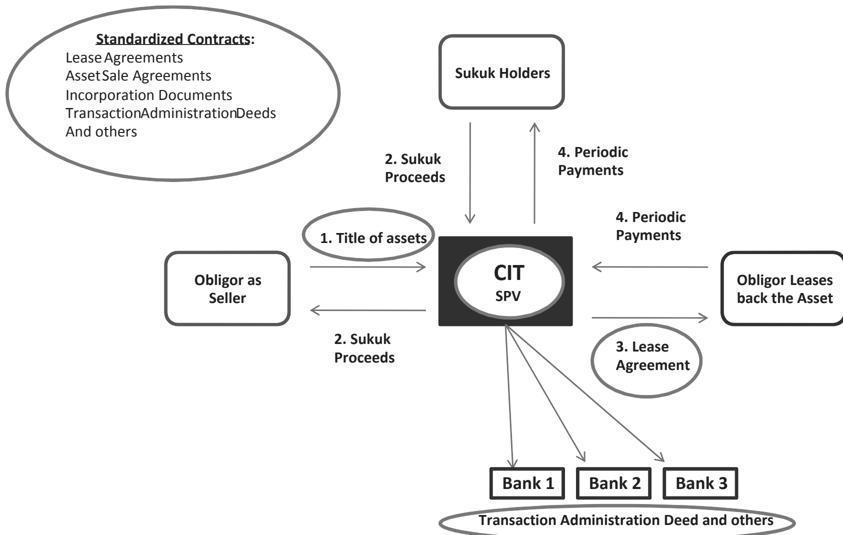


Figure 4: CIT in an *Ijara Sukuk* Structure



In order to achieve its purpose and engage all the existing players in the *sukuk* market, the CIT will need to have a set of strictly defined functions or services. The list below is not exhaustive, but clearly defines the role of *sukuk* facilitator in the market alongside other players.

Central Islamic Trustee (CIT) Services and Delivery

- Facilitating *sukuk* issuance for interested parties;
- Establishment of SPVs for *sukuk* issuance;
- SPV administration for *sukuk*;
- Administrative and secretarial support to SPVs for *sukuk*;
- Provision of full set of incorporation documentation for SPVs;
- Provision of directors and statutory officers (including company secretary) for SPVs, and provide registered office service and address for SPVs;
- Provision of legal documentation to create the *sukuk* structure;

- Audit coordination;
- Transaction accounting;
- Security issuance and accounting.

The SPVs created and owned by the CIT must be segregated from each other. This is critical in order to avoid the potential systemic risks that could arise from such a central institution acting as a party to so many transactions. Although, as discussed earlier, given the nature of *sukuk*, CIT SPVs will not be the actual obligors in these transactions, and thus will not have any ongoing reporting responsibilities. However, they will play an active role in representing *sukuk* holders, safeguarding their rights, monitoring the issuance process, coordinating the different functions of the issuer SPV, and will be an actively managed independent institution from the obligor or the originator.

Indeed, in many ways, given the functions and services of the CIT as described here, the idea is quite close to other conventional SPV providers in the securitization and structured finance industries. The fundamental differences are three key features of the CIT: (1) the CIT will have to be an Islamic entity organized as a charitable trust that aims at promoting the growth and development of the *sukuk* industry; (2) the CIT will be acting as a genuine third party in the *sukuk* transactions thus ensuring that the link between the Sukuk holders and the obligor is not just a legal entity, and finally (3) the CIT will not just be in the business of bankruptcy remoteness, but in the business of *sukuk* investor representation, protection, and monitoring.

CONCLUSION

Like every young and developing industry, market size and reach are crucial issues for the *sukuk* market. This paper reveals an exciting and promising picture for these new and unique instruments. As of 2007, a total of 576 *sukuk* had been issued globally, with an issuance value of US$105.524 billion. Between 2001 and 2007, the number of *sukuk* issuances per year has been rising at a CAGR of 52 percent. In terms of value growth, the CAGR is 56 percent. Between 2005 and 2006 the increase in value is 86 percent, while between 2006 and 2007 the increase is 63 percent. In total, 81 *sukuk* (14 percent of a total of 576) have been listed on exchanges around the world, representing a value of US$37.4 billion.

While providing a snapshot of numbers and values in the *sukuk* market, this paper's main contribution is to identify standardization as a key strategic target for this industry and to suggest an institutional solution that could potentially become a crucial catalyst for lower fees and a wider mass market that encompasses small and medium sized players.

The paper proposes that standardization could be achieved through a trust entity that provides support to investors, issuers, and investment banks through SPV provision and pre-approved contracts. Indeed, the Central Islamic Trustee (CIT) does not provide a product-specific solution, but an infrastructural contribution.

The Central Islamic Trustee is conceived as a centralized institution of trust, providing the current *sukuk* structures with SPVs that are more than just mere legal formalities, but entities that are managed and centralized through a trustworthy and credible institution, truly managed as a third party. The CIT will have to act as a genuine third party in *sukuk* transactions, thus ensuring that the link between the *sukuk* holders and the obligor is not just a legal entity. It should be emphasized that the CIT will not be in the business of bankruptcy remoteness, but in the business of *sukuk* investor representation, protection, and monitoring.

The CIT will achieve lower legal and *shari'a* compliance costs through the development of standardized contracts and economies of scale. It would facilitate the supply of *sukuk* and provide necessary infrastructure for the entry of small and medium sized enterprises into the *sukuk* market. After all, the CIT will be acting as a trustee for investors and a variety of originators, providing them with issuer SPVs, making it a genuine third party in *shari'a* compliant transactions.

The *sukuk* market needs an institution like the Central Islamic Trustee in order to take a leap into a greater, wider, broader, and more credible future.

Islamic Securitization Market: The GCC Debt Market Turns *Shari'a*-Compliant

Hatim El-Tahir[1]

INTRODUCTION

Shari'a-compliant financial instruments have become increasingly popular in the Middle East and in particular in the Arab Gulf Council Countries (GCC). This is attributed to the ravenous need—of both sovereign and corporate enterprises—for capital to finance development projects in the region. The thrust of economic growth in the region has lifted business activities and corporate expansion. Surging oil prices generated unprecedented income surpluses. The gross domestic product (GDP) of the six states is estimated at $675 billion. This has meant an average GDP growth of 6.6 percent for the six nations, with the UAE and Qatar achieving a growth rate of 8.5 percent and 8.4 percent respectively.[2] At the forefront of this economic growth, the financial service industry continued to provide the necessary mechanism required to sustain growth and development in sectors of the economies. Banks expanded by leaps and bounds. More branches were opened to facilitate the growing need for financial services. GCC banks embarked on big expansions through network branching, which generated good returns to their stakeholders. The figures of return on equity (ROE) in 2006 varied from 2.75 percent to 6.94 percent, the latter being achieved by Al Rajhi Bank of Saudi Arabia.

The year 2007 was a happy year for the GCC region. GCC financial institutions adopted vital new strategies such as

[1] Manager of Training, Dubai International Financial Exchange, United Arab Emirates.
[2] "GCC Annual Banking Review," *Gulf News Quarterly Financial Review* 4, November 2007, pp. 54–62.

diversification, consolidation, product innovation, international integration (global *sukuk* issues), and indeed tapping on securitization. Moreover, the GCC states announced the launch of an economic common market or a GCC single market as of January 2008. Naturally, the Islamic financial industry continued to grow at the same pace and new players continued to enter the market to assume their role. The Islamic capital market thrived and introduced new innovative *shari'a*-compliant instruments. In the current wave of oil revenues and increasing demand for *shari'a*-compliant products, stakeholders are starting to realize the potential.[3] The market is set to continue to develop in 2008 and it is expected to be in excess of $1 trillion by 2010.[4]

AIMS AND OBJECTIVES

This paper will explore the merits of an Islamic Securitization Market (ISM) in the GCC region. It examines the market for, and usage of, debt and debt-based financial instruments and discusses how ISM continues to evolve through engineering innovative *shari'a*-compliant asset-backed instruments. The paper also investigates the role and impact of ISM in the emerging market of the Arab Gulf countries. The examination looks into the different structures of debt securities that have evolved and their usage. The discussion includes analysis of the factors underpinning their growth and popularity in the region. The regulatory and *shari'a* compliance challenges that impede their growth are also examined.

THE RISE OF GCC DEBT CAPITAL MARKET (DCM)

The financial and economic outlook in the GCC region is best described as rocketing—though this might look paradoxical in view of what the West is experiencing now with the credit crises and liquidity

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[3] Zamir Iqbal and Hiroshi Tsubota, "Emerging Islamic Capital Markets: A Quickening Pace and New Potential," Washington, D.C.: The World Bank, 2005.

[4] Interview with Edwin Ball, COO, Gulf Finance House, "Banking and Finance: Investment Banking," *Gulf News Quarterly Financial Review* 3, August 2007, pp. 22–24.

scarcity. In contrast, the GCCs' Sovereign Wealth Funds (SWFs), accumulated from oil revenues, bred new forms of indigenous Sovereign Investment Corporations (SICs). [5] This has been stimulated by economic reforms devised to entice foreign direct investment (FDI) in and out of the region. This has helped the internationalization of the new indigenous investment corporations. The Gulf SWFs and their investment corporations embarked on significant investment through the acquisition of several international firms. This new phenomenal growth in GCC's outward investment created a debt-based market. International financial institutions were eager to tap into this market and help further the process and provide the necessary mechanism for its growth. This move by the latter created the recognition and support needed to develop a Debt Capital Market (DCM) in the region. European and U.S investment banks were pivotal in the issue and underwriting of significant Gulf debt securities. Bond issues and Islamic *sukuk* issues soared to record highs.

The issuing of Dubai Bonds 2003 by the Government of Dubai in 2003 is considered to be the first issue of its kind in the Gulf region by a Gulf government. Moreover, Dubai's state-owned corporations pioneered bond and *sukuk* issues in the region. The foundation of the region's first financial free zone in 2004, Dubai International Financial Center (DIFC), has changed the region's capital market forever. The Dubai International Financial Center introduced international best practices of finance and investment. The independent standard setter, Dubai Financial Services Authority (DFSA), regulated the new financial center and introduced a regulatory framework in line with international standards and best practices. The world financial market embraced the new center and many key players obtained licences to operate in the Dubai International Financial Center. The number of licensed firms in the Dubai International Financial Center now exceeds 400 organizations. This includes a wide spectrum of financial institutions and supporting service providers. Subsequently, Bahrain and Qatar followed suit by introducing Bahrain Financial Harbour (BFH) and Qatar Financial Center (QFC) respectively. Many financial analysts view this replica move as a positive development, which will

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[5] The Sovereign Investment Corporations (SICs) phenomenon surfaced as a result of the accumulated Sovereign Wealth Funds generated by oil revenues. Examples include: Saudi Arabia General Investment Authority (SAGIA), Abu Dhabi Investment Authority (ADIA), Qatar Investment Authority (QIA), Kuwait Investment Office (KIO), and Dubai International Capital (DIC).

further boost the well-being of the Gulf capital market. In a recent report published by Reuters, the Dubai International Financial Center told Reuters that the region's Debt Capital Market (DCM) has the potential to be worth up to $250 billion in two to three years, from about $2.5 billion in 2007.[6] More borrowers are considering offering *sukuk* sales in Europe and the United States to gain better pricing for longer-term maturities.[7]

FACTORS UNDERPINNING THE GROWTH OF ISLAMIC DCM

Undoubtedly, the broad political and economic change in the region has contributed to the evolution of the Islamic capital market. The industry now encompasses a wide range of areas including corporate and project finance, Islamic investment funds, Islamic Real Estate Investment Trusts (IREITs), *shari'a*-compliant asset-backed securities, and *Waqf* Asset Trusts (WATs), to name a few. Among the specific factors worth noting are:

The Crux of Macroeconomics

The economic outlook remains positive with the petrodollars accelerating the rate of the infrastructure boom in the region. The economic expansion is expected to continue over the next few years supported by high levels of government investments in infrastructure and good macroeconomic management. Citibank reported that the GCC countries have accumulated a $750 billion surplus from oil revenues. The bank expects this to rise to $1.1 trillion by the end of 2008.[8] Saudi Arabia, the largest economy of the GCC, estimated a staggering US$800 billion expenditure for the next two decades to build mega-

[6] "Islamic Securitisation Market in Gulf Set for Massive Expansion," *Reuter*, August 16, 2007.
[7] "Interview with Arul Kandasamy, Head of Islamic Markets, Barclays Capital," *Emirates Today*, November 6, 2007.
[8] Citigroup Global Market, Equity Research, "Investing in the Middle East, Strategy Focus," November 16, 2007.

cities.[9] In the UAE, Dubai has led the way in services. It has become the favorite city for finance in the region. Dubai also continues to improve its leisure and tourism industry, which has generated a considerable contribution to its GDP. Unsurprisingly, the city maintains its leading role as the trade center for many Middle Easterners and African visitors. Kuwait and Qatar enjoy a similar growth rate in GDP as seen earlier. The latter has been one of the most dynamic GCC states. The development of Liquified Natural Gas (LNG) production and an open-door policy for foreign investment have been instrumental to the phenomenal economic development in Qatar. Its GDP growth is estimated to strike 8.5 percent in 2007.[10] Oman and Bahrain had lesser fortunes compared with other GCC members. The former's economy was slowed by the Cyclone Gonu disaster in the year 2007.[11] The damage was significant and it is certain that the country will have to spend significant sums of its oil surplus on infrastructure and rebuilding as a result of the damage caused by the crisis. Conversely, Bahrain's economy continued to perform well through economic diversification.

In addition, needless to say, the GCC's exchange policies remained unchanged and are set to continue at the same dollar-marriage system—de facto fixed currency pegs to the U.S. dollar—despite market rumors of possible divorce by the UAE and Qatar. The plan for a GCC single currency, expected in 2010, is moving closer to completion. Economic convergence is soon to be realized with the recent announcement of a GCC common market in 2008.

Undoubtedly, inflationary pressures in the GCC states are alarming and causing concerns in all quarters of the economy. It is interesting to see that governments are taking unfailing efforts to curb its effects on the economies. In the UAE, Qatar, Saudi Arabia, and Kuwait, governments have on many occasions reviewed civil servants' remuneration to reflect inflation. The weakness of regional currencies is also stirring discontent among migrant workers who make up the bulk of the labor force in the GCC countries. After the recent incident of South Asian workers' riots in Dubai over savings lost due to the dollar's slide, the UAE Central Bank governor, Sultan Nasser Al-Suweidi, admitted that he was under growing social and economic

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[9] "GCC Economy Report," *Gulf News Quarterly Financial Review*, November 2007, p. 45.

[10] Ibid., p. 57.

[11] Cyclone Gonu, also known as Super Cyclonic Storm Gonu, was the strongest tropical cyclone on record in the Arabian Sea.

pressure to drop the peg.[12] But in general, the strong and improving financial strength of the GCC governments give them considerable room to maneuver.[13]

Catalyst of Microeconomics

In this strongly growing economy of the GCC region, corporations prospered and grew to new highs. This growth comes from a variety of sources. Banks have expanded their activities and made good returns, as noted earlier. Real estate developers embarked on large-scale residential and commercial developments. Infrastructure and investment development projects also helped small and local business activities and created long-term employment in many sectors of the economy.

Subsequently, the development was crowned by a more active involvement of global financial institutions in the region, primarily via operations in Dubai. This created more market makers of local stock markets and resulted in the launch of investment research on companies.[14] A vital supportive factor is the strategy of "peripheral growth" in neighboring emerging markets in the wider Middle East and North Africa (MENA) and Indian Subcontinent regions. Emaar Properties and the telecommunication giant Etisalat of the UAE are among the most active in cross-border expansion.

Risk Factors

Given the scale of the dependency of many GCC corporations (especially in the UAE, Qatar, and Bahrain) on real estate and its supporting services, fears have surfaced over the risk of future oversupply in the residential and commercial developments. Any slowdown in demand could create supply-demand disequilibrium, resulting in a correction that could in turn have a negative impact on

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[12] Babu Das Augustine, "UAE Talks Tough on Price Rises as Pressure Mounts," *Gulf News*, 3 December 2007.
[13] Moody's Investors Service, "Global Credit Research, Potential Changes in the GCC Exchange Rate Policies," January 2007.
[14] Andrew Howell and Shakir Iqbal, "Investing in the Middle East," Citigroup Global Market, Equity Research: Citigroup, 16 November 2007.

other parts of the economy as well as on the good of corporations and enterprises.

THE ROLE OF *SHARI'A*-COMPLIANT DEBT-BASED INSTRUMENTS IN THE GCC

Islamic debt-based instruments now make up a considerable percentage of the region's debt market. In the UAE, semi-government investment corporations—largely investing in real estate—such as Nakheel and Emaar are tapping into the *sukuk* market. This pattern is also experienced in Qatar, Bahrain, and Saudi Arabia. The Dubai International Financial Center's (DIFC) investment arm, DIFC Investments, had listed a US$1.25 billion *sukuk* issue in the Dubai International Financial Exchange (DIFX). The five-year issue has attracted more than US$2 billion in orders. More than two-thirds of the subscriptions came from outside the Middle East region, with 54 percent of subscribers being banks and 35 percent being fund managers.[15] Table 1 charts the recent *shari'a*-compliant corporate issues in the GCC. The GCC total issues of *sukuk* in 2007 amounted to US$16.2 billion. This represents 19 percent of the worldwide total US$87.4 billion issues. The trend is expected to continue over the next few years.

Two observations can be made here. First is the growing Islamic mortgage finance market, which creates increasing *shari'a*-compliant capital requirements in the region. The demographic change in the region and the land law reforms created numerous demands for homebuyers, in particular from expatriates, who were denied this right of ownership in the past. Statistics that might indicate the size of this market in the region are unavailable, but individual countries have estimated their needs on varying methodological forms. The value of mortgages in the UAE nearly doubled to $12.5 billion in the first half of year 2007.[16] The largest potential remains with Saudi Arabia due to its size and population. No accurate figures are available to determine the true current demand for mortgage finance, but housing finance is estimated at a mere 2 percent of the GDP.[17] The second is the growing demand for project finance in the region. Governments continue to

[15] IntelliNews, "Islamic Bond Report," July 2007.
[16] *Gulf News*, Gulf Annual Banking Review, November 2007, p. 31.
[17] Ibid.

announce new mega-projects in the oil, gas, and petrochemical sectors, as well as in real estate and infrastructure development. Equally, the increasing role of the private sector in the GCC infrastructure created significant demands for *shari'a*-compliant financing. Traditionally, the dominant family-owned private sector advocates *shari'a*-compliant investment. History tells us that almost all the Islamic banks were started by private investors who preferred their business to be financed in compliance with *shari'a*.

Table 1: GCC Islamic Corporate Issues: 2007

Issuer	Country	Lead Manager/ Bookrunner	Type of Issue	Value in US$ million
Tamweel PJSC	UAE	Barclays Capital	Exchangeable *Sukuk*	300
Jebel Ali Free Zone FZE (JAFZ)	UAE	Barclays Capital Deutsche Bank Dubai Islamic Bank Lehman Brothers	*Sukuk Al-Musharaka*	2,042
Dubai International Fin Center	UAE	NA		1,000
The Nakheel Group	UAE	JP Morgan	Exchangeable *Sukuk*	750
RAK Properties	UAE	NA	*Sukuk*	1,500
Dana Gas	UAE	JP Morgan	*Mudaraba*	1,000
Omniyat Holdings	UAE	NA	*Sukuk*	150
Ras Al Khaimah Investment Authority	UAE	Credit Suisse HSBC Amanah National Bank of Dubai	*Sukuk Al-Wakala*	325
Thani Investment Group	UAE	Emirates Islamic Bank Liquidity Management Center	*Sukuk Al-Musharaka*	100
Total UAE Issues				**7,167**
Saudi Basic Industries Corp. (SABIC)	S. A.	NA		1,336

Saudi Electricity Company (SEC)	S. A.	-		1,336
Zamil Group Holding Company	S. A.	-	*Sukuk Al-Ijara*	1,000
Dar Al-Arkan Real Estate	S. A.	-		1,000
Total Saudi Arabia Issues		**-**		**4,672**
Kuwait Resorts Company	Ku-wait	Kuwait Financial Center	*Sukuk Al-Ijara*	50
Abyaar Real Estate Development	Ku-wait	Merrill Lynch	*Murabaha*	700
Total Kuwait Issues				**750**
Doha Bank	Qatar	Doha Islamic	*Sukuk*	1,000
Qatar Real Estate Investment Company (Alaqaria)	Qatar	NA	*Sukuk*	270
Qatar Real Estate Investment Company (Alaqaria)	Qatar	-	*Sukuk*	300
Barwa Real Estate	Qatar	-	*Sukuk*	800
Total Qatar Issues		**-**		**2,370**
Bahrain Islamic Bank	Bah-rain	-	*Sukuk*	1,000
Gulf Holding Company	Bah-rain	-	*Sukuk*	NA
Bahrain Financial Harbor	Bah-rain	Liquidity Management Ctr	*Sukuk Al-Ijara*	250
Total Bahrain Issues				**1,250***
Total GCC Issues				**16,209**

Source: Utilized different sources including IFIS's *Sukuk* Report, 2007.
* not including the Gulf Holding Company.

THE NEED FOR ISLAMIC SECURITIZATION OR *SHARI'A*-COMPLIANT INSTRUMENTS

A recent report reveals that the issuing of asset-backed Islamic bonds is likely to surge in the Gulf as growing assets and new laws allow many of the region's rapidly expanding firms to borrow more cheaply.[18]

Asset-Based Versus Asset-Backed

Most of the issued *shari'a*-compliant bonds and *sukuk* have been asset-based. Their returns are derived from underlying assets to comply with Islam's ban on interest. However, note holders only have recourse to the borrower, not the assets, in case of a default. On the other hand, in asset-backed and securitized bonds, including *sukuk*, the note holder has recourse to the assets, potentially making the debt more secure. The assets used in a securitization can be rated independently of the borrower, giving their bonds a higher debt rating than for the borrower themselves, making borrowing cheaper. Moody's senior credit officer, Phillip Lotter, claims "the structure is particularly suited to firms with significant assets, or those hoping for credit enhancement over a lower rating the company itself might otherwise achieve."[19]

STRUCTURES OF *SHARI'A*-COMPLIANT ASSET-BACKED INSTRUMENTS

Shari'a-compliant asset-backed notes (*sukuk*) are generally issued by sovereign governments, banking institutions, and corporate enterprises. The commonly used types or structures are: *sukuk al-ijara*, *sukuk al-murabaha*, *sukuk al-mudaraba*, and *sukuk al-musharaka*. Figure 1 illustrates the structure of the *ijara sukuk*, while Figure 2 shows the basic Islamic securitization structure.

[18] "Islamic Securitisation Market in Gulf Set for Massive Expansion," *Reuter*, 16 August 2007.
[19] Ibid.

Figure 1

The Structure of *Ijara Sukuk*

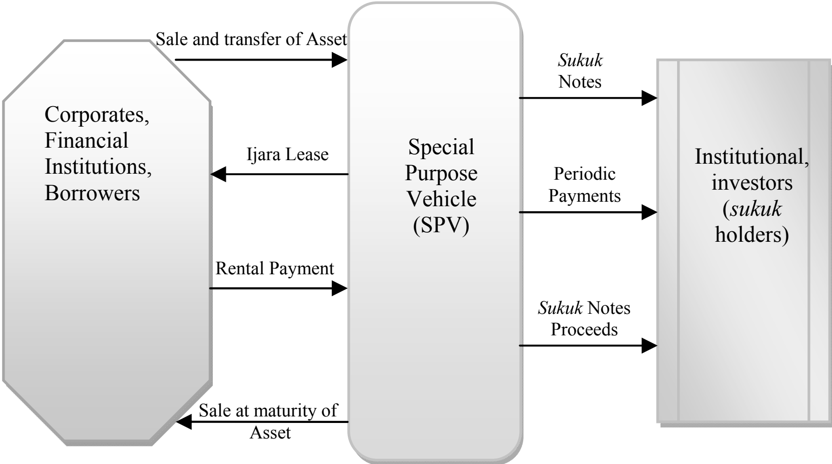
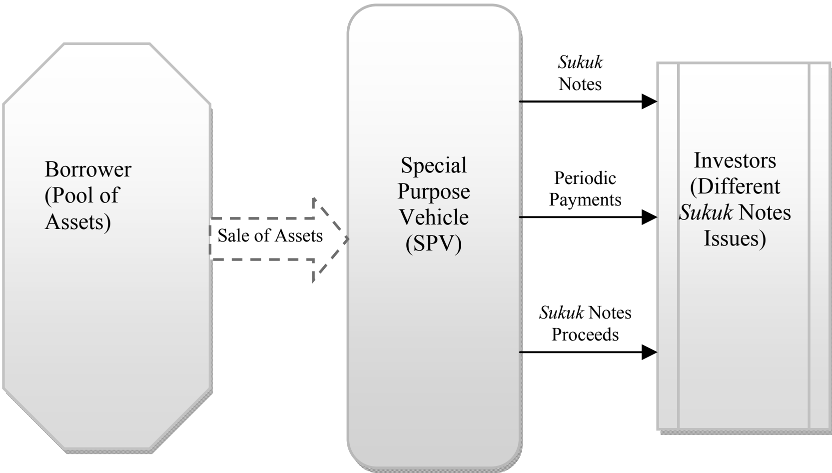


Figure 2

Basic Islamic Securitization Structure



A milestone development in the region is the recent launch in of the Emirates National Securitization Corporation (ENSC), the UAE's debut in asset-backed securitization. The firm is a specialized

structuring and advisory organization focused on the securitization and structured products arena of the international capital markets. ENSC has structured two major asset-backed securities including Tamweel Residential ABS. The issue is the first internationally-rated, residential asset-backed securitization issued in the Middle East.

REGULATORY AND COMPLIANCE ISSUES

The growth opportunity, as well as the challenges facing the rise of the Islamic securitization market (ISM) in the global financial market, have raised public policy issues in the jurisdictions in which they operate and internationally. These have led international standard setters, national regulatory authorities, law firms, policy makers, and academics to examine various aspects of Islamic financial systems and institutions, each from their own perspective. Focus has been directed notably on Islamic financial institutions' (IFIs) risk management practices, the broad institutional environment in which they operate, and the regulatory framework that governs them.[20] In the GCC, for instance, the mortgage finance market offers great potential for asset-based securitization finance. What is required from the GCC governments is to improve laws and regulations that govern land ownership by foreign entities or investors. The land registry laws and regulations cause great concern for rating agencies, investors, law firms, and issuers alike. The Government of Dubai has made strenuous efforts to introduce new land registry laws that conform to international best practice and cater to local demographic requirements. Similar work has been done in Abu Dhabi, Qatar, Bahrain, and to a lesser degree in Saudi Arabia. The challenge is to sustain growth in this important sector and provide the necessary regulatory framework that ensures its integrity and growth.

The Islamic finance industry in general has been positively engaged in dialogue and debate aimed at educating investors, issuers, and stakeholders of its merits and value propositioning. More importantly, the industry policy makers set practice standards in line with international best practices. Equally, international regulators recognized the Islamic finance industry as a major economic driver not only in the Muslim world but also in Europe, the United States, and

[20] Dahlia El-Hawary, Wafik Grais, and Zamir Iqbal, *Regulating Islamic Financial Institutions: The Nature of the Regulated*. Washington, DC: The World Bank, 2004.

elsewhere in the world. Michael Ainley of the Financial Services Authority (FSA), UK, noted that "what is important for the wider acceptance of Islamic banking in developed countries is the harmonization of standards . . . the FSA is happy to participate in discussion seeking to reconcile Islamic and Western standards."[21] Rodney Wilson asserts that "many Western bankers view Islamic finance as a curiosity, and perhaps even a business opportunity . . . it can be regarded as an area in which those from the West can engage in dialogue with Muslims."[22]

Another important factor that improved regulatory systems in the region is the creation of an onshore, free zone financial center in Dubai. The Dubai International Financial Center's initiative led to greater change in the region. The industry's view is that many other countries in the GCC responded to legal and regulatory changes introduced by the Dubai International Financial Center. Saudi Arabia's new Capital Market Authority (CMA) set another example of introducing international standards in the region. Bahrain Monetary Agency (BMA) revamped to become the Central Bank of Bahrain (CBB) and introduced a new regulatory framework including the Islamic business rules. Oman has similarly established a new financial regulator in the country, the Capital Market Authority (CMA). Qatar Financial Center (QFC) is perhaps the most obvious response to Dubai International Financial Center.[23] The difference is that the Dubai International Financial Center (DIFC) is a free financial zone that is regulated independently by Dubai Financial Services Authority (DFSA). The other GCC regulators tend to perform the role of a single regulatory system in each country.

Moreover, it is also evident that the Islamic finance industry is working on greater harmonization in *shari'a* research and *fatawa*, which could lead to standardized contracts and better understanding among investors, issuers, regulators, and stakeholders at large. This should make the task of compliance much easier than in the current situation.

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[21] Interview with Michael Ainley, the FSA, UK, *Gulf News Quarterly Financial Review* 3, August 2007, pp. 12–15.
[22] Rodney Wilson, "Where East Can Meet West in Warm Embrace," *Gulf News Quarterly Financial Review* 3, August 2007.
[23] Niall O'Toole and Ashley Painter, "Pursuing Excellence," *Gulf News Quarterly Financial Review* 3, August 2007, pp. 19–20.

CREDIT RATING AND RISK ASSESSMENT

A number of questions arise when we consider corporate credit rating (CCR) or issue rating and risk assessment in the GCC. How would corporations and governments benefit from seeking lengthy, costly, and difficult rating processes? Is it worth it? There has been a lot of development as far as the practice is concerned. GCC corporations and government sovereigns sought issue-ratings to meet international standards and requirements when they consider issuing securities in the international financial marketplace. Early in 2008 Moody's Investor Services established their MENA office in the Dubai International Financial Center (DIFC) and Standard & Poor's was set to make a similar move by the end of 2008. However, what is important for the GCC corporations is to continue improving their management systems and corporate governance frameworks. The latter is lacking in almost all of the GCC enterprises as well as in the Middle East in general. The Dubai International Financial Center envisaged the importance of corporate governance and boldly set up the Institute of Corporate Governance—Hawkamah. The Institute is working with international organizations such as the World Bank's International Financial Corporation (IFC) to develop a framework that works for the MENA region and to adopt the international best practice in corporate governance. The Hawkamah has already embarked on an educational program and a series of workshops in the UAE and elsewhere in the region.

Another important factor is that most rating agencies view *shari'a*-compliant instruments as being no different from their conventional counterparts. Fitch Ratings considers that the majority of risks in *sukuk* instruments are no different from those seen in the bond structures. However, it claims that *ijara sukuk* will likely be the preferred choice by corporations.[24] What matters more to the rating agency is whether the lease obligation in *sukuk* structures ranks equal to the issuer's other conventional debt obligations.[25] Moody's view is no different. Its rating process connotes that "the building blocks of finance are the same: Cash flows, Risk, Return, Losses, Contracts, Rights, Obligations,

[24] Fitch Ratings, "Demystifying Corporate *Sukuk*," Fitch Special Report, March, 2007.
[25] Ibid.

Assets, etc."[26] Moody's approach to rating mortgage-based securities in the wider region of Middle East combines the use of Moody's Individual Loans Analysis (MILAN) model for portfolio analysis—which determines the credit enhancement relating to specific category—and a cash flow model such as Moody's Analyser of Residential Cash Flows (MARCO). Each of the markets requires specific parameters and inputs, reflecting, for example, potential changes in property prices, regional concentration, and the length and cost of foreclosure procedures.[27] In a recent industry-briefing event organized by Standard & Poor's Corporate Ratings in GCC, the rating agency emphasized its methodology in two broad categories, business risk and financial risk. The rating agency also considers corporate governance, country risk, and ownership structures as vital parts of the process.[28] In its second quarter report, the rating agency raises concerns about the lack of investment risk management among Middle Eastern issuers.[29]

The Fitch ratings recently assigned the Government of Abu Dhabi a long-term issuer default rating of AA, just two notches away from the best possible rating of AAA. It made the Emirate the highest-rated sovereign in the Gulf.[30] Likewise, Moody's Investor Service provided significant sovereign and corporate rating services. Table 2 shows the GCC demand for rating while Table 3 lists recently rated corporations in the region.

[26] Khalid Howladar, "Rating *Shari'a Sukuk* Workshop," DIFX Academy, Dubai, November 2007.

[27] Moody's Investors Service, "Moody's Approach to Rating RMBS in Emerging Securitisation Market—EMEA," June 2007.

[28] Peter Tuving, "Corporate Ratings in GCC Workshop," Presentation at Standard & Poor's Conference, Dubai, United Arab Emirates, April 2007.

[29] Standard & Poor's, "Middle East Outlook," *Standard and Poor's Quarterly Report*, Second Quarter 2007.

[30] Charles Seville, "Setting Benchmarks for Growth," *Gulf News Quarterly Financial Review* 3, August 2007, pp. 32–34.

Table 2: GCC Demand for Rating

Country	Bank	Corporate	Sovereign	Securitization	Total	New 07
Bahrain	8	1	3	0	12	1
Kuwait	9	1	2	0	12	2
Oman	6	1	2	1	10	3
Qatar	3	6	2	0	11	2
Saudi Arabia	11	3	2	0	16	4
UAE	13	10	3	3	29	12
Total	**40**	**22**	**14**	**4**	**90**	**24**

Source: Moody's Investors Service, 2007.

Table 3: Moody's Recent GCC Ratings

Country	**Corporate**	**Rating**	**Country**	**Corporate / Govt.**	**Rating**
Bahrain	Golden Belt 1 *Sukuk* Company	Baa1	**Saudi Arabia**	Saad Group Limited	(P) Baa1
				Saad Trading, Contracting Fin. Servicing Company	Baa1
Kuwait	Boubyan Bank	Baa2		Saudi Basic Industries Corporation (SABIC)	A1

	National Industries Group Holding NIG	Baa2		Saudi Orix Leasing Company	Ba1
Oman	Oman Power & Water Procur. Co	A2	**UAE**	Abu Dhabi Government	Aa2
	Bank Dhofar	A3		DIFC Investments	A1
Qatar	Qatar Fertiliser Company (SAQ)	Aa2		DP World	A1
	Qatar Real Estate Investment Co.	A2		Dubai Electricity & Water Authority	A1
	-			Dubai Holding Commercial Operations Gr LLC	A1
	-			Dubai *Sukuk* Center	A1
	-			EMAAR Properties	A3

Source: Moody's Investors Service.

CONCLUSION

Although the Islamic securitization market is in its infancy stage, the GCC capital market—given its current strong economy and future potential—offers a significant incubator platform for growth and development of innovative and highly sophisticated products. The relatively quick globalization of *sukuk* issues and its diversified participation as a new investment asset class could be repeated in the *shari'a*-compliant asset-backed instruments. The prospect of its growth and integration into the mainstream of international capital market depends on three main factors:

1. GCC financial regulators continuing to improve legislation and business rules that match international financial markets, including property laws, arbitration and enforcement laws, corporate governance, and risk management in investment, to name a few.

2. Policymakers continuing to encourage—through economic incentives—the participation of global financial institutions in the structuring, underwriting, and issuing of these instruments.

3. GCC financial institutions could leverage from the peripheral growth opportunities offered by adjacent emerging markets in the Indian subcontinent and MENA. Historically, the GCC built strong political, social, and economic ties with countries of the two regions. Although regulatory and investment legislation in these countries may not meet international investors' expectations, a local GCC corporate guarantor can readily be structured into the deal to overcome this problem.

Part IV

Islamic and Socially Responsible Investment

Breaking the Formalist Deadlock? Islamic Investment and Corporate Social Responsibility

Kilian Bälz[1]

TWO MACRO-LEVEL TRENDS

The purpose of this paper is to examine two macro-level financial practices, Islamic investment and socially responsible investment. Islamic investment is defined as investing in accordance with the principles of Islamic law (*shari'a*). It is one aspect of Islamic finance. Socially responsible investment means investing in accordance with ethical principles. Socially responsible funds promote sustainable development and environmental protection. Socially responsible investment is one aspect of corporate social responsibility, the idea that a corporation has a social responsibility extending beyond the responsibility towards its shareholders. Corporate social responsibility and socially responsible investment both have attracted a lot of attention recently. Upon the initiative of former Secretary General Kofi Annan, the United Nations in 2000 launched the United Nations Global Compact, with the intention of spreading the idea of corporate social responsibility in the corporate world.[2] The European Union followed suit, issuing a Green Paper on corporate social responsibility in 2001.[3]

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[1] The author is Attorney at Law, Frankfurt/Main and Cairo. Research for this paper was carried out in spring 2008 while the author was a research fellow at the Islamic Legal Studies Program of Harvard Law School. He is indebted to Harvard Law School for the institutional support it provided. In addition, he wants to extend his thanks to the directors Baber Johansen, Peri Bearman, and Nazim Ali.

[2] On the activities affiliated with the UN Global Compact and its underlying principles and goals see:

Socially responsible investment and Islamic investment have one important feature in common: under both regimes, the investment decision is partly based on non-economic criteria. Both socially responsible investment and Islamic investment testify to a global "correctionist striving" in which ethics are introduced to economic decisions. In light of these criteria, it does not come as a surprise that socially responsible investment often is discussed in the context of Islamic finance, and, vice versa, Islamic finance has been viewed as a form of socially responsible investment. Moreover, it has been suggested that a rapprochement between Islamic investment and socially responsible investment might provide a cure for one of the most pressing issues in Islamic finance, namely that the industry at times is more concerned with formal adherence to Islamic legal rules instead of promoting alternative, specific Islamic business values. This is what I refer to as the "formalist deadlock": in present day Islamic finance, form can often prevail over function. Instead of implementing specific Islamic business values, the industry follows a formalist interpretation of Islamic law, which allows it to disguise conventional financial products in a *shari'a* -compliant form.

In this paper I want to explore if and how the concept of socially responsible investment can help to overcome this situation. I will isolate areas in common between socially responsible investment and Islamic investment and attempt to figure out what one area can learn from the other. Contrary to what has occasionally been claimed,[4] I will argue that Islamic investment and socially responsible investment are two different concepts with only a limited overlap. This implies that socially responsible investment cannot be expected to cure the alleged flaws of Islamic finance. However, Islamic investment and socially responsible investment tend to raise similar sets of issues and questions. Enhancing cooperation between these two fields can therefore nevertheless be beneficial—and I will come up with some

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http://www.unglobalcompact.org/AboutTheGC/index.html (accessed May 8, 2008).

[3] European Commission—Employment & Social Affairs, *Green Paper Promoting a European Framework for Corporate Social Responsibility,* July 2001, http://ec.europa.eu/employment_social/soc-dial/csr/greenpaper_en.pdf (visited on May 8, 2008).

[4] For a typical argumentation see Blake Gould, "Social Responsibility and Islamic Finance," available at http://investhalal.blogspot.com/2008/04/social-responsibility-and-islamic.html (accessed March 9, 2009).

concrete suggestions on what Islamic investment can learn from socially responsible investment.

THE "FORMALIST DEADLOCK" AND THE CALL FOR A REVIVAL OF SUBSTANTIVE VALUES IN ISLAMIC FINANCE

The tremendous success of the Islamic finance industry in recent years has been accompanied by increasing unrest and dissatisfaction with how Islamic financing transactions actually are implemented. Critical voices tend to emphasize that Islamic finance largely is limited to mimicking *shari'a*-compliant versions of conventional financial products, and that the industry has failed to establish a financial system actually based on different, genuine Islamic values.[5] This becomes clearer when looking at recent debates on *sukuk* and *tawarruq*, in both of which the Harvard Islamic Finance Project was involved:[6] in both cases the concern was raised that the practice of Islamic finance has departed from genuine Islamic economic principles—in particular the concept of risk sharing—and has designed structures imitating conventional structures in terms of function and allocation of risk; only the legal means to achieve this structure are different, in order to formally satisfy *shari'a* requirements.

I will present two hypotheticals to illustrate the discomfort with a simply formal application of Islamic legal rules: Would Islamic finance have prevented the credit crisis? And would Islamic finance enhance carbon trading? Both questions, which are presently being debated in Islamic scholarly circles, illustrate the issues related to a formal application of Islamic legal rules.

(i) Case Study 1: Would Islamic finance have prevented the credit crisis? Potentially. But for the right reasons?

The credit crisis is a complex phenomenon and this is not the right place to go into the details. For the purpose of this paper it

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[5] For a forceful critique of alleged formalism in Islamic finance see Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics and Practice*, Cambridge: Cambridge University Press, 2006.

[6] See materials from the 2007 workshop on *Tawarruq* at http://ifptest.law.harvard.edu/ifphtml/ifpseminars/WorkshoponTawarruq.pdf; the website for the 2008 workshop on *Sukuk* is now being prepared.

is sufficient to point out the major factors that contributed to this devastating development. Fundamentally, the crisis is due to the fact that (1) banks granted loans to house buyers with a low creditworthiness secured only by a mortgage ("subprime lending") and (2) that the loans were securitized, repackaged as mortgage based securities ("MBS") or collateralized debt obligations ("CDOs"), and sold to investors all over the world (due to repackaging, the risk structure became very opaque). When home buyers, due to rising interest rates, could no longer repay the loans, banks found out that the value of the mortgaged property did not provide sufficient security. The system collapsed and, due to the globalization of the secondary market, sent shockwaves around the globe.

Shari'a principles arguably would have posed considerable constraints on the securitization and trading of the loans, as the exchange of one debt for another generally is held impermissible under *shari'a* law.[7] This makes securitization structures difficult to implement, unless they are asset-based. An application of Islamic financial rules, therefore, would have prevented the credit crisis, an argument that is regularly put forth in Islamic financial circles.[8] However, it remains questionable whether Islamic finance would have actually addressed the problem underlying the credit crisis, namely that (1) the asset used as security was not sufficient to secure the debt and (2) that no thorough analysis of creditworthiness of the debtor had been made ("subprime lending"). Although Islamic finance might have prevented the crisis from a purely practical standpoint through its limitations on securitization, it still would not alleviate more fundamental issues of subprime lending.

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[7] For an exposition of the rules of *fiqh*, see Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Risk, Religion and Return,* Boston: Kluwer Law International, 1998, pp. 114–125.

[8] See, e.g., "Islamic Finance can Solve Global Crisis, Says Scholar," *Arab News*, April 24, 2008, available at http://www.arabnews.com/?page=6§ion=0&article=109247&d=24&m=4&y=2008 (accessed May 6, 2008).

(ii) Case Study 2: Would Islamic finance endorse emission trading?

Emission trading, as envisaged in the Kyoto Protocol, is among the key instruments for combating climate change. In simple terms, emission trading (the system also is known as the Clean Development Mechanism or "CDM") is based on a limitation of carbon emissions by setting a ceiling for permissible emissions and allocating emission rights to individual polluters. These rights are tradeable, so that a polluter not fully using its allowance can sell the pollution rights to another polluter. Environmentalists disagree on whether emission trading will save the planet (it is argued that the ceilings are too high and that the trade in emission rights may encourage an increase of emissions rather than a cut-back, depending on where prices settle).[9] In any event, there seems to be a consensus that this is a step in the right direction and there seem to be no really practical alternatives. What would Islamic finance say? This is not merely a hypothetical question, as emission trading is high on the agenda of most international financial institutions (and some Islamic financial institutions have started to devise relevant structures, too).[10] Under Islamic law, the trade in emission rights poses a whole set of problems, including (1) whether an allowance constitutes property (*mal*), if not framed by a contract, (2) if an allowance relating to a time period in the future can be sold (this might be deemed unlawful speculation—*gharar*), and (3) whether the right to pollute the environment constitutes *mal mutaqawwam*, i.e., can be legally traded.[11]

Although coming to a definite conclusion on the permissibility of emission trading is beyond the scope of this enterprise, there

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[9] For a critical assessment of the CDM, see, e.g., Melanie Jarman, *Climate Change,* London: Pluto Press, 2007, pp. 45–66.

[10] "Doha Bank to Trade Carbon Emissions the Islamic Way," *Arab Environment Watch*, October 14, 2007, http://www.arabenvironment.net/archive/2007/10/350490.html (accessed May 7, 2008).

[11] On the *fiqh* rules relating to property, see Vogel and Hayes, *Islamic Law and Finance,* pp.94–95.

is a general sense in the Islamic scholastic community that emission trading would pose several significant problems. First, there is the issue of whether these rights could be legally traded, and next, whether the trading of future rights is permissible, Again, the conclusion is: Islamic finance would most likely ban emission trading, but not because of a disagreement with the CDM as provided for in the Kyoto Protocol, but because a formal interpretation of Islamic legal principles makes it difficult to accommodate emission trading schemes. Again it is arguable that Islamic finance would ban emission trading for the wrong reasons.

Both examples, the credit crisis and emission trading, show that an application of Islamic legal rules may lead to results that are primarily driven by legal technicalities and not underlying values. Does the concept of socially responsible investment provide a cure? Would a rapprochement between socially responsible investment and Islamic finance help to overcome the formalist deadlock?

ISLAMIC INVESTMENT AND SOCIALLY RESPONSIBLE INVESTMENT COMPARED

In order to investigate what socially responsible investment can contribute to Islamic investment, I will first analyze what both currents have in common and what separates them. On that basis, I will then proceed to discuss what Islamic investment can contribute to socially responsible investment and vice versa.

Socially responsible investment and Islamic investment have the following features in common:

(i) *Investing in accordance with values:* The investment decision is partly based on non-economic criteria. The paradigm "risk and return," which underlies any investment decision, is enriched with an ethical component. Islamic investment and socially responsible investment both can be termed "ethical investment" in the sense that they claim to abide by certain ethical/religious principles.

(ii) *Advisory bodies foster legitimacy:* Typically, the investment company would entrust a board of external advisors (in the case

of an Islamic fund, the *shari'a* board) with bringing in the ethical/religious values. Normally, there would be a division of labor between the fund manager on the one hand (in charge of the financials) and the ethical/religious advisors (in charge of ethical/religious compliance) on the other.

(iii) *Juridification of Ethical Principles:* Both Islamic investment and socially responsible investment result in a juridification of ethical (extra legal) principles, in the sense that ethical principles are being integrated into a contractual arrangement with the effect of becoming legally binding among the parties. A typical example for such a juridification of ethical rules would be the screening procedure of socially responsible and Islamic funds. Ethical rules become legally binding for the parties concerned.

(iv) *Negative Screening:* Traditionally, the screening procedures have been negative (i.e., excluding certain non-permissible investments). Certain investments are excluded. Although both Islamic investment and socially responsible investment share a certain vision (the "Islamic economic order" and "sustainable development" respectively), they normally would have a negative selection on the implementation level. Recently a shift toward a positive investment policy can be observed, where funds either use their shareholdings in order to influence corporate behavior or selectively invest in companies active in certain areas (including the "best of class" approach, where investments target companies that which are most advanced in terms of social responsibility in their industry).

(v) *Liberality:* Liberality, in the sense of donations to charities or the common good, is employed as a means to purify the assets. Both socially responsible and Islamic funds typically provide that a certain percentage of the income (reflecting "impure" activities) has to be given to charity.

(vi) *Shared Values:* There is a certain overlap of values with regard to the investment policy. Both socially responsible and Islamic funds tend to abstain from investments in morally questionable industries such as alcohol, gambling, prostitution, and pornography. Although coming from an entirely different

background, Islamic investment and socially responsible investment have certain values in common.

There is certainly room for cross-pollination between socially responsible investment and Islamic investment. The commonalities suggest combining socially responsible investment and Islamic investment as "ethical investment," in particular as far as regulatory, legal, and tax issues are concerned. Whereas the first Islamic investment funds set up in the West may have benefited from the experience in socially responsible investment, now the situation has changed and I believe that socially responsible investment benefits from the growth in and the technological development of Islamic investment. Both Islamic funds and socially responsible funds, for instance, must cope with a fair amount of pluralism regarding the ethical principles guiding the investment policy. Here, Islamic funds in the meantime have developed a set of mechanisms to deal with divergent interpretations of the *shari'a* (and the effect that what qualifies as a *shari'a*-compliant investment from the perspective of one scholar does not need to be compliant from the perspective of another—also termed *shari'a* risk).[12]

There are, however, certain issues that distinguish socially responsible investment from Islamic investment:

(i) *Rules and Values:* Socially responsible investment puts emphasis on values, whereas mainstream Islamic investment tends to be rule-oriented (in the sense that it requires adherence to a formal

[12] The juridification of ethical principles that are open to a pluralist interpretation actually entails intricate legal issues on the documentation level. If a certain investment is sold with the claim to comply with certain religious/ethical principles, the question arises whether it can amount to misselling (with the liability on the side of the fund or sponsor) if the investor can demonstrate that the ethical pledge is not correct. In legal practice, therefore, offer documents regularly contain a "risk factor" pursuant to which the fund/sponsor points out that religious/ethical standards are open to interpretation and normally are not unanimously shared, that the fund/sponsor follows the advice of a certain body regarding religious/ethical permissibility, and that it encourages the investor to form an opinion of its own. As a result, the juridification again is partially reversed. I have discussed this aspect in more detail in my paper "Shari'a Risk: How Islamic Finance has Transformed Islamic Contract Law," which is forthcoming as an occasional paper of the Islamic Legal Studies Program.

interpretation of *shari'a*). What this entails can be seen by looking at recent innovations in the respective fields.

Traditionally, socially responsible funds have employed a "negative selection" (or screening method) where certain companies and industries are excluded from the investment universe. This method increasingly is seen as inappropriate, mainly because it does not account for attempts by certain "unclean" industries (e.g., the oil industry) to make steps toward improving environmental friendliness. To remedy this situation, the "best in class" approach has been introduced, which abandons a formal application of negative screening principles in favor of an evaluation of companies in light of the industry environment they operate in.[13] The result is that a company can qualify as a permissible investment even if it is active in a non-acceptable industry—provided that it is engaged in steps toward the right direction. This approach is based on a value judgment as opposed to a formal application of rules and recognizes the will to improve in a non-perfect world. It simultaneously demonstrates what I mean by socially responsible investment being value based as opposed to rule based: the overarching goal (to promote environmental friendliness) overrides the strict application of rules (negative screening criteria). A company active in an unclean area of business qualifies as a permissible investment provided it makes efforts in the right direction.

The situation is quite different in Islamic finance, as becomes obvious when looking at the attempts to structure *shari'a*-compliant fixed income products, such as the structure proposed by Dar al Istithmar in the "White Paper" published last year.[14] The structure proposed in the White Paper is based on creative legal reasoning and is beautifully crafted. It intends to tackle one

[13] Australian Government, Department of the Environment, Water, Heritage and the Arts, "Socially Responsible Investing: Your Questions Answered," available at http://www.environment.gov.au/settlements/industry/finance/publications/respon-investment.html (accessed May 7, 2008).

[14] See http://www.deutschebank.de/presse/en/content/press_releases_2007_3347.htm (accessed May 5, 2008).

of the most pressing issues in product development and does so by bringing together different legal and economic perspectives. However, it avoids addressing directly the issue whether there may be a fixed return on an investment and how this is consistent with the general principle of Islamic finance that any return must be based on sharing of business risk.[15] This also differentiates the approach of Dar al Istithmar from the way other Islamic scholars have treated the issue (including Muhammad Abduh and the former Egyptian Muftî Tantâwî, who both opined that under certain conditions the investors' profit share under a *mudaraba* contract may be fixed, as this would not inflict any harm on either party).[16]

To conclude: socially responsible investment tends to put more emphasis on values, whereas mainstream Islamic finance prefers to adhere to legal principles. This may be an important difference between socially responsible investment and mainstream Islamic finance. However, it is not a suitable remedy for breaking the formalist deadlock. It only pinpoints the problem, without offering a solution.

(ii) *Where are the Stakeholders?* Corporate social responsibility, as the overarching concept embracing socially responsible investment, is stakeholder oriented as opposed to rule oriented. Corporate social responsibility grew out of the idea that under U.S. company law, management decisions of a corporation will primarily be oriented toward the shareholders' interests (what is termed the shareholder approach). This at least is the general principle. A company is owned by its shareholders, who have entrusted capital to the management. Management, therefore, owes a fiduciary duty toward the shareholders, and is barred from taking into consideration the interests of other stakeholders, such as the employees, business partners, the environment, and the community at large. The idea of corporate social responsibility

[15] See, e.g., Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance*, Singapore: John Wiley, 2007, pp. 43–44.

[16] For a summary and critical discussion of the opinion see, e.g., Mallat Chibli, "Tantawi on Banking Operations in Egypt," in *Islamic Legal Interpretation: Muftis and Their Fatwas*, ed. Muhammad Khalid Masud, Cambridge, MA: Harvard University Middle Eastern Studies, 1996, pp. 286–297.

> evolved as a concept counterbalancing the shareholder orientation of U.S. company law, which in turn is a byproduct of its capital market orientation and widespread shareholding. A corporation has a social role to play, which extends beyond providing its shareholders with the highest possible return. Formulating corporate social responsibility policies thus allows the company's management to also take into consideration interests other than interests of the shareholders.

The actual difference, therefore, seems to be that corporate social responsibility policies are stakeholder oriented, whereas Islamic finance is rule oriented. This leads me to the conclusion that it is the stakeholder orientation that distinguishes socially responsible investment from Islamic investment.

BREAKING THE FORMALIST DEADLOCK: A STAKEHOLDER-ORIENTED APPROACH TO ISLAMIC INVESTMENT?

How to bring a stakeholder oriented approach to Islamic finance? How to define the concerns and interests of people and to integrate them into the body of rules of Islamic finance? If possible at all, this requires three steps. First, the stakeholders of Islamic finance need to be determined. Second, the place and role of these stakeholders must be defined. Finally, a process must be designed permitting an integration of stakeholder interests into the discourse on Islamic finance rules.

Discussing the place of stakeholders in Islamic finance simultaneously means talking about the aim of Islamic finance. Islamic finance is about an implementation of Islamic values in business: It is both religious (in terms of its origin) and worldly (in terms of its implementation). For Muslims, on the individual level, Islamic finance can be seen as the performance of a religious duty. On the collective level Islamic finance is aimed at implementing an Islamic financial system, a system that is deemed to promote justice and thus to be superior to the conventional financial system.[17] Islamic finance, consequently, is more than an act of worship. It is both a religious obligation for Muslims and a worldly practice. In addition, Islamic

[17] These discussions are summarized in Florian Amereller, *Hintergründe des "Islamic Banking,"* Berlin: Duncker & Humblott, 1995, pp. 84–96.

finance today is no longer confined to Muslims or Muslim markets, but has managed to attract customers irrespective of their faith and geographic location. This makes it legitimate to also inquire into the worldly application of Islamic finance — in order to improve its worldly application. And when focusing on the worldly implementation of Islamic finance, the search for stakeholders comes into play. Among the stakeholders are:

(i) *Shareholders:* As in any other company, the financial institution's shareholders will also be among the company's stakeholders (possibly the shareholders are among the most important stakeholders). The shareholders will primarily have an interest in the corporation being profitable (although this interest may well extend to a long term profitability of the company and is not limited to the short term). This implies that for an Islamic financial institution it will be of central importance to operate profitably and disburse returns to its shareholders and other investors.

(ii) *Employees:* Another central stakeholder group will be the financial institution's employees. Again, in this regard an Islamic financial institution is not different from any other corporation.

(iii) *Customers and Business Partners:* Further stakeholders will include the institution's customers and other business partners. Here, for the first time, specificities of Islamic finance will come into play. The customers will expect an Islamic bank to operate in a *shari'a*-compliant way, as Islamic finance is based on the *shari'a* promise (the institution's pledge that it will abide by Islamic legal principles in its dealings). This is why the customers have chosen an Islamic financial institution. Arguably, the customers may also expect a higher degree of fairness in dealings of an Islamic financial institution, at least on the retail level. It has been suggested, for example, that Islamic financial institutions must scrutinize the creditworthiness of their clients with particular care (in order to prevent, e.g., subprime lending).

(iv) *Environmental Concerns:* Environmental consequences also need to be taken care of under a stakeholders' approach. In project finance, for example, it would be expected that an Islamic bank

adheres to the relevant codes of conduct regarding environmental protection such as the Equator Principles.[18]

(v) *The Industry at Large:* Finally, the industry at large also belongs among the stakeholders. In the context of Islamic finance, this will include the development of the regulatory, legal, and tax framework of the industry as well as its overall reputation, including the further development of *shari'a* rules. Talking about the overall framework of the industry, I believe that in particular the latter aspect may be central: Viewing Islamic finance from a stakeholder perspective, I believe that there is a specific duty resting on Islamic financial institutions to develop *shari'a* principles skillfully and carefully.

But how to take matters forward? What is required is to integrate stakeholder interests in the *shari'a* process? Stakeholder interests, in the area of Islamic finance (as elsewhere in the business world), are not easily defined. One of the issues is that the conventional *shari'a* process, focusing on the ad hoc certification of a specific transaction, makes it difficult to integrate the larger picture and to take on board the interests of the stakeholders at large. A *shari'a* opinion rendered in view of an individual case will inevitably focus on the peculiarities of the matter. In this case it will be difficult to integrate interests of stakeholders who are not a party to the contract.

In this context, drawing a parallel to Islamic constitutionalism may help. Islamic constitutionalism and the process of Islamic legislation face a similar challenge when trying to distill certain values out of the *shari'a* and molding it into state-enacted legislation. Principles of governance also can be applied to corporate governance and investment. A value-based system depends on an institutionalization of the *shari'a* process. In other words: A value-based approach may be promoted by a change in the *shari'a* process that moves away from the certification of the individual product and puts more emphasis on institutionalization, what may enhance sustainability in the field of *shari'a* innovations.

[18] http://www.equator-principles.com/principles.shtml (accessed May 7, 2008).

How does this work?

First, it is important to point out that the debate on form versus substance is not limited to Islamic finance, but a recurrent theme in the debate on the application of *shari'a* law. The emphasis on Islamic values is in no way unique to Islamic finance. The debate in the area of Islamic financial law is only an offspring of the general debate on *maqasid al-shari'a* and the role *shari'a* values will play.[19] Looking at this debate more generally, in particular from the perspective of Islamic constitutionalism, one will note the following trend: in interpreting the sources of Islamic law and defining *shari'a* values, the role of Islamic scholars is paramount. Islamic scholars will interpret the sources of Islamic law and come up with a suggestion on what values can be derived from it. In view of the interpretative pluralism in Islamic jurisprudence, however, there must be another authority that determines the binding interpretation. The task of the latter authority is to tame the natural pluralism of *shari'a* law and make it operable on the level of implementation. In Islamic constitutionalism, this authority normally is assigned to the parliament (or another representative body). Parliament is entrusted with finding the authoritative interpretation of *shari'a* values, based upon the guidance of the scholars, and defining it for the nation-state. Parliament also ensures that the *shari'a* discourse is put on a broader discursive basis, so that what is required as the binding force of the interpretation will not only apply to one specific situation but is going to be enacted as a law.[20]

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[19] On this debate, see e.g. Hashim Kamali, "*Maqasid al Shari'a:* The Objectives of Islamic Law," http://awis-islamforschung.eu/archiv-1/archiv/maqasid-al-sharia-i/view (accessed March 9, 2009).

[20] This can be seen most clearly in the jurisdictions that refer to "the principles of the *shari'a*" as "a" or "the" source of legislation. Here, there seems to be an emerging consensus that this requires parliament to implement *shari'a* principles by selecting one possible interpretation within the overall framework of the *shari'a*. To the extent there is a plurality of opinions, parliament may find an interpretation that fits the time and clime, so to speak, exercising legislative *ijtihad*. See, most notably, the approach of the Egyptian Supreme Constitutional Court (discussed in great detail in Clark B. Lombardi, *State Law as Islamic Law in Modern Egypt*, Leiden: Brill, 2006). On the negotiation of the content of the *shari'a*, see also Abdullahi Ahmed An-Na'im, *Islam and the Secular State: Negotiating the Future of the Shari'a*, Cambridge, MA: Harvard University Press, 2008.

How can this mechanism possibly be transferred to Islamic finance? Global financial markets are no democracies, they do not have parliaments and hardly ever hold elections. Defining stakeholder interests is a complicated, at times ill-defined process—this holds true for the realm of corporate social responsibility and Islamic finance. Let me nevertheless point at two actors who will be crucial. As in the realm of constitutionalism, the *shari'a* scholars have an important role to play. The production of *shari'a* knowledge is the key competence of *shari'a* scholars and this cannot be changed. However, it might be the responsibility of the *shari'a* scholars to find *shari'a* innovations that do not just permit achieving a certain financial result (e.g., to mimic a certain conventional product). Further, I believe that industry associations (such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)) and possibly also the regulator will have to play a more significant role in the *shari'a* process. In the absence of parliamentary representation, industry associations and regulatory bodies will have to take on the responsibility to integrate stakeholder interests and reconcile them with an interpretation of the *shari'a*. Integration of stakeholder interests, it seems, will be facilitated by a *shari'a* discourse that is no longer focused on the individual transaction, but engages in standard setting, approaching the issues from a broader framework. A *shari'a* certification process that is disconnected from an individual transaction (and not curtailed by the requirements of a specific case) will make it easier to put interpretation of *shari'a* rules into a broader perspective. An institutionalization of the *shari'a* process, therefore, seems key to integrating stakeholder interests and overcoming the formalist deadlock.

CONCLUSION

Contrary to what is occasionally put forth, there is a notable difference between mainstream Islamic finance and socially responsible investment. It therefore is an oversimplification to promote Islamic finance as simply "one more form of socially responsible investment," the reason being that socially responsible investment is value based, whereas conventional Islamic finance tends to be rule based. Nevertheless, there is a strong tendency in the Islamic finance industry calling for a revival of Islamic business values in Islamic finance and giving values priority over legal rules. The concept of socially responsible investment, I believe, can help to elucidate the quest for

Islamic business values. It shows that business values must be determined from a stakeholder perspective. Adopting a stakeholder perspective in Islamic finance, I argue, will help a reorientation of the industry, making it value based as opposed to rule based. In order to define stakeholders and values, a reorganization of the *shari'a* process may help, which will put more emphasis on the institutional aspects. *Shari'a* scholars will continue to play the predominant role in the *shari'a* process. It nevertheless is required that the *shari'a* process move away from certifying individual transactions to setting up industry standards.

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List of Terms

Ahkam **(**sing., *hukm*) — court judgment; value assigned by *fiqh* to an act

Al-daruriyyat al-khams **—** "The five necessities," which are: maintenance / protection of religion, life, offspring, mind and property. The 'necessities' are the highest of the three levels of public interest or welfare (*maslaha*) expounded by al-Ghazzali as embodying the purposes (*maqasid*) of Sacred Law. (See individual entries *hifz al-din*, *hifz al-nafs*, *hifz al-nasl*, *hifz al-`aql*, *hifz al-mal*.)

Al-ghurm bi-ghunm **—** loss, i.e., liability, goes with gain, i.e., profit sharing comes with risk sharing

Al-kharaj bi-daman **—** profit goes with liability

Al-`uqud Al-murakkaba **—** compound contracts. A compound contract is one composed by tying together two or more separate, individual contracts (e.g. lease and sale) that are related to each other.

`Alamin **—** the universe, the worlds

Awqaf (sing., *waqf*) — charitable foundation or trust; see *waqf*

Bay' **—** sale

Bay' ma laysa 'indak — selling what you do not have. A *hadith* (saying reported from the Prophet) prohibits a person from selling something that is not under his ownership.

Bay' al-dayn — sale of obligation/debt

Daman — (1) contract of guarantee (also called *kafala*); (2) one of two basic relationships toward property, entailing bearing the risk of its loss

Daman al-'aib — seller's liability for defects. If a defect is found to have been present in the merchandise before it was handed over to the buyer, and the buyer then objects to this defect, then the majority of jurists maintain that the seller is required to cancel the sale and refund the purchase price. Other jurists hold that the seller is only required to refund a portion of the price corresponding to the decrease in value resulting from the defect.

Daman al-'aqd — contract guarantee. A term used in Shafi`i law to refer to the liability of dissolving the contract in the event that the merchandise or its payment perish before being acquired by the other party.

Daman al-istihqaq — an undertaking to refund the purchase price upon entitlement

Daman al-istirdad — in a hiring contract: the liability for restitution for those things that the hirer provides before the work begins and which are necessary for the work (e.g., tools, materials, and money needed during the job). If the hired employee then fails to do the job as stipulated, the hirer can recover those costs, whereas if the job is completed, the costs are deducted from the employee's wage.

Daman al-darak — guarantee for defective title; an undertaking to return the purchase price upon entitlement

Daman al-'uhda — liability for refunding the purchase price to the buyer in case of entitlement, or in case of the merchandise he purchased being found defective

Daman al-yad — a term used in Shafi`i law for liability for damage/destruction of property. Some specify it further, as applying

regardless of whether one directly destroyed the property, or was a cause for its destruction.

Dharoriyyat (sing., *darurat*) **—** basic needs

Fatwa (plur., *fatawa*) — an authoritative legal opinion issued by a scholar of *fiqh*

Fiction de droit *or* ***présomption de droit*** **—** a legal fiction; a fact or situation assumed or created by a court which is then used to resolve matters before it

Fiqh **—** Islamic jurisprudence

Fiqh al-mu'amalat **—** the ethics and law of financial transactions

Fiqhi **—** of or pertaining to *fiqh*

Fundauq **—** specialized trading centers

Gharar **—** uncertainty

Hadith **—** lit., report; historical account of a saying, act, or omission of the Prophet or, secondarily, of an esteemed figure among his companions and early Muslim generations

Hajiyyat **—** needs or exigencies; legitimate interests that are complementary to the essentials (*daruriyyat*), but not as crucial**.** Absence of the *hajiyyat* leads to hardship, though short of severe disruption. This is the second level of public interest or welfare (*maslahah*); lower than *daruriyyat* but higher than *tahsiniyyat*.

Hanafi **—** one of the four Sunni schools of law

Haram **—** prohibited; unlawful under sacred law

Hawala **—** contract of assignment of debt

Hawkamah — Arabic name of the Institute of Corporate Governance, Dubai, UAE. Also means corporate governance

Hayat tayyibah — the good / wholesome life

Hifz al-aql — protection of the mind / intellect

Hifz al-din — protection of religion

Hifz al-mal — protection of wealth

Hifz al-nafs — protection of life

Hifz al-nasl or al-ird — protection of offspring / family or honor

Hila — juristic stratagem

Hikma — wisdom

Hiyal (sing., *hila*) — legal artifices or stratagems

Hiyal ghayr mashru'a, madhmuma, or fasida — stratagems, unlawful (*ghayr mashru`a*) contrivances, religiously blameworthy (*madhmuma*) or unsound (*fasida*) schemes designed to circumvent sacred law

Ijara — operating lease

Ijara muntahiya bi-tamlik — lease ending with ownership

Ijara tawarruq — *tawarruq* based on a lease-contract (*ijara*)

Ijma' — unanimous agreement of all qualified *fiqh* scholars of an age; one of the four roots *(usul)* of *fiqh*

Ijtihad — lit., personal effort; the effort by a qualified *fiqh* scholar to determine the true ruling of the divine law in a matter on which the revelation is not explicit or certain

Ikhtilaf — scholarly disagreement

'ilal- (sing., *`illa*) — the effective cause of the ethical-legal value (*hukm*) of a case

'illa mundabita **—** an effective cause or ratio legis (*`illa*) that is well-defined and objectively verifiable (*mundabita*)

Indibatiyya **—** objective verifiability

Istihsan **—** doctrine allowing exceptions to strict legal reasoning, or guiding choice among possible legal outcomes, when considerations of human welfare so demand

Istiqra' **—** induction, inductive reasoning

Istisna'**—** contract providing for the manufacture and purchase of a specified item

Istisna' muwaz **—** *istisna`* is a contract providing for the manufacture and purchase of a specified item. *Istisna' muwaz* is parallel, or back-to-back, *istisna'.*

Kafala **—** contract of guarantee (also called *daman*; see *daman*)

Madarrah **—** injury, harm; the opposite of *maslaha*

Maisir **—** gambling

Mal **—** property; tangible things to which human nature inclines

Mal mutaqawwam **—** goods or property that may legitimately (under sacred law) be utilized, or that have a market value

Majella, / Mejelle **—** the civil code of the Ottoman Empire from 1869 to 1926 CE

Makharij (sing., ***Makhraj***) *or* ***hiyal mashru'a*** **—** recourses, lawful contrivances

Manfa'a **—** use, usufruct

Mani' **—** a preventative, i.e., something whose presence determines the absence of something else

Maqasid **—** objectives

Maqasid al- shari'a **—** objectives of the *shari'a*

Maslaha mursala **—** a welfare-based consideration that is not explicitly endorsed by sacred texts

Maslaha *(*plur. *masalih)* **—** benefit

Mu'amalat **—** dealings or transactions among human beings

Muazarah **—** crop sharing

Mudaraba — (also called *qirad*) a form of partnership to which some of the partners contribute only capital and the other partners only labor (some schools do not treat it as a partnership but as a contract *sui generis*)

Mudarib — a partner contributing labor in a *mudaraba*

Mufti **—** an Islamic jurisconsult

Mujtahid — a jurist who exerts his legal talents to find the proper interpretation of the law

Mundabita — objectively verifiable

Muqawala — parley, bargain

Murabaha — sale at a percentage mark up; one of the sales *(bay')* in which the price is stated in terms of the sale object's cost to the seller, the others being sale at cost *(tawliya)* and sale at discount *(wadi'a)*

Murabaha li'l-amir bi'l-shira' **—** lit., sale by mark up to one commissioning a purchase; a transaction involving two sales; A promises B that, if B buys for A certain specific goods, A will purchase them from B by *murabaha*, i.e., at a mark up

Murabahah synthetic — *murabahah* is a mark up sale. A synthetic *murabahah* is a debt-based sale, in which the form of the *murabahah* contract is exploited, by bypassing the requirement of the bank taking

ownership of the commodity, in order to replicate a conventional, interest-bearing loan.

Muraba tawarruq — *tawarruq* based on a markup (*murabahah*) sale

Musharaka — equity participation contract

Musharaka sukuk — see *sukuk al-musharakah*

Mutaqawwam **—** things the use of which is lawful under the *shari'a*

Muwakkil — the person who authorizes another (his *wakil*) as his agent, to act on his behalf

Muzara`a **—** crop sharing; a partnership contract between the owner and tiller of agricultural land, to share the resulting produce

Qiyas — analogy; one of the four roots *(usul)* of *fiqh*

Qard hasan **—** goodwill short-term loans with no compensation whatsoever

Qawa'id **—** general rules; maxims

Rabb al-mal — lit., the owner of the property; a partner who contributes capital

Riba — usury as forbidden in the Qur'an; interpreted in classical *fiqh* as including interest and various other forms of gain in contract

Ribawi (adjective) — *riba*-based. *Riba* is usury as forbidden in the Qur'an; interpreted in classical *fiqh* as including interest and various other forms of gain in contract.

Ribh ma lam yadman — profit from what one is not liable for

Rukhsa (pl. *rukhas*) **—** a relaxation, or exemption of a general injunction under specific circumstances

Salam — sale with deferred delivery of the sales item

Sakk — check/Islamic bond

Shari'a — the divine law known from the Qur'an and *sunna*

Sharik — partner

Sharika — partnership; modern company or corporation; applied also to ownership in common

Shart — condition, stipulation

Shart munaf li-muqtada al-'aqd — stipulations within a contract that are contrary to the purpose of the contract. E.g. stipulating that there will be no sharing of produce in a crop-sharing contract, or that the lessee of a car will not be allowed to use it during the lease period

Siftajah or ***suftajah*** — bill of exchange

Sukuk — (sing., sakk) Islamic bonds; certificates

Sukuk al-ijara — Islamic bond based on an *ijara* asset

Sukuk al mudaraba — a bond whose underlying activity is based on the mark-up sale contract *mudaraba*

Sukuk al murabaha — a bond whose underlying activity is based on *murabaha*

Sukuk al-musharaka — a bond whose underlying activity is based on the equity participation contract (*musharaka*)

Sukuk al-wakala — a bond whose underlying activity is based on authorization to invest

***Sunna* —** the Prophet Muhammad's normative example, as known from the *ahadith*; one of the four roots *(usul)* of *fiqh*

Tahsiniyyat — "embellishments," legitimate interests that are beneficial, and enhance the quality and refinement of life, yet whose absence leads neither to severe disruption or to hardship. This is the

third level of public interest or welfare (*maslahah*); lower than the *daruriyyat* and *hajiyyat*.

***Ta'lil* —** identifying the effective cause (*`illah*) for an ethical-legal law

Takaful — lit. mutual support. Islamic insurance; based on the concept of mutual financial support, an Islamically acceptable alternative to conventional commercial insurance.

Takhrij al-manat *or* ***takhrij al-'illa*** — derivation of the ratio legis, where it is not explicitly stated in the sacred texts; *manat* in this context is in the same sense of '*illa*, ratio legis

Tawarruq — a process in which a person purchases a commodity on credit, then sells it for cash, to someone other than the original seller, for less than what he purchased it at, in order to thereby acquire cash

Tawatu' *or* ***Muwata'*** — pre-arrangements; collusion

'Ulama (sing., `alim) — Muslim religious scholars

Umma — the Muslim community

Usul al-fiqh — principles of legal reasoning

Wakala — agency; a standard Islamic practice wherein X (the *wakil*) acts as the agent of Y. In this capacity X may execute the affairs of Y. A widely applicable phenomenon in Islamic practice, *wakala* is often used in financial transactions. Whenever a party cannot personally supervise a given affair, it deputizes another party to execute it on its behalf.

***Wakil* —** agency

Waqf (plur. *awqaf*) **—** legal trust (it. cessation). A standard Islamic transaction where one 'freezes' one's property such that it is considered to have been arrested in perpetuity and can neither be sold, inherited, nor donated. The term *waqf* frequently refers to the property itself. The use of a *waqf* (e.g., a park) is often reserved for the relief of the poor, for the public at large, or for other charitable ends.

***Zakat* —** the third pillar of Islam; obligatory alms-giving that every well-off Muslim is required to relinquish to the Islamic authority for distribution to the poor and needy

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Islamic financial institutions proved remarkably resilient during the financial crisis of 2008, and although they have not been immune from the effects of the 2008–09 recession, the outlook for the industry is encouraging. The crisis resulted in increasing awareness of moral and ethical issues in finance, and focused attention on whether lessons can be learned from Islamic financial institutions given their moral underpinnings.

The contributors to the Eighth Harvard University Islamic Finance Forum, which was held in April 2008, nevertheless questioned whether innovation in the industry has been at the expense of authenticity. Despite the achievements, there is concern that some of the financial products and legal contracts are unsatisfactory from a *shariʿa* perspective. The controversies over some of the structures used for *sukuk* were examined at the Eighth Forum, as was the acceptability of *tawarruq*.

Participants also debated regulatory issues pertaining to Islamic finance and the question of an Islamic monetary union, arguably a distant aspiration at present. Yet regulatory reforms and currency regimes are subjects increasingly debated in the G20, a forum that includes three major Muslim countries, Saudi Arabia, Indonesia, and Turkey. This volume throws some light on these international financial debates from an Islamic perspective.