INTEGRATING ISLAMIC FINANCE INTO THE MAINSTREAM

Regulation, Standardization and Transparency

S. Nazim Ali
Editor

With an introduction by
Ibrahim Warde

Islamic Finance Project
Islamic Legal Studies Program
Harvard Law School

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Preface

This is the second publication of the Islamic Finance Project (IFP) following its relocation to the Harvard Law School Islamic Studies Program. The Seventh Harvard University Forum on Islamic Finance is part of a conference series hosted by the IFP on a biannual basis and brings together experts from all fields related to Islamic finance to discuss issues currently confronting the industry. This year the forum was entitled "Integrating Islamic Finance into the Mainstream: Regulation, Standardization, and Transparency" and addressed the issues arising as Islamic finance grows and interacts with the conventional finance community. The proceedings of this forum, published here, include eleven papers selected from the twenty-four that were presented during the conference. For the first time, a pre-conference workshop was also held, entitled "Select Ethical and Methodological Issues in *Shari'a*-Compliant Finance." In this workshop, specific issues regarding the legal and moral problems that arise within Islamic finance were discussed by a number of pre-eminent scholars who were present at the conference. The workshop took place behind closed doors due to the sensitivity of the subject matter. Here we have included the position paper presented by M. Nejatullah Siddiqi at the pre-conference workshop, which elaborates upon the role of *shari'a* experts in the economics and progress of the multidisciplinary field of Islamic finance. We thank Ibrahim Warde, Adjunct Professor at the Fletcher School of Diplomacy, Tufts University for contributing an excellent introduction to this publication.

The success of the pre-conference workshop has led the IFP to host more focused events that target issues that have not received adequate attention, including a workshop on *tawarruq* held jointly with LSE in London, and a seminar on Islamic microfinance held at the Harvard Law School. Both events attracted participants from across the globe. We at the IFP are not only committed to the development of the industry, but also to exposing the field to a larger audience. To that end, we encourage student contributions in our activities and seek to involve persons outside the

Islamic finance community in our events. This conference is a testament to that conviction and we hope that our efforts will continue to build on the strengths of the fields of Islamic finance and economics.

The Seventh Forum, with its blend of academic scholarship and industry experience, remains a unique venue for critical and objective examination of Islamic finance. The keynote address was delivered by Anwar Ibrahim, the former Malaysian Minister of Finance and current Distinguished Visiting Professor at Georgetown University as well as the Malaysia Chair of Islam in Southeast Asia in the Prince Alwaleed bin Talal Center for Muslim-Christian Understanding. During his tenure in the Malaysian Cabinet, he was instrumental in introducing Islamic finance into the economy, and his experiences allowed him to provide unique insights into the evolution of the industry and its future trajectory. In a speech entitled "Forging a New Framework for Islamic Finance and Fulfilling the Higher Objectives of the Shari'a," Ibrahim began by lauding the achievements of Islamic finance since its resurgence a few decades ago, when critics thought it was a system impossible to sustain. While acknowledging its achievements, Ibrahim reminded the audience of the larger framework in which Islamic finance functions: the *shari'a*. Specifically, he stated that there was a need for an expanded discourse with global relevance and impact. It was appropriate, he argued, that we strive not only to be contractually *shari'a*-compliant, but also to achieve the main goals of the *shari'a* (*maqasid al-shari'a*). He encouraged Islamic financial institutions to consider profit-loss sharing as a better alternative (vis-à-vis the *maqasid al-shari'a*) to debt financing. As Islamic finance grows, Ibrahim hoped to observe a causally related growth in commitment to public works, consumer protection regulation, microcredit, education, and community welfare.

The opening remarks by Frank E. Vogel provided a good general overview of the field since the preceding Sixth Forum, and highlighted the fact that Islamic finance is gaining increasing entry and acceptance within the mainstream finance community, which has given rise to several issues addressed here. The growth of Islamic finance domestically and abroad continues at a tremendous rate, with many domestic banks now offering Islamic finance products. Internationally, *sukuk* issuances have significantly increased, the Islamic Financial Services Board (IFSB) has issued a new standard on capital adequacy and risk management, new financial centers have been established (in Qatar, Bahrain, and Dubai) with sections devoted to Islamic finance, and more research centers are opening (for example, Bank Negara Malaysia, Oxford Centre for Islamic Studies).

A special session during the conference entitled "Governors and Institutions Roundtable" provided an excellent stage for representatives of various central banks, including Rashed Al-Maraj (Governor of the

Bahrain Monetary Agency), Fahad Faisal Al-Thani (Deputy Governor of Qatar Central Bank), Ahmad Jachi (First Vice Governor of the Central Bank of Lebanon), William Rutledge (Executive Vice President of the Federal Reserve Bank of New York), and Pervez Said (Advisor to the Governor of the State Bank of Pakistan). Together they discussed developments in their regions and attempted to clarify how government bodies and regulatory institutions have dealt with Islamic finance in the past and present, the hurdles they currently face, and solutions they would propose. This session was particularly valuable given that regulators are becoming increasingly involved in Islamic finance, as evidenced by the Interagency Forum on Islamic Banking in the United States that was held at the Federal Reserve Bank of New York on March 3, 2006.

Another highlight of the conference was the keynote address delivered by Jay Collins, CEO of the Public Sector at Citigroup. In his speech, entitled "Global Best Practices in Islamic Finance: The Way Forward," he offered ten critical components for the future success of the industry, including greater standardization and regulatory alignment, increasing transparency, simplifying the *shari'a* board process, and accelerating the issuance process. He also advocated greater outreach to non-Muslim players, encouraging governments to play a greater role in signaling a commitment to Islamic investments, greater liquidity, increasing governments' role to overcome first-mover's disadvantage, sustaining innovation, and increasing the role of international banks in the innovation charge.

The importance of the Harvard University Forum on Islamic Finance extends beyond the academic world and Islamic finance community. Not only does the event attract attendees specializing in economics, industry, and *shari'a* aspects of the field, it also provides exposure for Harvard faculty and affiliates to the scope of the industry, and helps to educate the next generation of industry leaders and academics. Indeed, the forum would not have been possible without the support of several outstanding individuals who have worked alongside IFP to ensure its success. I would like to take this opportunity to thank Frank Vogel, who stepped down from his position as the Director of the ILSP at the Harvard Law School this year. Professor Vogel's contribution from the very inception of this project in 1995 will always be appreciated and remembered. I would also like to welcome Baber Johansen, the Acting Director of the ILSP and Affiliated Professor at Harvard Law School, for his interest and continued support in sustaining the project. Samuel L. Hayes III, Professor Emeritus at the Harvard Business School, was also particularly helpful in organizing this forum and supporting IFP initiatives.

The very existence of the forum and the IFP is due to the generous support of our sponsors who continue to encourage our endeavors in

promoting education and development in Islamic finance. We are extremely grateful to Arcapita Bank B.S.C of Bahrain, HSBC Amanah of the United Arab Emirates, and Kuwait Finance House of Kuwait for their generosity.

Last but not least, we are 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 Taha Abdul-Basser, AB ’96, PhD candidate; M. S. Shaheen, JD ’06; Arsalan Suleiman, JD ’07; Aziz Bakar, MBA ’06; Ibrahim Majeed, MBA ’06; Nadiah Wan, AB ’07; Julia Buchmann, AM ’07; Shaheer Rizvi, AB ’08; Hisham Mabrook, AB ’08; and Zain Khalid, AB ’08 for their work and contributions. 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 Aamir Rehman, AB/AM ’00, MBA ’04; Abdur-Rahman Syed, AB ’00, Ph.D candidate at BU; Munir Zilanawala, AB ’01; Mansoor Shakil, LLM ’05; Rafe Haneef, LLM ’97; and Kamal Mian, LLM ’01, for their immeasurable support. In addition, I take this opportunity to thank Husam El-Khatib at the London School of Economics for his aid in organizing the joint conference on *tawarruq* at LSE.

I would also like to acknowledge the contributions of Nabilah Siddiquee, AM ’07; Nilufer Ali, BSBA candidate at NEU; and Sanjida Rahman, AB ’10, in compiling and editing the pieces of this publication.

S. Nazim Ali
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Introduction

Ibrahim Warde[1]

"Islamic finance, long considered in the West as more of an oddity than an opportunity, is going mainstream." [2] This observation, made in the *Economist* in December 2006, discusses the evolution of attitudes toward the Islamic sector. A few months earlier, the Seventh Harvard University Islamic Finance Forum had dealt with that very issue. Entitled "Integrating Islamic Finance into the Mainstream: Regulation, Standardization, and Transparency," the forum addressed the challenges arising from this evolution. This book is a selection of twelve papers presented at the forum and at other events sponsored by the Islamic Finance Program at Harvard University. They deal with four aspects of the integration of Islamic finance into the mainstream: (1) regulatory dilemmas; (2) religious, legal, economic, and political perspectives; (3) the *sukuk* phenomenon; and (4) perspectives and controversies.

When it first appeared in the mid-1970s, Islamic finance was generally dismissed as an inconsequential byproduct of the oil boom. Introducing the religious factor in what was seen as a quintessentially secular area struck many as bizarre, and many critics asserted that its growth was bound to remain stunted.[3] Although the early objective of an alternative, partnership-based finance system was never fulfilled, Islamic finance experienced rapid growth. Instead of *murabaha* and *musharaka*, most Islamic institutions focused on "cost-plus" operations such as *murabaha*, where the bank would purchase the goods needed by the "borrower," and then resell them to him at a profit. For all intents and purposes, Islamic banking appeared more and more as an attempt to mimic many aspects of conventional finance, albeit through Islamic contracts and

[1] Adjunct Professor, Fletcher School of Diplomacy, Tufts University, Medford, Massachusetts.
[2] "Islamic Finance: Calling the Faithful," *The Economist*, December 7, 2006.
[3] Timur Kuran, *Islam and Mammon: The Economic Predicaments of Islamism* (Princeton University Press, 2004), p. xii.

within boundaries imposed by religion. Deregulation in the 1980s and 1990s proved a boon for Islamic finance, as it fostered the creation of tailor-made Islamic products. Until then, financial institutions could only sell a narrow range of financial products. With the lifting of constraints on the products that "financial engineers" could devise to suit every need—religious or otherwise—countless new Islamic products could be created.

In recent years, the growth of the Islamic sector has greatly accelerated. This trend is being driven by a combination of factors. The most obvious one is the impact of surging oil prices and the attendant economic boom in the Gulf region. Excess liquidity has raised the demand for a wider range of financial products. Related factors include what could be broadly described as the "September 11 effect"—a combination of rising religious and nationalist sentiment since the launch of the "war on terror," along with a serious effort by the Islamic finance industry to rid itself of go-it-alone tendencies. The increased religiosity translated into greater demand for Islamic financial products. Also, unlike the oil boom of the 1970s, more of the financial revenues are staying within the Islamic world. Another aspect of the new environment is the growing convergence between the Arab and the Malaysian models of Islamic finance, which became an essential building block in the rationalization and harmonization effort.[4]

Indeed, until recently, Arab and Malaysian Islamic banks had evolved along separate paths, and had minimal interaction. Scholars in the Arab world considered their Malaysian counterparts to be a bit too lax in their religious interpretations,[5] and that Islamic institutions, in their rush to grow, were cutting too many corners. Behind those differences were fundamental political-economic and religious factors. From a political-economic standpoint, the Arab *ijtihad* was primarily driven by the surpluses generated by the oil boom of the mid-to-late 1970s whereas the Malaysian effort was driven by the developmental imperative combined with domestic political factors aimed at improving the political and economic position of the Muslim majority. In other words, Arab Islamic finance was concerned with asset management while Malaysian Islamic finance focused on generating sources of financing for the economy.

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[4] Ibrahim Warde, "Islamic Finance after September 11: Towards Arab-Malaysian Integration," Seattle, WA: National Bureau of Asian Research, 2007.

[5] Especially contentious were the issues of *Bay' Dayn* (sale of debt) and *Bay' 'Ina* and, which were essential building blocks to Islamic corporate debt. Outside of Malaysia, most scholars consider the sale of debt to be un-Islamic. As for *Bay' 'Ina* (under which somebody sells a good for cash and then buys it back from the same person at a higher price in exchange for deferred payment), most schools of Islamic jurisprudence consider it a *hila* (ruse or legal artifice) to get around the prohibition of *riba*, though the Shafii school generally regards it as acceptable.

Another difference between the two systems is that the Arab model had evolved in somewhat haphazard fashion whereas the Malaysian model was clearly based on a directive, top-down approach. Whereas the *shari'a* guidance model was fragmented and decentralized, Malaysia sought consistency by centralizing the process at its Central Bank.

A crucial development was the freezing of the assets of Middle Eastern individuals and the crackdown on Islamic financial institutions and charities, which led many Muslim investors to take a significant chunk of their assets out of the United States. Home markets could not absorb all those withdrawals (estimated at about $200 billion) and the quest for a new diversification strategy led more or less naturally to Malaysia, a Muslim country that had achieved an impressive level of economic development. Other forms of political and economic interaction also intensified. Malaysia started working closely with Arab regulators, especially those of Bahrain and the United Arab Emirates, on matters of Islamic finance.

Especially worthy of mention is the creation of the Islamic Financial Services Board (IFSB) in Malaysia in 2002. This organization sought to coordinate bank supervision, promote Islamic finance, and facilitate the integration of the Islamic sector in mainstream finance. Working closely with the International Monetary Fund, the Islamic Development Bank, and the Basel Committee, the IFSB issued in 2005 a draft on the Basel II rules for Islamic institutions. Although in existence since 1991, the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was reenergized in its effort to harmonize accounting and auditing rules and create standard contracts.

Those new interactions led to a quest for common ground. On matters of Islamic finance, the most dramatic example of cooperation was the 2002 sovereign Malaysian *sukuk*, which explicitly targeted Gulf investors. (For that issue, Malaysian as well as Arab *shari'a* scholars gave their endorsement.) Soon afterwards, those *ijara sukuk* formed the template for a number of Arab *sukuk* issues.[6] The Malaysian Central Bank alongside with its Arab counterparts played a key role in finding common ground. As a way of promoting its own viewpoint, Bank Negara Malaysia is spending $57 million to invite Islamic scholars from around the world to Kuala Lumpur for a "*shari'a* dialogue" program.[7]

The Arab-Malaysian integration is part of a broader phenomenon of regionalization of Islamic finance. Since 2006, three Arab Islamic banks

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[6] Ibrahim Warde, *Islamic Finance in the Global Economy*, second edition (Edinburgh University Press, forthcoming).

[7] Yaroslav Trofimov, "Borrowed Ideas: Malaysia Transforms Rules For Finance under Islam; In a Lesson to Arabs, Asian Bankers Mix Religion, Modernity," *The Wall Street Journal*, April 4, 2007.

have been authorized to operate in Malaysia: Kuwait Finance House, Saudi Arabia's Al-Rajhi, and the Asian Finance House. Dubai Islamic Bank, the first Islamic bank, has also recently expanded its operations to Pakistan, and the Development Bank of Singapore (DBS) has recently established, in association with Arab investors, the Islamic Bank of Asia, to focus on wealth management and capital market instruments for corporate and private banking clients in the Middle East and Asia.

In its first couple of decades, conventional financial institutions as well as international regulators largely ignored the Islamic sector. The involvement of large international financial institutions started when Citibank created Citi Islamic in Bahrain in 1996. Two years later, HSBC established Amanah Finance, a global Islamic financial services division. Since that time, ABN AMRO, BNP Paribas, Standard Chartered, Goldman Sachs, and many others have become significant players in Islamic finance. Indeed, today one would be hard-pressed to find a large global financial institution that is not involved in one way or another in Islamic finance. The massive participation by global players has led to greater innovation, more competitiveness, and increasing acceptance of the Islamic sector. Once confined to corporate and investment banking, the Islamic sector has penetrated the retail market. A significant development was the creation in the United Kingdom of the Islamic Bank of Britain, the first fully *shari'a*-compliant bank in Europe, in 2004.

In addition to Islamic countries such as Malaysia or Bahrain, the United Kingdom and Singapore have announced their intention of becoming hubs of Islamic finance. Today, the most unlikely players in the most unlikely places are raising funds Islamically. Consider the case of Japan, where the government announced plans to issue *sukuk* for infrastructure development. At the same time Daiwa, the country's second-largest securities house, announced plans to list on the Singapore Exchange an exchange-traded fund based on Japanese equities and screened by Islamic investment principles, and Société Générale, the French bank, announced plans to launch a *shari'a* mutual fund based on Japanese equities.[8]

With the rapid and sustained growth of the Islamic sector and the growing involvement of institutions from outside the Islamic world, international regulators have taken notice. Concerns about standardization and transparency have taken center stage. Despite recent efforts at harmonization, there is still too much diversity in the interpretation of the *shari'a*. And despite efforts at explaining Islamic finance, some have complained of the opacity that makes it difficult to fully appreciate risk.

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[8] D. Turner and J. Burton, "Daiwa Joins Rush to Create Shariah Funds," *Financial Times*, July 29, 2007.

Furthermore, many Islamic structures have yet to be legally tested in bankruptcy and other proceedings. The essays in this book aim at discussing and clarifying these issues.

Part I deals with the regulatory dilemmas generated by the entry of the Islamic sector into the mainstream of global finance. The first paper in this section, authored by Nasr-Eddine Benaissa, Xavier Jopart, Melanie Maddux, Ozgur Tanrikulu, and Fenton Whelan, deals with the impact of regulation on the future of Islamic finance. It is premised on the idea that "the framework that regulators choose for the industry can have a positive or negative impact on the Islamic bank's credibility, ability to compete, and financial performance." The paper provides a useful synthesis of options available, from the structure of regulatory framework to direction-setting on *shari'a* compliance and approaches to Basel II and risk management.

The structure of regulation reflects different attitudes toward Islamic finance. In that respect, there are wide variations as some countries such as the Sudan have fully Islamicized their banking sectors while others (such as Oman and most European countries) do not allow Islamic banks. In those countries where Islamic banks can operate, different regulatory options are available. There can be a single licensing framework as in Saudi Arabia, or a dual one as in Kuwait or the United Arab Emirates, in which case only those banks with an Islamic license can offer Islamic products. Malaysia has introduced a third possibility—a license allowing conventional banks to create Islamic windows. In addition, banking regulators have wide latitude in terms of allowing or forbidding certain types of Islamic operations.

Benaissa and his colleagues go on to analyze the implications of various forms of regulation in terms of credibility, competitiveness, and consumer protection. The dual license framework, for example, may protect Islamic institutions against competitive challenges from conventional banks, although this can have significant long-term competitive drawbacks. It could "lead Islamic banks to become complacent, fostering the belief that being Islamic is a sufficient criterion for success: innovation, quality of service, convenience, and operational improvements might be overlooked, creating a rapidly expanding gap with conventional players." Over time, Islamic banks could thus "lock themselves out of future growth."

As for the regulation of *shari'a* boards, there are also different possibilities. Some countries have focused on process, that is, the rules governing the operation of *shari'a* boards or the selection of their members, and others have focused on outcomes of religious rulings. In this respect too, Malaysia has innovated by creating a *shari'a* board for its central bank, whose rulings supersede those of individual banks.

Both this paper and the next, "Basel II and Corporate Governance in Islamic Banks" by M. Kabir Hassan and Mehmet F. Dicle, dwell on the impact of Basel II on Islamic financial institutions. The prudential standards established by the Islamic Financial Services Board (IFSB) in coordination with the Basel Committee can have an adverse competitive impact on Islamic banks insofar as they would impose greater capital requirements on Islamic banks. Although many unresolved matters remain, the application of Basel rules is a good news-bad news story. The good news is that the reality and specificity of Islamic finance are formally recognized by the mainstream of international finance—which stands in sharp contrast to the first Basel ratios in the 1980s, which simply ignored Islamic banks. The bad news, of course, is that the Basel committee has chosen to err on the side of caution: based on the assumption that the risk factor in Islamic banks cannot be fully appreciated, a greater capital cushion has generally been required, despite the fact that under the logic of profit-sharing investment accounts (PSIA), such account holders bear part of the risk that in conventional finance is borne by the bank alone.

On the subject of corporate governance, Hassan and Dicle discuss the relation between *shari'a* compliance and market discipline. They argue that *shari'a* compliance is a necessary though not sufficient condition for good governance, as it must be supplemented by market discipline and regulatory supervision. By the same token, in matters of financial engineering, Islamic banks must both comply with the *shari'a* and endeavor to achieve international economic recognition through transparency and acceptance.

Ali Adnan Ibrahim's paper, titled "Convergence of Corporate Governance and the Islamic Financial Services Industry: Toward an Islamic Financial Services Securities Market," addresses two simultaneous pressures facing regulators in the Islamic world. First are the broad challenges facing all developing countries—making capital markets attractive to domestic and international investors and consistent with global regulatory norms. At the same time, however, there are pressures to make those norms consistent with the *shari'a*, more specifically in matters pertaining to "future codification of fiduciary duties and related ethical practices." The author asks whether "*shari'a*-based codes of corporate governance will help achieve the expected level of transparency and accountability on comparatively economical agency costs." He wonders whether designing *shari'a*-based codes of corporate governance are necessary in the first place, and considers those modern transactional practices that may not be consistent with Islamic law. More transactional divergence should lead to more transactional innovation in the Islamic finance industry, making convergence between Islamic finance and modern governance practices inevitable.

The final paper in the first section, Philipp Wackerbeck's "Regulation, Supervision, and Their Role in the Development of Efficient Islamic Insurance Markets," deals with the "often underestimated" role of insurance in economic development and financial deepening and the opportunities afforded by Islamic insurance (*takaful*). A sound regulatory framework is essential considering the implications of the failure of an insurer on the overall economy, and the need to protect the insured, noting that "premiums are paid up-front for an uncertain event, with many contracts including long-term saving components." Problems such as adverse selection and moral hazard are compounded by the general lack of familiarity in many markets with insurance, and of course by the *shari'a* element, more specifically the need to eliminate the elements of *riba*, *gharar,* and *maisir*. The paper makes concrete recommendations on matters ranging from confidence-building measures to the setting up of a sound regulatory and supervisory framework

The second part of the book considers the question of integration of Islamic finance into the mainstream from a variety of perspectives—religious, legal, economic, and political. In his paper titled "*Shari'a*, Economics, and the Progress of Islamic Finance: The Role of *Shari'a* Experts," M. Nejatullah Siddiqi discusses the question of religious interpretation, with a special emphasis on *tawarruq*. The author makes a number of useful distinctions: between Islamic economics and Islamic finance, between *maqasid al-* s*hari'a* and *fiqh*, and between the *shari'a* advisers and the broader category of Islamic intellectuals. Islamic economics, conceived early in the twentieth century, was a vast "civilizational" project emphasizing social justice and presenting an alternative to secular ideologies such as socialism and capitalism. Islamic finance, in contrast, was much narrower and of more recent vintage: it only came into existence in the 1970s and focused on interest-free finance. The first was conceived not by religious scholars but by a variety of Islamic intellectuals and activists, and was oriented toward *maqasid al-* s*hari'a*, or the objectives of Islam, whereas the second was the preserve of religious experts and focused on *fiqh*, Islamic jurisprudence, the laws and regulations as codified in early Islamic history.

The blurring of those distinctions has resulted, in Siddiqi's view, in a number of "malfunctions." In particular, many *shari'a* experts' "training is no longer well designed to serve the *maqasid al-shari'a* in circumstances very different from the environment reflected in the books they study." In the early days of Islamic finance, most of the experts were not even well versed in the English language. A central challenge as Islamic finance enters into the mainstream is to achieve conceptual and structural changes in *shari'a* advising.

In his paper titled "The Tension between Legal Values and Formalism in Contemporary Islamic Finance," Abdurrahman Habil is also preoccupied by the frequent triumph of form over substance. He sees a growing reliance on *hiyal* (plural of *hila*, "legal artifice"), an illustration of the predicament of a system that has grown far removed from its original guiding principles. In the author's words, the systematic recourse to *hiyal* "may even look irrational and ethically questionable as it defeats the very purposes of Islamic law by uprooting a great legal system from its ethical foundations." He recommends that *shari'a* experts "remain faithful to the ethical foundations of the *shari'a* without losing sight of the complexity of modern life."

Legal scholar Kilian Bälz's "Islamic Retail Finance in Europe: Market Potential and Legal Challenges" discusses the market potential and legal constraints for *shari'a*-compliant retail products in Europe, with a special focus on the contrast between the UK market, where Islamic products are widely available, and Germany, where they barely exist. The paper highlights the limits of standardization when it comes to retail products. Unlike wholesale finance that has developed more or less common standards, retail products "are neither universal nor based on globally uniform standards." As a result, their development hinges "on a double cultural accommodation: adjusting the product to the requirements of local laws as well as the specificities of local Muslim communities."

The author also asks why certain European countries such as Germany or France, despite substantial Islamic populations, "seem to be not susceptible to Islamic finance." In Germany, there are no Islamic mortgages, current accounts, or consumer loans available. Islamic products are largely limited to investment funds. Reproducing the British model is not likely, since there is a common perception that "further development of Islamic retail products is neither required nor desirable." In any country, Islamic finance has to be integrated into existing institutional arrangements and adapted to the overall legal and regulatory framework. In Germany "this framework may be less responsive to the needs of ethnic and religious minorities."

Robert R. Bianchi's article, "Islamic Finance and the International System: Integration without Colonialism," discusses the efforts to integrate Islamic finance into the global economy in a context of crisis and soul searching. It looks specifically at the interaction of Islamic institutions with governments, conventional financial structures, multinational enterprises, and international organizations and argues that the outcome is likely to be "an improvised series of reciprocal influences and mutual adaptations that could evolve into an intentional process of collective learning and cooperation." Unlike many other essays in this book, this one adopts a sanguine view of the lack of standardization. Bianchi asks: "The

current patchwork of law and practice might seem chaotic at times, but is it any worse than the incoherence of the common law before the advent of the Uniform Commercial Code?" He also considers it more important for the industry "to adopt internationally accepted standards of good business than to pursue a phantom of religious perfection." Bianchi is especially critical of the idea of a *shari'a* "super court."

Part III of the book discusses the phenomenal rise of *sukuk* since 2002. In a few short years, those "Islamic bonds" have exceeded the US $50 billion mark, becoming the principal building block of Islamic capital markets. A few facts and statistics are worth pondering: they constitute more than 80 percent of fixed-income products in the Middle East; Malaysia, with about 60 percent of the market, remains the biggest player; firms outside the Islamic world are increasingly resorting to them for financing, and hedge funds have been major purchasers of those securities.[9] Michael J. T. McMillen's article, "*Sukuk* (Islamic Bonds and Securitizations): Toward a Viable Capital (Including Secondary) Market," describes generic *sukuk* structures and discusses the legal factors that impede or inhibit the growth of Islamic capital markets. The article considers the implications of the English appellate case, *Shamil Bank v Beximco*, and discusses ways of removing or resolving certain legal impediments. McMillen also shows that most *sukuk* issuances to date are not true asset securitizations but Islamic bonds, because the credit base is not an asset pool but rather the credit of an operating entity, often a sovereign. He argues that "to achieve success in the development of capital markets and secondary markets, and benefits of asset securitizations, *sukuk* issuances will need to be structured as true asset securitizations that are broadly distributed across both the Islamic finance and the conventional finance markets." The private and public sectors of Islamic countries should work together to achieve this goal.

Reza Djojosugito's article brings more specificity to the question of legal implementation by considering the case of Indonesia. As the largest Islamic country, an important emerging market, and a late-comer to Islamic finance, the country provides an interesting example of the barriers as well as the potential for *sukuk*. The country had issued conventional asset-backed securities in 1997 and 1998, but *shari'a*-compliant options were few. Before the implementation of a new law, the mobilization of resources could be done through "*shari'a* bonds" (defined by contrast to a conventional bond as "not a debt instrument" and whose coupon payments "do not represent interest"). In his article "Regulating *Sukuk* in Indonesia: Challenges for Implementation," Djojosugito calls for the introduction of legal reforms that would create a robust Islamic asset securitization system

[9] "Islamic Finance: Calling the Faithful," *The Economist*, December 7, 2006.

and make specific suggestions to bridge the gap between civil law and *shari'a*.

The final part of the book is titled "The Way Forward: Perspectives and Controversies." It consists of two papers presenting sharply different perspectives. One, "Global Best Practices in Islamic Finance: the Way Forward" by Jay Collins, CEO of the Public Sector at Citigroup, could be seen as the conventional perspective of the conventional financial sector. It invites the Islamic sector to follow the lead of institutions such as Citigroup, and to do so faster in part by simplifying the diverse *shari'a* board process. In Collins's words: "The exponential advances in the pace of information and capital movements, the increasing sophistication of global markets and the tremendous effort of global regulators to keep up with these changes have only fed the integration process." The disastrous subprime crisis, which shook many of the largest financial institutions, including Citicorp in 2007 has cast some doubt on the idyllic view of financial innovation and existing risk management tools.

The final paper, "A Simple *Fiqh*-and-Economics Rationale for Mutualization in Islamic Financial Intermediation" by Mahmoud A. El-Gamal, calls for a sharp departure from the current direction of Islamic finance. In other writings, the author had been critical of an industry that "glorifies irrational adherence to outdated medieval jurisprudence."[10] In this paper El-Gamal argues that much of Islamic financial intermediation "can and should be conducted through mutual financial institutions." An added benefit in his view is that since mutual financial institutions are quite common in Europe and the United States, "regulatory frameworks are already in existence, thus reducing the need for inventing new regulations for Islamic financial institutions."

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[10] See Mahmoud El-Gamal, "Incoherent Pietism and Sharia Arbitrage," *Financial Times*, May 23, 2007.

Part I

Regulatory Dilemmas

The Impact of Regulation on the Future of Islamic Finance

Nasr-Eddine Benaissa,[1] Xavier Jopart,[2] Melanie Maddux,[3]
Ozgur Tanrikulu,[4] and Fenton Whelan[5]

Islamic banking markets have grown dramatically and have exhibited increasing profitability in the last few years, with many banks growing above their respective market averages and several new players emerging. Although this recent evolution has been positive, a closer look reveals that the penetration and the growth of Islamic banking, as well as profitability levels compared with conventional peers, vary significantly between countries.

Despite the growth, market pressure on Islamic banks is mounting rapidly in all markets: they are expected to grow even faster and further to improve profitability. In this context, overall competitiveness with conventional banks is likely to become even more important to success.

Regulation, therefore, acquires a huge significance in this situation; especially because it can influence the ability of Islamic financial institutions to compete and innovate the Islamic credibility of those institutions and the overall financial performance of the industry.

There is still some debate surrounding what would be the best way to regulate Islamic banking. There has been much experimentation, resulting in a variety of frameworks. Progress is being made with many of these frameworks, with some regulatory concepts emerging as potential best practices. The regulation, however, has not yet reached the level of completeness or harmonization that exists in the conventional sector.

Recent efforts initiated by the industry show great promise in tackling these issues. Regulators, banks, and industry bodies are finding ways to share ideas and to harmonize regulatory frameworks. These efforts need to

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be intensified if Islamic banks are to compete on an equal footing with their conventional peers.

PERFORMANCE OVERVIEW AND NEED FOR CONTINUED IMPROVEMENTS [6]

Islamic finance, once considered a niche activity, is growing rapidly and is now becoming a mainstream banking choice across a large number of markets around the world.

Some of the recent growth is due to the positive influence of the rise in oil prices[7] on the GDP growth of Islamic banking countries. As GDP growth in key economies reached levels of 10–30% per year, overall banking sector asset growth in these countries witnessed growth between 13 and 42%,[8] well above the growth levels observed in typical developed markets (Exhibit 1). Islamic banks have managed to capture a disproportionate share of that growth (Exhibit 2).

To cite instances from two of the most developed Islamic banking markets, the share of Islamic banking in the overall banking sector has grown from 14.7% in 2000 to 21.6% in 2005 in Kuwait and from 6.9% in 2000 to 11.3% in 2005 in Malaysia. In fact, leading Islamic banks in these markets (KFH in Kuwait, and Islamic windows of conventional banks in Malaysia) have consistently witnessed growth rates well above their underlying market average. The situation is largely the same in most other Islamic banking markets (Exhibit 3). In 2005, specifically, Islamic banks' growth accelerated even further and reached record levels (Exhibit 4).

With a few notable exceptions, such as Al-Rajhi Bank and Qatar Islamic Bank, Islamic banks still struggle to reach profitability levels comparable to conventional peers. The return on assets of most Islamic banks, large or small, nascent or well established, has been consistently below the average of their respective markets (Exhibit 5).

What drives the profit and growth performance of the Islamic banking sector? Clearly, the managers of Islamic financial institutions, through the decisions they make, influence the profit and growth performance of their institutions. The disappointing profitability record can be attributed to three main factors.

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[6] McKinsey & Company, "World Islamic Banking Competitiveness Report, 2006" presented in the context of the World Islamic Banking Conference, 2006. Bahrain December 2005.

[7] "Arcapita: Focus on Unique Deals," *Islamic Finance Review* (January 2006): 4. The journal is published by the Bahrain Monetary Authority.

[8] Except Malaysia and Jordan, respectively at –2% and –9% asset growth.

The first factor is size: in spite of tremendous growth, most Islamic banks remain subscale[9] and have not yet managed to generate returns sufficient to cover the substantial investments they have made. Either through seeking lower-cost investments (such as outsourcing) or by fundamentally changing their business model (by partnering or merging), Islamic banks can seek scale for better performance.

The second factor is linked to the business model. While Islamic banks in general have been successful in capturing deposits, they have been less successful on the financing side. The Islamic institutions have, thus far, focused largely on the thinner margin corporate financing business rather than the more lucrative retail business, or they have invested in lower yielding instruments (for example, international *murabaha*), while their conventional counterparts have recently shifted their focus to the more profitable retail business. Greater development of higher-margin retail business, especially on the asset side, would help boost performance.

Finally, and most important, Islamic banks are still not at par with their conventional peers in either managing their businesses for optimal profitability through good service, or in tightly managing their cost base. A recent survey among retail customers of Islamic banks has shown that the majority of these customers are captive customers, that is, those that have chosen the bank not because of its products or service, but simply for its *shari'a* compliance (Exhibit 6). The survey also shows that overall levels of satisfaction with service and convenience are low (Exhibit 7). Islamic banks will have to improve their offerings to capture customers beyond the captive base, including those who mainly seek performance and convenience and are indifferent to *shari'a* compliance.

The industry is slowly coming to terms with the harsh reality of good growth but disappointing profitability. Participants in the 2005 World Islamic Banking Conference indicated that major efforts will be required in several areas of their businesses if Islamic banks are to improve their performance and meet future market expectations (Exhibit 8).

If Islamic banks start to seriously engage in performance improvement efforts, they should be able to reach levels of performance comparable to those of conventional banks. This assumes, however, that an even playing field exists between Islamic and conventional banks. Though this might seem like a natural assumption, we believe that the regulation of the financial sector has a very important role to play in the way the Islamic banking sector develops over time and compares with the conventional sector.

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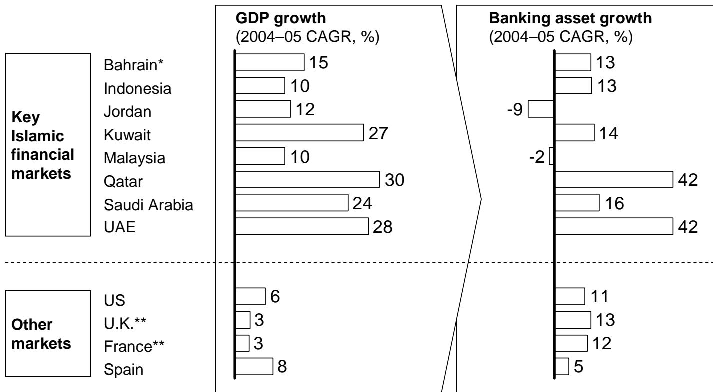
[9] "Islamic Banks Urged to Consolidate," *Islamic Finance Review* (January 2006): 1.

Exhibit 1

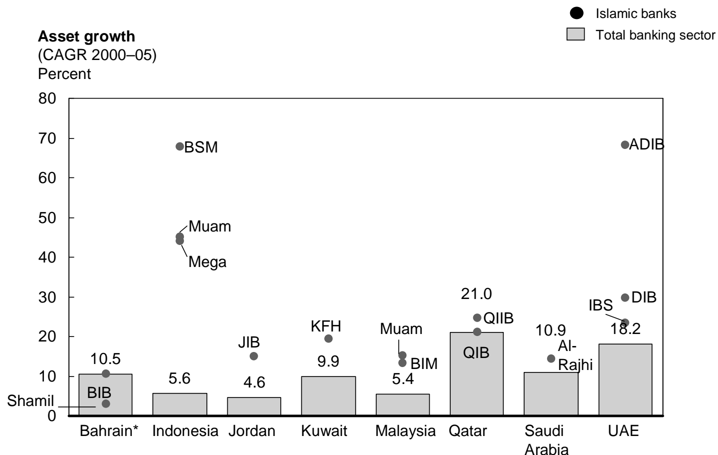
GDP AND BANKING SECTOR GROWTH IN ISLAMIC FINANCIAL MARKETS



* On-shore banks only
** Banking assets 2002–03 CAGR
Source: global insight; central banks; McKinsey analysis

Exhibit 2

COMPARISON OF ISLAMIC BANKS' GROWTH AND AVERAGE SECTOR GROWTH



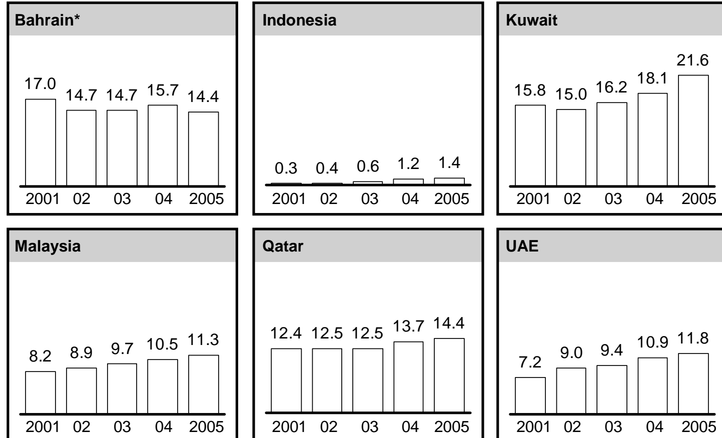
* On-shore banks only
Source: central banks; annual reports; Bankscope; IMD; capital intelligence reports; McKinsey analysis

Exhibit 3

EVOLUTION OF ISLAMIC BANKING PENETRATION

Islamic banking as part of total banking assets, percent

NOT EXHAUSTIVE

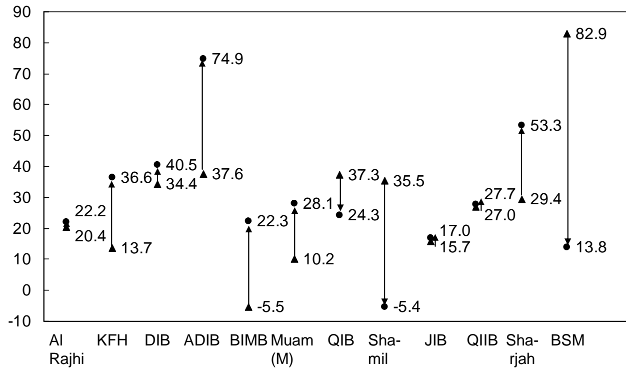


* On-shore banks only

Source: central banks; banks' annual reports; capital intelligence reports; Zawya; McKinsey analysis

Exhibit 4

EVOLUTION OF GROWTH BETWEEN 2004 AND 2005

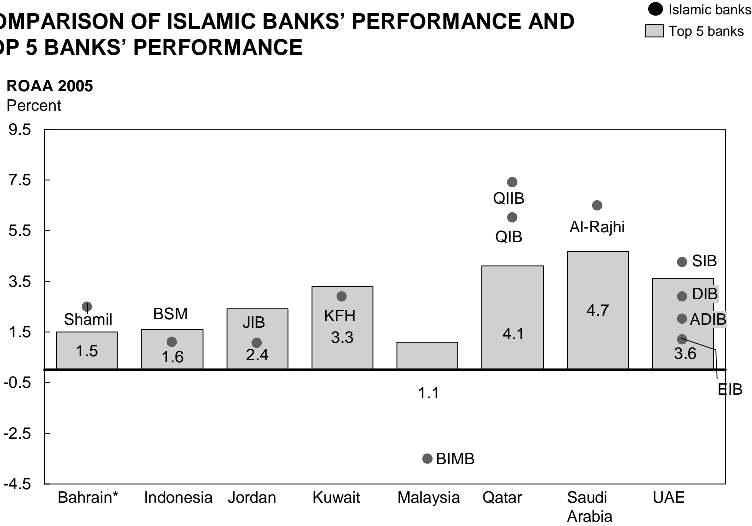


Key: KFH: Kuwait Finance House; DIB: Dubai Islamic Bank; ADIB: Abu Dhabi Islamic Bank; BIMB: Bank Islam Malaysia Berhad; Muam: Bank Muamala; QIB: Qatar Islamic Bank; JIB: Jordan Islamic Bank; QIIB: Qatar International Islamic Bank; BSM: Bank Syariah Mandiri

Source: banks' annual reports; Bankscope; McKinsey analysis

Exhibit 5

COMPARISON OF ISLAMIC BANKS' PERFORMANCE AND TOP 5 BANKS' PERFORMANCE

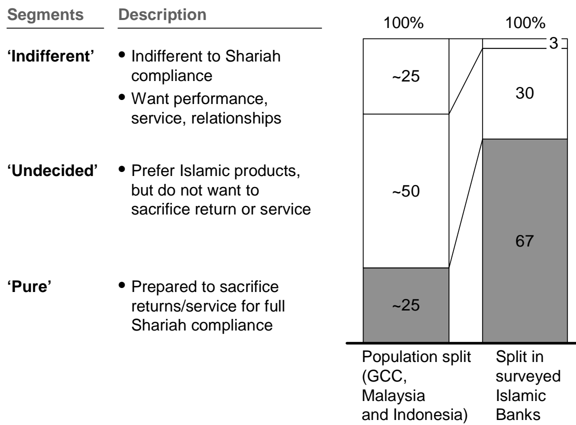


* On-shore only

Source: central banks; annual reports; capital intelligence reports; McKinsey analysis

Exhibit 6

COMPARISON OF CURRENT STRUCTURE OF ISLAMIC BANKS' CLIENTELE AND POPULATION STRUCTURE

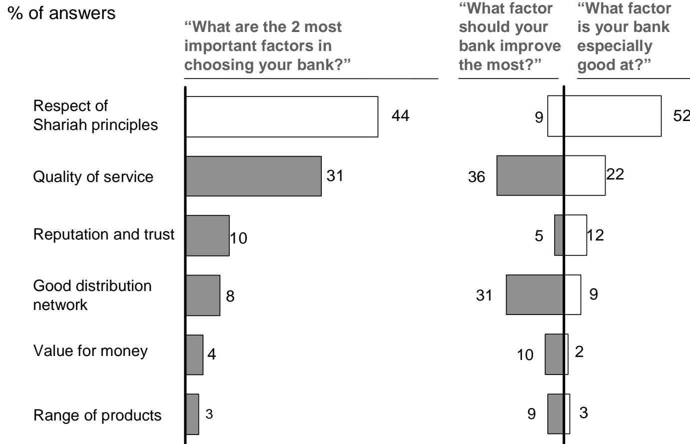


Source: 2005 Islamic Banking customer survey; McKinsey analysis

Exhibit 7

IMPORTANCE AND LEVEL OF SATISFACTION OF BANK SELECTION FACTORS

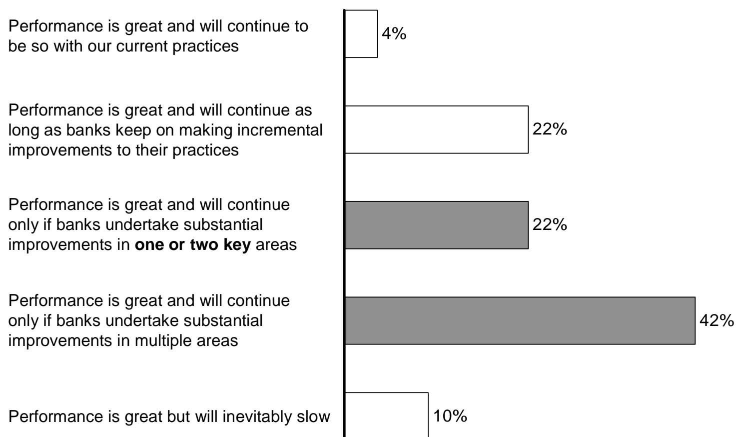
% of answers



Source: 2005 Islamic Banking customer survey; McKinsey analysis

Exhibit 8

INDUSTRY LEADERS’ PERSPECTIVE ON THE FUTURE EVOLUTION OF ISLAMIC BANKS’ PERFORMANCE

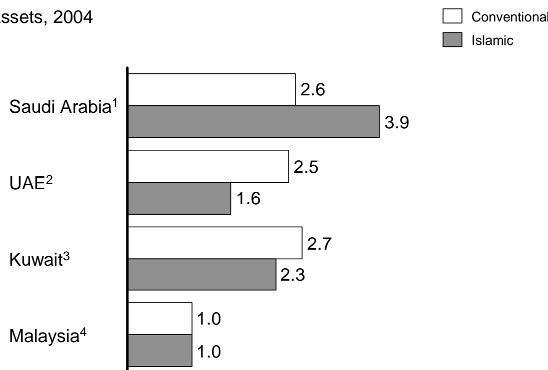


Source: 2005 World Islamic Banking Conference consensor survey

Exhibit 9

COMPARISON OF ISLAMIC AND CONVENTIONAL SECTOR PERFORMANCE BY COUNTRY

Return on Average Assets, 2004



1 Islamic banks: Al-Jazira, Al-Rajhi; Conventional banks: ANB, SABB, NCB, Riyad Bank
2 Islamic banks: DIB, SIB, EIB, ADIB; Conventional banks: EBI, NBAD, ADCB, NBD, Mashreq
3 Islamic bank: KFH; Conventional banks: NBK, Gulf Bank, CBK, BKME
4 Islamic banks: BIMB, Maybank Isl., Public bank Berhad Islamic, RHB Islamic, AMMB Islamic, Hong Leong Islamic, EON Islamic, Bank Muamalat; Conventional banks: Maybank, Bumiputra, Public Bank, RHB, AMMB, Hong Leong, EON

Source: banks' annual reports

More explicitly, the existence of specific regulations for Islamic financial institutions, or the absence thereof, can dramatically influence the ability and speed at which Islamic banks grow and improve profitability. The comparison of the performance of Islamic banks versus conventional banks in key Islamic markets clearly illustrates these differences (Exhibit 9). In Kuwait, the UAE, and Saudi Arabia, the Islamic banking sector is relatively concentrated and has largely been dominated by a single player (KFH, Dubai Islamic Bank, and Al-Rajhi, respectively). These players have been active for a long time in markets that have witnessed roughly the same economic evolution. Their performance, however, varies widely, suggesting that country-specific factors such as regulatory approaches may influence individual bank performance. Examples of such factors include the approach toward the *mudaraba* deposits and the ability of conventional banks to offer Islamic products and hence push the competition beyond *shari'a* compliance.

In Malaysia, the Islamic banking market is much more fragmented, but its performance is comparable to that of the conventional sector. Here, too, regulatory factors may be shaping the sector. For example, most of the players are Islamic windows of the dominating conventional banks, benefiting from a centralized *shari'a* decision-making process at the Central Bank.

The development of Islamic banking regulations that vary substantially from country to country could be one of the prime reasons for the wide variation observed in the growth, performance, and structure of markets across countries, and could strongly influence the evolution of these markets going forward. As the industry starts to globalize, attempts to harmonize the regulatory framework have increased.[10] It is very hard to say with certainty, at this point, if any specific model will emerge as the dominant regulatory framework in the future. What can be said is that there is still a lot of work and thinking to be done surrounding the various models if they are to be developed fully, and if convergence to a global standard is to be achieved.

IMPACT OF REGULATION ON THE DEVELOPMENT OF THE ISLAMIC BANKING MARKET

Banking regulation has the primary objective of protecting customers by promoting the stability and performance of the sector while ensuring fair and transparent practices by banks at several levels, including product development, pricing, risk and liquidity management, accounting practices, investment practices, and governance.

When regulating Islamic banking institutions, regulators have to make choices over and above the usual conventional regulation practices. As with financial innovation itself,[11] the regulatory decisions to accommodate this innovation present opportunities and risks. The key choices can be grouped in three categories:

- Structure of the regulatory framework for licensing;
- Direction setting on *shari'a* compliance;
- Approach to risk management and Basel II compliance.

Depending on the choices made by the regulator on each of these fronts, different banking sectors will emerge. In general, the outcomes will differ in aspects of competitiveness of the overall banking sector (especially of Islamic versus conventional banks), Islamic credibility, and general financial performance of Islamic banking players.

[10] "New Shari'a Standards on Way," *Islamic Finance Review* (October 2005): 2.
[11] Dalia El-Hawary, Wafik Grais, and Zamir Iqbal, "Regulating Islamic Financial Institutions: The Nature of the Regulated," World Bank Policy Research Paper 3227, (March 2004): 3.

Structure of the Regulatory Framework for Licensing

In its approach to formulating a regulatory framework for Islamic banking, a regulator can determine the degree of separation between Islamic and conventional banking.[12] Around the world, regulators have made this choice along the entire spectrum, ranging from not allowing Islamic banking (for example, Oman, most European countries) to engendering a fully *shari'a*-compliant banking sector (for example, Sudan).

In Saudi Arabia, for example, a single licensing and compliance framework (*single framework*) exists, covering conventional banks, Islamic banks, and Islamic windows. Within this context, banks can either be fully conventional, fully Islamic, or a mix of both.

In the UAE and Kuwait, two banking licenses exist, differentiating between conventional banks and fully *shari'a*-compliant institutions (*dual framework*). In these markets, by definition, a bank is either conventional or Islamic. In Kuwait, the offering of Islamic products by conventional players is only allowed for off-balance-sheet products (for example, Islamic funds) or for products offered via specialized consumer finance companies. Only Islamic banks are allowed to offer on-balance-sheet Islamic banking products (for example, *murabaha*, *ijara* finance). In the UAE, while a window license exists, to date few of the conventional players have received such a license.

In Malaysia, a third license exists for Islamic windows. In this model, banks must be either fully Islamic or conventional, or be an Islamic window of a conventional player. In fact, encouraged by the Central Bank, nearly all of the conventional players have an Islamic window license.

In addition to deciding which of these broad models to adopt, regulators can make the choice of specifically allowing or forbidding a particular product (for example, *mudaraba* accounts in Saudi Arabia), or even consciously promoting one format of banking (as Malaysia is actively promoting the growth of its Islamic banking sector). Depending on the choices made, very different outlooks for the banking sector as a whole will emerge.

[12] Zeti Akhtar Aziz, "Building the Progressive Islamic Banking Sector: Charting the Way Forward" (22 June 2005): 3 (lecture given by the Governor of Bank Negara Malaysia at a seminar on the ten-year master plan for the Islamic Financial Services Industry).

The dual licensing framework

The dual framework has the effect of protecting the Islamic banking industry by creating a regulatory barrier to conventional players wishing to offer Islamic products.

The dual model creates a walled garden around Islamic banks, protecting them from having to compete with established conventional players. As a result, Islamic banks will initially witness above-market growth since they will start by addressing the needs of "pure" customers. This protection from competion with established players may, however, lead Islamic banks to become complacent, fostering the belief that being Islamic is a sufficient criterion for success. Innovation, quality of service, convenience, and operational improvements might be overlooked, creating a rapidly expanding gap with conventional players. When Islamic banks start becoming relatively well established, the dual system, once protective, may become detrimental to future growth as banks try to expand their reach outside of the "pure" customers and make themselves attractive to a wider range of customers. If Islamic banks have initially been complacent, attracting new customers may represent a formidable challenge as it will require stepping up service, network convenience, and product quality to the level of conventional banks. If they fail in their turnaround, growth may slow down as the "pure" segment becomes saturated. In this situation, performance would also decline. As a result, Islamic institutions may not only witness lower performance than their conventional peers, but they may also lock themselves out of future growth. The result could be as dramatic as a "two-speed" banking sector.

The dual licensing system might also impact overall convenience to customers as they will have to develop multiple banking relationships if they desire access to products that do not exist in a *shari'a*-compliant form (for example, derivatives trading, specific funds, and credit cards in some markets).

However, the dual system does present some strong advantages. Because it creates a real distinction between the two formats of banking, the system is more likely to foster the development of a credible Islamic banking sector. It could help dispel the perception that *shari'a* compliance is just a label that any bank, conventional or Islamic, can appropriate. Yet the approach of separating regulatory and licensing models for conventional and Islamic banking is not the only way to achieve credibility for the sector. Other approaches may yield similar results without the possible long-term impact of the dual system. Regulators can, for example, envisage more micro-regulatory approaches. One way of achieving the same goal is to ensure that individual players are *shari'a*-credible through specific regulation or audits.

The single licensing framework

If a regulator chooses to pursue a single licensing framework, it must consider the potential impact its decision may have. While a single licensing system may allow an individual bank to offer a wider range of products and to be better equipped to serve its customers, it can also negatively impact the evolution of the sector.

Within a single licensing model, the regulator must take a specific stance on product-specific regulation. Any decision that is taken may have a substantial impact on a *shari'a*-compliant bank's ability to compete. For example, the Saudi Arabian regulator had to decide on *mudaraba* accounts. As a consumer protection measure by the regulator, these accounts are not allowed. The regulator imposes the basic requirement that deposits be capital protected, which is not the case with a *mudaraba* account, where customers are considered "shareholders" in the bank and are hence exposed to risk. For "pure" customers who do not wish to deposit their funds in interest-bearing accounts, the range of available accounts was until recently limited to non-interest-bearing deposits (NIBs) and longer-term investment accounts.

If the dual system's offer increased Islamic credibility with the institutions operating there, the inverse is true of the single model system. The single model allows players to distribute Islamic products whether they are Islamic or conventional. In a nascent market, this model could actually make it more difficult to educate customers about the values of Islamic banks as customers would find it hard to really assess the difference between fully *shari'a*-compliant banks, windows, and products distributed by conventional banks. It could also raise the long debated question of whether windows are really Islamic or whether they are just a way for opportunistic conventional banks to capture a new market. In summary, the single model can lead to a questioning of the overall credibility of the sector.

Direction Setting on *Shari'a* Compliance

Islamic banking depends fundamentally on the interpretation and application of *shari'a* law to previously unknown problems. Because there is no single answer to how Islamic law should be interpreted and applied, there is currently a wide variation, domestically and internationally, in the

ways in which different Islamic banks operate.[13] Not only are there clearly several schools of thought on *shari'a* interpretation, but interpretations vary between scholars as well. Innovative banks can use their *shari'a* boards' readiness to consider new, more sophisticated products as a competitive weapon.

The current practice of an individual *shari'a* board for each bank raises several questions. How can banks guarantee a minimum quality level on their *shari'a* boards? How can banks guarantee the impartiality, fairness, and independence of their *shari'a* boards when a limited number of scholars sit on numerous boards, sometimes even those of direct competitors? How can *shari'a* boards themselves become a source of innovation for the bank? How can banks avoid adopting progressively more lenient interpretations of *shari'a* in order to compete more easily with conventional banks? Should *shari'a* interpretation become more standardized across countries?

In the face of these questions, regulators have adopted several approaches. The first approach is the *regulation of shari'a boards*. The regulator creates an "approved list" of *shari'a* scholars and vets the membership and structure of *shari'a* boards. This model, provided it is based solely on the evaluation of the knowledge and expertise of scholars and not on their beliefs or interpretations, has the advantage of creating a check on standards across the industry, while at the same time giving banks the freedom to innovate and adopt different positions in the market based on different interpretations of *shari'a*. Interestingly, this is also the model closest to traditional Islamic methods of ensuring a fair and just application of *shari'a*. This model is, for example, the model applied in Qatar.

The second approach is *market-based regulation.* It puts the responsibility on banks or independent market actors to develop methods to ensure that standards do not drop. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has, for example, driven efforts for developing generally accepted accounting principles and financial structuring of major products across the industry. Another example is the recently established Islamic Rating Agency (IIRA), which is evaluating the tightness of *shari'a* compliance verification and *shari'a* auditing in banks.[14]

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[13] Datuk Zamani Abdul Ghani, "Accelerating Growth of the Islamic Financial System through Effective Linkages and Integration, lecture delivered by the Deputy Governor, Second Annual Asian Islamic Banking and Finance Summit (20 September 2005): 3.

[14] "IIRA: Assessing 'Unique' Risks," *Islamic Finance Review* (October 2005): 6. A *shari'a* audit is the procedure by which the *shari'a* department of the bank verifies, on behalf of the *shari'a* board, whether or not the procedures that are followed in the bank fit with *shari'a* requirements (for example, that the bank staff do not talk to clients

The third approach is the *centralization of shari'a board approvals*, where a central *shari'a* board controls *shari'a* standards across the market. A form of this model has already been adopted in Malaysia, where Bank Negara has its own *shari'a* board that vets the products issued by banks and hence creates a minimum threshold to meet for the *shari'a* compliance of products. The *Shari'a* Advisory Counsel is "the sole authority and reference on all *shari'a* matters pertaining to Islamic banking and finance."[15] So far, this model is the strongest example of involvement of a regulator in controlling *shari'a*-related aspects of the industry.

The quality of *shari'a* rulings is an important element that should be regulated in some form or another. Regulating the *outcomes* of *shari'a* rulings is a totally different question.

Regulating the quality of rulings can be achieved through the direct intervention of the regulator in the selection of *shari'a* board members for banks and through regular audit processes conducted by the regulator, the banks themselves, or a third party. These approaches should be hailed and encouraged as they monitor quality while leaving the banks' individual *shari'a* boards with the complete freedom to issue the rulings they deem appropriate. Regulators should even consider making *shari'a* rating mandatory once the IIRA has become a well established actor in the market.

Involving the regulator in the decision about whether a practice or a product is *shari'a* compliant is another issue. The involvement of the regulator is generally envisaged to ensure a minimum threshold of *shari'a* compliance. This idea is laudable but needs to be conducted with care to avoid distortion of the competition.

First of all, the central *shari'a* board should maintain confidentiality about the product structure. The details of the product should not be communicated outside of the board's debates, in order to prevent competitors from gaining access to the product or copying it, destroying the applicant's competitive edge. Such confidentiality is challenging to maintain as members of the central *shari'a* board are typically chosen from among the members of individual banks' *shari'a* boards. Second, the centralized board should have a clearly defined mandate. It should verify compliance with clear rules and accepted interpretations but should not use its own interpretations in its debates. Indeed it might, as a whole, have a different view on *shari'a* compliance than the *shari'a* board of the bank filing for approval. If the central *shari'a* board uses its own interpretation

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about interest, and that forms are filled out properly and in the right sequence for a *murabaha* deal).

[15] Zeti Akhtar Aziz, "Ensuring stability in the Islamic financial system," speech delivered by the Governor of the Central bank of Malaysia (13 January 2004).

to assess the product, a product considered compliant by the applicant's board might be rejected by the central board, leading to a possible decrease in banks' ability to innovate.

The problem would be similar if any third party in the industry were to rule on the compliance of products, for example, if the IIRA were expanding its mandate to cover the outcome of rulings. Judgments on the *shari'a* compliance of banks would be a dangerous tool, as it could lead to banks losing credibility and also to a curb on innovation by more sophisticated or progressive institutions.

From the perspective of *shari'a* credibility, the involvement of the regulator in making *shari'a* boards and processes credible while meeting basic healthy standards is positive for the entire sector's credibility. On the other hand, the regulator's involvement in *shari'a* rulings, if this is chosen, must be conducted with utmost care to avoid constraining the competitive intensity and innovation in the industry.

Overall Performance Related to Risk Management

The implementation of the Basel II recommendations on capital adequacy and risk governance could have a significant impact on the risk-adjusted performance of Islamic banks.

Under Basel I, banks have to ensure that capital exceeds 8% of the Risk Weighted Assets (Cooke Ratio) to cover the credit risk that is inherent in a bank's portfolio. The Basel I approach barely distinguishes between different types of obligors and would allocate a risk weight of 100% to all types of credit obligations except for retail mortgages, sovereign borrowers, and banks incorporated in an OECD country. The Basel II approach introduces distinctions between the various types of obligors and allows banks to differentiate between borrowers on a much more detailed level than does Basel I.

In March 2005, the IFSB (Islamic Financial Services Board) drafted capital adequacy guidelines for Islamic banks. The draft was officially adopted in December as a prudential standard on capital adequacy for financial institutions offering only Islamic financial services (IFS). In this prudential standard, IFSB translated the Basel II standardized approach to Islamic banks' concepts and extrapolated Basel II guidelines for specific *shari'a*-compliant products that have no direct conventional equivalent. Several countries have already announced their intention to adopt IFSB standards either fully (for example, Indonesia, Malaysia[16]) or after making

[16] Governor of Bank Negara Malaysia, speech at the Annual Islamic Finance Summit in London (24 January 2006).

minor amendments (Bahrain). IFSB's prudential standard is essentially based on the standardized approach for credit risk management, while the basic indicator approach is used to cover operational risk.

Basel II already introduces significant differences in the treatment of the credit risk portfolios compared to Basel I, essentially to account for the underlying risk profiles of the portfolios. Furthermore, the IFSB's prudential standard includes notable differences in risk treatment for products structured under certain concepts such as *ijara*, *mudaraba,* and *musharaka* vis-à-vis Basel I. The risk weights for these products can be up to 400% versus 100% under Basel I, especially if the counterparty is not rated.[17]

The Islamic financial institutions that choose a standardized approach under Basel II might require significantly higher capital compared to conventional banks, especially if they are using the previously mentioned concepts. For example, under Basel II, residential mortgage financing involves a 35% risk weight for an unrated counterparty, as long as the loan is fully secured with the property. In order to create a similar product with variable pricing, many Islamic financial institutions are using the *ijara* structure, which requires a 100% risk weight.

For the Islamic banks that choose a standardized approach, the difference in risk weights could lead to a higher pricing for the same product when compared to conventional counterparts. Under the IRB approach, this difference would be significantly reduced.

Regulators should therefore actively encourage and enable banks to move toward IRB approaches. This will generally prove a challenge as most Islamic banks are small and relatively young. They lack the expertise, the infrastructure, and, most importantly, the data history to move towards more advanced approaches. The regulator could start sector-wide initiatives such as training and data pooling to enable Islamic banks (as well as small conventional banks) to achieve IRB compliance, thus maintaining their competitiveness.

One other impact of increased risk weighting beyond pricing is the potential capital adequacy requirements under the new guidelines.[18] Although most of the Islamic financial institutions have strong capital positions, some of them may still lack the same level of extra-capital cushion once the new framework is applied and operating and market risks have been accounted for. Eventually, this would lead not only to reduced return on capital (that is, performance), but would also hamper Islamic

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[17] "Capital Adequacy Standard for Institutions (Other Than Insurance Institutions) Offering Only Islamic Financial Services," Exposure Draft Number 2 (March 15, 2005): 15-17.

[18] Ibid., 26-28.

financial institutions' growth, as they will require significant contributions in capital to finance this growth.

Also, many of the Islamic financial institutions' liabilities are mainly constituted of Profit Sharing Investment Accounts (PSIA). These PSIA accounts are similar to savings accounts where the bank uses the funds available to finance its lending and investing transactions. The profit (or loss) generated by these transactions is shared with the PSIA account holders.[19] Therefore, PSIA accounts might be used to reduce the risk weighting of the assets, essentially a measure left to the discretion of national supervisors. While this could provide some capital relief for Islamic banks, it could also lead to unexpected changes in risk profiles.

Regulators should carefully examine the potential impact of applying currently developed capital adequacy guidelines to Islamic banks and consider the risks inherent in the structure of these concepts that might include some country-specific factors. They should do this before undertaking any decision with respect to the relevant capital adequacy requirements for Islamic banks. They should also take active measures to promote and enable advanced risk measurement capabilities at Islamic financial institutions. Otherwise, Basel II and other regulations might have unforeseen implications such as declining competitiveness or performance of Islamic financial institutions, or transfer of certain risks from conventional banks to Islamic financial institutions.

CONCLUSION

Despite their recent positive evolution, Islamic banks are witnessing an increased pressure to continue growing and further improve profitability. As they embark on the difficult journey of attracting new customers by stepping up service and convenience and developing new products, they might be supported or restrained by the regulatory environment in which they evolve in.

The framework that regulators choose for the industry can have a positive or negative impact on the Islamic banks' credibility, ability to compete, and financial performance. Many different regulatory models exist around the world, and each of them presents both advantages and drawbacks. None of them emerges as a clear winner.

In general, the guideline that regulators should adopt is to foster healthy competition between conventional and Islamic banks. This does not necessarily mean treating them equally (especially given the asset-backed transaction nature of the Islamic banks), but it does mean removing

[19] Ibid., 47-51.

all possible barriers to competition. This decision would naturally result in a wider choice for customers, a stronger drive for quality of service, and better prices. This decision would also be consistent with efforts from the regulator to minimize its direct influence on the sector and to make as much space as possible for self-regulation. In any case, regulators must consider carefully the implications of any decisions they may choose to make.

Recent innovations in regulation and attempts at harmonization are starting to create some consistency in regulatory frameworks and approaches across countries. While we are still far from the level of harmonization that can be seen in the conventional sector, these efforts should be praised and intensified.

Basel II and Corporate Governance in Islamic Banks

M. Kabir Hassan,[1] Mehmet F. Dicle[2]

Those who devour usury will not stand except as stand one whom the Evil one by his touch Hath driven to madness. That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are companions of the Fire: They will abide therein (for ever).[3]

The Apostle of Allah (peace be upon him) cursed the one who accepted usury, the one who paid it, the witness to it, and the one who recorded it. (Narrated by Abdullah ibn Mas'ud.)[4]

Stakeholder theory for Islamic banking defines the related parties and their rights within Islamic banks. The concept of the stakeholder is well defined in Islamic schools of thought and in *fiqh*. For this reason, compliance with *shari'a* will ensure effective corporate governance. Jameel Ahmad defines corporate governance as "the system by which business corporations are directed and controlled by structuring rights and responsibilities of different participants in the corporation, such as, the board, managers, shareholders and stakeholders."[5] According to Shleifer and Vishny's definition, corporate governance "deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their

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[3] Qur'an 2:275 (Translation of Yusuf Ali).
[4] *Sunan Abu Dawud*, Book 22, Number 3327.
[5] Jameel Ahmad, "Handbook of Corporate Governance," State Bank of Pakistan (2003), http://www.sbp.org.pk/about/corp_gov/index.htm.

investment."[6] The unique structure of banks and their ability to collect deposits differentiates corporate governance of banks from that of any other entity.

In their summary of the stakeholder's model of corporate governance, Iqbal and Mirakhor state that stakeholders may include "customers, suppliers, providers of complementary services and products, distributors, and employees," and that corporations "ought to be managed for the benefit of all who have some stake in the firm."[7] Stakeholders for banks include shareholders, board members, management, employees, regulators, account holders, and credit customers. The main difference with Islamic banks lies in the types of accounts and credit instruments that are used in daily transactions. Islamic banks comply with the rules of *shari'a*. Such rules apply to corporate structures as well as relationships between stakeholders.

The first section of this paper explains Islamic banking products with reference to the stakeholder model, in order to discuss the unique characteristics of corporate governance for Islamic banks. The second section explores each stakeholder within an Islamic banking system. Specifically, terms of corporate governance in Islamic banking are discussed. The corporate governance of Islamic banks under Basel II is discussed in the third section. Compliance issues related to Basel II and possible problems with compliance are presented in the final two sections.

ISLAMIC BANKING PRODUCTS

The main distinguishing feature between Islamic banks and conventional banks is the exclusion of interest (*riba*) and excessive risk taking (*gharar*) in Islamic banks. Where Islamic banks coexist with conventional banks, they must comply with regulations designed for conventional banking products as well as with *shari'a*.

With the exception of Iran, Sudan, and Pakistan, Islamic banks operate alongside conventional banks[8] and hold less than 15 percent of the market that contains all the deposit-accepting banks. Such a limited share

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[6] Andrei Shleifer and Robert Vishny, "A Survey of Corporate Governance," *Journal of Finance* 52, no. 2 (June 1997): 737.

[7] Z. Iqbal and A. Mirakhor, "Stakeholders Model of Governance in Islamic Economic System," Paper presented at the International Islamic Banking and Finance Conference in Bahrain, October 2003; (hereafter cited as Iqbal and Mirakhor (2003).

[8] M. K. Hassan, "Cost, Profit and X-Efficiency of Islamic Banks in Pakistan, Iran and Sudan," Paper presented at the International Seminar on Islamic Banking: Risk Management, Regulation, and Supervision, Jakarta, September, 2003.

of the market forces Islamic banks to operate with products that are more acceptable to the financial environment in which they operate.

Figure 1: Selected financial figures for Islamic banks and for conventional banks for the 19 countries where Islamic banks operate[9]

	Year	Total Banks	Islamic Banks	Conventional Banks	Islamic % of Market	Conventional % of Market
Number of Banks; % of Market		411	64	347	15.57%	84.43%
Loans	2002	505,383,319	58,564,690	446,818,629	11.59%	88.41%
Loans	2001	497,606,526	69,300,868	428,305,658	13.93%	86.07%
Loans	2000	495,145,769	116,638,461	378,507,308	23.56%	76.44%
Loans	1999	449,567,899	96,120,001	353,447,898	21.38%	78.62%
Fixed Assets	2002	19,715,333	2,773,090	16,942,243	14.07%	85.93%
Fixed Assets	2001	19,720,726	3,510,021	16,210,705	17.80%	82.20%
Fixed Assets	2000	17,847,920	6,758,194	11,089,726	37.87%	62.13%
Fixed Assets	1999	16,939,848	5,861,634	11,078,214	34.60%	65.40%
Total Assets	2002	1,126,695,543	132,135,866	994,559,677	11.73%	88.27%
Total Assets	2001	1,114,631,294	149,229,165	965,402,129	13.39%	86.61%
Total Assets	2000	1,095,932,093	223,272,903	872,659,190	20.37%	79.63%
Total Assets	1999	993,367,109	177,700,412	815,666,697	17.89%	82.11%
CSTF*	2002	934,003,534	113,246,918	820,756,616	12.12%	87.88%
CSTF	2001	921,927,397	124,025,964	797,901,433	13.45%	86.55%
CSTF	2000	873,399,971	167,403,328	705,996,643	19.17%	80.83%
CSTF	1999	802,595,458	125,042,571	677,552,887	15.58%	84.42%
Equity	2002	106,358,733	11,194,457	95,164,276	10.53%	89.47%
Equity	2001	97,029,410	10,664,704	86,364,706	10.99%	89.01%
Equity	2000	88,103,263	13,286,790	74,816,473	15.08%	84.92%
Equity	1999	70,147,503	9,027,731	61,119,772	12.87%	87.13%
Net Income	2002	15,558,691	2,300,606	13,258,085	14.79%	85.21%
Net Income	2001	4,075,413	1,542,070	2,533,343	37.84%	62.16%
Net Income	2000	11,589,934	2,209,955	9,379,979	19.07%	80.93%
Net Income	1999	–1,051,917	1,078,110	–2,130,027		

*Customer & Short Term Funding

[9] Source: BankScope Database, Bureau van Dijk, release 165.2, update April 2004. Amounts indicate thousands of U.S. dollars.

Credit Instruments: Trade Related

Murabaha transactions are Islamic banking products that are the most similar to conventional banking credit utilization in terms of customer financing. Due to such similarity, Islamic banks use the *murabaha* transaction extensively. This preference may be due to regulatory compliance, lower associated risks compared to other Islamic credit instruments, or ease of use. With the *salam* transaction, Islamic banks may purchase goods that will be delivered at a future date with full payment in advance. With *salam* contracts, Islamic banks are able to provide pre-harvest financing for farmers. *Istisna'* transactions are very similar in nature. However, *istisna'* transactions do not require a payment in advance and involve production of the underlying goods. The main intention is to provide financing for manufacturers, much like pre-export credits or contract-based credits. The parties involved in *murabaha, salam,* and *istisna'* transactions include the Islamic bank, a seller, and a buyer.

Ijara transactions are more like operational leasing transactions than financial leases. Regulations of leasing transactions for conventional banks make them very easy for Islamic banks to follow. With *ijara* transactions, Islamic banks are the owners of the subject goods and are simply renting them. Therefore, the renter is directly involved with the Islamic bank as long as the *ijara* transaction is valid.

Credit Instruments: Equity Related

The important aspect of *mudaraba* partnerships is the long-term relationship that exists between the investing and the managing partners. In terms of corporate governance, the managing partners become stakeholders at the Islamic bank, even though they have no claims against the Islamic bank after the investment has been completed. Well-defined terms of the relationship between the Islamic bank and the managing partners are required for successful implementation of *mudaraba* transactions. Therefore, the importance of corporate governance within an Islamic bank will be reflected in any *mudaraba* partnership that it enters.

Corporate governance becomes a major issue for *musharaka* partnerships, considering the fact that Islamic banks actively participate in the operations. Therefore, any business partner within a *musharaka* partnership naturally becomes a stakeholder. The corporate governance of the *musharaka* partnership, as well as that of Islamic banks, should be well designed to allow for the successful operation of *musharaka* partnerships. Any control facilities and operational responsibilities should be described well in advance.

Deposit Instruments

Islamic banks collect deposits into current accounts for the purpose of safekeeping, and in some cases, these accounts form more than 75 percent of total funds under management.[10] Considering the magnitude of these accounts and their usage, special attention should be given to current accounts. Although the purpose of current account holders is safekeeping, in practice they face much of the same risks as investment account holders. Funds from current accounts may be utilized to generate profits, yet these profits are not shared with them. Iqbal and Mirakhor state that in Islam, "a stakeholder is the one whose property rights are at stake or at risk due to voluntary or involuntary actions of the firm."[11] Based on this definition, current account holders should be considered as stakeholders.

Depositors of investment accounts, or profit and loss sharing (PLS) accounts, assign the Islamic bank to act as their agent to conduct credit transactions and generate profit. Thus they assume the risk involved with credit instruments and are directly influenced by the performance of the bank. Since there is no deposit insurance coverage for any loss on these accounts, their stakeholder status is imperative. Investment deposit holders are exposed to risk as much as shareholders. The question is whether to allow investment account holders to participate in the management of the Islamic bank to the same degree as shareholders. With commercial banks, deposit insurance would represent the time deposit holders as a whole.

STAKEHOLDERS FOR ISLAMIC BANKS

Iqbal and Mirakhor (2003) summarize property rights in Islam.[12] Their justification for stakeholder participation in the decision-making process is based on four principles. The first is collectivity, where each individual has sharing rights of the properties acquired. The second is the principle that exercising a property right should not cause damage to others or to the property of others. Third, the rights of others and their property are subject to rules regarding property rights. Fourth, according to *shari'a*, a property leading to denial of a right is not recognized as a property and is considered unlawful. Iqbal and Mirakhor conclude, "It is not necessary for each stakeholder to be a participant in the decision-making as long as their rights are protected through sound institutional arrangements."

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[10] T. Khan and H. Ahmed, "Risk Management: An Analysis of Issues in Islamic Financial Industry," Islamic Research and Training Institute, 2001, http://www.irti.org/publications/publications_english6.htm.
[11] Iqbal and Mirakhor (2003).
[12] Ibid.

In his comment about Islamic economics, Lewis quotes Khaliffa: "The distinctive characteristics of Islamic economics are that it is Godly, ethical, humane, and moderate and balanced."[13] Lewis further states that Islamic businesses conducted by Muslims should reflect the characteristics of Islamic economics. It is expected that Islamic banks comply with *shari'a*, and that insiders of Islamic banks comply with the Islamic way of life. This view is contrasted with the fact that some Islamic banks are owned by international financial corporations and some interest-bearing banks operate Islamic banking windows. However, this is an issue for *fiqh*. Our discussion is purely from a financial and economic perspective.

Shareholders select the board of directors, and in turn, the management. Thus, they are in a position to control the activities of the Islamic bank, including *shari'a* compliance. The regulatory responsibility of shareholders also requires them to control Islamic banks against any excessive risk. This is especially true for countries where deposit insurance exists. A failure would affect the whole Islamic banking system and might result in the loss of public confidence.

The board of directors is at the primary level of authority in an Islamic bank. They are the key decision makers in implementing policies and bylaws within the bank. Their responsibilities include profitability, safety, and compliance with laws. Compliance with *shari'a* is also a key concern. The board of directors may establish subcommittees, such as committees for risk management, credit, internal audit, and compensation, in order to delegate authority and share responsibility with the management. The Islamic Financial Services Board suggested in 2005 that a governance committee be established for corporate governance along with an audit committee for oversight of the accounting process.[14]

The importance of the *shari'a* board has been emphasized by Suleiman who states, "those who deal with an Islamic bank require assurance that it is transacting [in compliance] with Islamic law."[15] Hassan and Chowdhury explain the role of the *shari'a* board as follows: "The *shari'a* board plays a very significant and multi-dimensional role related to the relation between the bank and its clients, the bank and its depositors,

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[13] Mervyn Lewis, "Islamic Corporate Governance," *Review of Islamic Economics* 9, no. 1 (2005): 5-29; Azaddin Salem Kaliffah, "The Multidimensional Nature and Purpose of Business in Islam," *Accounting, Commerce & Finance: The Islamic Perspective Journal* 7, no. 1&2 (2003): 1-26.

[14] Islamic Financial Services Board, "Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services," Exposure Draft No. 3, December, 2005; hereafter cited as IFSB (2005).

[15] Nasser M. Suleiman, "Corporate Governance in Islamic Banks," *Arab Gateway* (December 2000), http:// www.al-bab.com/arab/econ/nsbanks.htm.

the bank and shareholders, and even the role of bank management."[16] IFSB (2005) suggests that Islamic banks should be persistent with their *shari'a* boards, and discourages "*fatawa* shopping."[17] Hassan and Chowdhury suggest that instead of having a separate *shari'a* board for every Islamic bank, a centralized board within each central bank should be established.[18] Chapra and Ahmed emphasize the costs of each Islamic bank having its own *shari'a* board, as well as the uncertainty generated by conflicting opinions.[19] Consequently, they suggest the creation of a centralized *shari'a* board. Iqbal and Mirakhor (2003) conclude: "A *shari'a* board for every firm, which is seen in present architecture of Islamic banking, is not efficient whereas only one set of rules is needed for appropriate corporate governance."[20] The standardization of Islamic banking operations can be established through centralized efforts such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB).[21]

Managers are the key personnel in terms of the decision-making process. Iqbal and Mirakhor (2003) state that "managers have a fiduciary duty to serve the interests of all stakeholder groups."[22] The balance between stakeholders may require tradeoffs. For instance, products such as *mudaraba* and *musharaka* may be suggested more in terms of *shari'a* compliance than *murabaha*. However, associated risk, complications with the credit evaluation process, and liquidity concerns make them less preferred by the management. According to Hassan, Wolfe, and Maroney, when the risk is high enough, "management may not invest in projects that are worthwhile to shareholders."[23] The illiquid nature of Islamic banking products, the lack of Islamic money markets, and the lack of a lender of last resort leave management with a problem of liquidity. There may also be tradeoffs for the decision of profit stabilizing techniques. Changes in an

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[16] M. K. Hassan and M. A. M. Chowdhury, "Islamic Banking Regulations in Light of Basel II," Paper Presented at the 2004 Harvard University Islamic Finance Forum Conference, Boston, April 12, 2004; hereinafter cited as Hassan and Chowdhury (2004).
[17] IFSB (2005).
[18] Hassan and Chowdhury (2004).
[19] M. Umer Chapra and H. Ahmed, "Corporate Governance in Islamic Financial Institutions," Islamic Research and Training Institute, Occasional Paper No. 5, 2002, http://www.irti.org/publications/ publication_english1.htm; hereinafter cited as Chapra and Ahmed (2002).
[20] Iqbal and Mirakhor (2003).
[21] See www.aaoifi.com and www.ifsb.org.
[22] Iqbal and Mirakhor (2003).
[23] M. Kabir Hassan, David R. Wolfe, and Neal C. Maroney, "Corporate Control and Governance in Banking," *Corporate Ownership & Control* 1, no. 4 (Summer 2004): 94-107.

Islamic bank's share ratio in profits is a tradeoff between investment account holders and shareholders. Therefore, effective corporate governance is crucial for management to find the optimum balance among each stakeholder.

Employees of Islamic banks invest their efforts and careers in the Islamic banks they work for. They are compensated through their salaries. Their place within the corporate governance as a stakeholder is certain. They are the applicators of all the rules, regulations, and procedures that are defined to them. However, their rights may require more attention since they are the actual field workers.

Current accounts holders provide Islamic banks with funds that expect no return. Therefore, any profit on investments done with current accounts will not be claimed and will be left to the Islamic bank. However, these accounts bear the indirect risk of loss through usage of these funds in investment activities. Thus, current account holders should either be compensated for the risk they are facing, or else usage of such funds should be restricted. One survey conducted in 2002 revealed that 50 percent of Islamic banks surveyed had extended deposit insurance to them.[24] Therefore, in case of no deposit insurance, current account holders are not properly represented within current stakeholder scheme.

Investment accounts, unlike current accounts, face the risk of loss even if the Islamic bank does not entirely fail. Facing credit risk directly may entitle investment account holders to a place in the decision-making process. In fact, the level of credit risks faced by the shareholders is similar to that faced by investment deposit holders. However, representation of investment account holders within the board of directors may become cumbersome, considering the large number of investment account holders. Extended transparency may prove to be very useful to protect the rights of investment deposit holders and protect them against any risks that they do not want to take.

Partners through *mudaraba* and *musharaka* transactions should be given special attention within the corporate governance structure, considering the fact that these partnerships have long term commitments and involve heavy consequences for dissolution. The auditing process should be structured to evaluate and control the relationship between the Islamic bank and the partnership. The situation gets more complicated for *musharaka* partnerships where Islamic banks participate with management.

Regulators should be able to monitor the activities of Islamic banks. The potential of systematic risk is the same for commercial banks as well as Islamic banks. Al-Jarhi summarizes such monitoring activity to include three kinds of supervision: *shari'a* supervision, financial supervision, and

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[24] Chapra and Ahmed (2002).

operational supervision.[25] It is recommended that regulators design frameworks for unique Islamic banking products. It is often Islamic banks that have to alter their products to local regulations. Such alterations could pose unforeseen risks. In order to maintain proper transactions and compliance with *shari'a*, regulators should establish ground-rules for Islamic banks.

External auditors provide objective evaluation of financial and operational situations. *Shari'a* compliance should also be included in an external audit, and external auditors should be familiar with Islamic banking products.

Chapra and Ahmed (2002) also include the overall economic, financial, legal, and accounting systems, as well as banking associations as being the key players along with the ones explained above. They explain that successful corporate governance requires an efficient legal system and the enforceability of contracts and laws facilitating Islamic banking operations. In addition, accounting and auditing standards are required to establish transparency and comparability.

BASEL II AND CORPORATE GOVERNANCE OF ISLAMIC BANKS

The Basel committee on banking supervision defines corporate governance as the manner in which the business and affairs of individual institutions are governed by their board of directors and senior management.[26] It should set corporate objectives and descriptions of day to day operational procedures, consider the interests of stakeholders, align corporate activities, and protect the interests of depositors. Such definitions should also include special stakeholders that are included within the Islamic banking framework. As explained in the previous section, credit customers and deposit holders have a special place within the stakeholder model and have very different rights and responsibilities compared with deposit holders of conventional banks.

Basel II suggests establishing strategic objectives and a set of corporate values. These apply to Islamic banks as well, which are mostly operational in developing countries. Due to a lack of developed and effective equity markets in these countries, the growth of the economy is primarily facilitated by banks. Therefore, banking institutions in these

[25] M. Al-Jarhi, "Issues of Corporate Governance in Islamic Financial Institutions," Corporate Governance and Risk Management in Islamic Financial Institutions Conference, Beirut, March 21–22, 2000.

[26] Basel Committee on Banking Supervision, "Enhancing Corporate Governance for Banking Organizations," Basel, September, 1999.

countries have particularly important roles within the economy. However, their operations are impaired by limited potential for deposits, and sometimes less than perfect legal environments. This is why banking institutions in developing countries need to integrate with international financial markets, even more than banks in developed countries need to integrate.

While international integration is a crucial issue for Islamic banks in developing countries, we must also keep in mind that the Islamic banking concept is a relatively new one, and competition is fierce. It is the aim of the standardization of banking procedures to provide comparability to facilitate international integration even for institutions established under differing principles, such as those of Islamic banks. Basel II, in this regard, provides guidelines for standardization as well as minimum financial stability requirements. Compliance with Basel II will enable Islamic banks and banks in developing countries to establish themselves as international banks. In this respect, Basel II provides the minimum requirements for Islamic banks to meet. The unique nature of Islamic banking products requires Islamic banks to extend Basel II for financial stability as well as for international integration.

IFSB's "Guiding Principles on Corporate Governance" (2005) provides several guidelines for Islamic banks to extend the already established guidelines for conventional banks. The principles provided are tailor-made for Islamic banks and are derived from Islamic banking experience. IFSB (2005) emphasizes the importance of international integration. One of the issues raised by the IFSB is the rating of Islamic banks. Transparency is emphasized along with following international reporting standards:

> IIFS shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognized accounting standards which are in compliance with *shari'a* rules and principles and are applicable to the Islamic financial services industry as recognized by the supervisory authorities of the country.[27]

Standardization will also benefit Islamic banks in terms of international benchmarking financially as well as operationally. It will enable Islamic banks to compare themselves to conventional banks and to each other. The comparability is the crucial issue for corporate governance. The advances in effective corporate governance will be achieved by following other effective practices and adopting principles that are proven successful. Considering the small size of the Islamic banking industry, the

[27] IFSB (2005).

collective development of issues will benefit individual Islamic banks as well as the Islamic banking industry.

Following the already proven corporate governance structure, Islamic banks will define and enforce the rights and responsibilities of each stakeholder. All procedures and interrelations should be defined for proper day to day activities. A total quality control mechanism that is in line with the guidelines of the International Standard Organization (ISO) may be suggested.[28] Although the system may need alterations, Islamic banks may adopt ISO standards to define all procedures and levels of hierarchy. The board of directors and management should work toward the establishment of a total quality system and its enforcement. Such systems will leave enough room for detecting process flow errors and points of weaknesses. After the implementation of such systems, internal auditors should check for compliance and any feedback from staff for system improvement. The total quality book for each Islamic bank should be made public for the purpose of developing standardized Islamic banking procedures and corporate governance structures throughout the Islamic banking community. External auditors, regulators, shareholders, deposit holders, and credit customers would benefit from a transparent total quality book. Those who interact with Islamic banks would gain more knowledge about the system. Inclusion of procedures, job flow charts, job descriptions, and product definitions would provide Islamic banking customers with information that may not be otherwise easily available to them. This would also assist in promoting and teaching Islamic banking to the public. Some of the Islamic banks are already certified through ISO 9000/1, but it is not possible for an outsider to obtain their quality books. The document may have privileged information that provides a competitive advantage to the Islamic bank. However, it may be possible to separate sensitive parts of the total quality book.

Standardization will ensure comparability and eventually international integration. The accountability in international financial markets is just as important as accountability within the domestic market and with different stakeholders. The accountability issue is also emphasized by the IFSB (2005), which states: "IIFS shall establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing the IIFS's accountabilities to various stakeholders."[29]

The accountability issue is also important in terms of compliance with *shari'a*. Because *shari'a* compliance is the main difference between Islamic banks and others, it is the main issue for effective corporate

[28] For detailed description of ISO standards, see www.iso.org.
[29] IFSB (2005).

governance structures that are tailor-made for Islamic banks. It is also imperative for Islamic banks to appoint board members and senior managers who are qualified and experienced in Islamic banking. Although an Islamic bank is still a bank, most of the transactions are unique. In particular, risks faced by Islamic banks are very different from those faced by conventional banks. The board of directors and senior management may have banking, supervision, or auditing background, but this expertise may not be relevant to Islamic banking. They should be aware of the importance of corporate governance and its influence on practice. Any internal or external audit performed should be closely watched and paid attention to in order to solicit suggestions for improvement.

Internal control systems also play an important role within the corporate governance structure of Islamic banks. Their duties include checking for compliance with internal procedures as well as regulations. Boards of directors and senior management enforce their policies, along with corporate governance, through internal audits. Any feedback from staff for the system should be directed to internal auditors. External auditors provide the same services with outside eyes, providing independence and objectivity. The auditing process also forces Islamic banks to comply with international standards, such as international accounting standards, even though such compliance is not required by their domestic regulators.

Hassan, et al. (2004) conclude that for developing countries where Islamic banks are mostly operative, "information asymmetries are more severe, market participants less experienced, and regulations, even if they exist, are not enforced effectively and impartially because of political corruption and the general weakness of judicial systems." They also conclude that "the adverse effects of ineffective corporate governance can be more serious in the case of financial institutions because the number of their stakeholders is much larger and the systemic risks are much greater."

Islamic banks face many complications for their operations. Although there are many financial entities that conduct businesses with products similar to Islamic banking products, Islamic banks contain them all. Mutual funds, venture capital, equity participation, leasing, foreign exchange, and international trade financing are just some of these common lines of businesses. The extent and variety of transactions involve many different stakeholders. Therefore, Islamic banks should pay adequate attention to each stakeholder group and incorporate them into their corporate governance structure. Basel II provides suggestions for corporate governance of conventional banks, but does not include Islamic banks. The definitions of each stakeholder, associated rights, and their responsibilities toward each other should establish the foundation for extending corporate governance to include every one of them.

With the development of Islamic finance and the considerable increase in Islamic funds, many banks are considering Islamic banking as an alternative instrument to their commercial banking activities. The latest trend is to include this alternative within the product portfolio. Islamic banking departments, windows, and subsidiaries have received considerable attention. Although many institutions have been offering Islamic banking products to their customers for years, the trend has received much attention within the last decade. These banks that offer Islamic products along with their usual commercial banking products comply with Basel II rules and suggestions without any alterations.

COMPLIANCE OF ISLAMIC BANKS WITH BASEL II

Systemic Risk

As participants in the financial system, Islamic banks pose risks to economic systems as well as to all stakeholders. Shakil provides several critiques to the Basel accord.[30] Some of the critiques are based in the very nature of Islamic banks. The characteristics of the economies in which Islamic banks operate also draw criticism.

The systemic risks that Islamic banks pose are similar to conventional banks. The profit and loss accounts, by nature, provide flexibility to Islamic banks to distribute losses. Holders of profit and loss accounts are aware of the illiquid nature of these accounts. Therefore, it is expected that Islamic banks would be immune to system-wide liquidity crises and bank runs. Lack of a lender of last resort, lack of deposit insurance, and inability to access short term money market instruments (and markets) affect Islamic banks negatively in terms of systemic risk. However, as long as Islamic banks do not make investments from current accounts and keep the adequate liquidity measures, profit and loss account holders cannot cause Islamic banks to fail. In practice, there are problems associated with liquidity of investment accounts. There have been failures of Islamic financial institutions, and hence, the extent of immunization is limited.

Ideally, Islamic banks should match every deposit to each investment and provide appropriate transparency to both sides about the details of the transaction. Any *mudaraba* and/or *musharaka* transaction is a partnership between the investment account holder and the credit-utilizing company. The Islamic bank is just an intermediary. Thus, all parties to the transaction

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[30] M. Shakil, "The Impact of Basel II on the Future of Islamic Banking," *Islamic Finance: Current Legal and Regulatory Issues* (Cambridge, MA: Harvard Law School, 2005).

have a right to transparency. However, heavy usage of *murabaha* transactions increases the number of transactions and decreases the likelihood of matching customers with projects. Thus, instead of one-to-one investments, a pooling method is utilized. This is also because of the fact that deposit customers are always relatively short-term oriented and credit customers are relatively long-term oriented. As a result of the pooling method, Islamic banks cannot match the maturities of deposits and credits. If there is a system-wide bank run, short-term depositors would have to wait longer than investment deposit holders to receive their funds. The difference of maturities between deposits and credits would need to be financed.

The conditions of immunization for Islamic banks against any system-wide risk are the following: current accounts will not be used in investments, required liquidity will be kept in cash, and investment deposits' maturities will match maturities of investments made from these accounts. The last condition is very hard to accomplish. Thus, Islamic banks are exposed to system-wide risks with a lack of a lender of last resort and money market instruments. In order to compensate for the additional risk, the maturity mismatch should be measured in terms of length and magnitude. Islamic banks should be required to report this data publicly. Islamic banks should also be required to report the measures they have taken to account for this difference in case of a run.

Financial Status

Islamic banks are financial intermediaries between lenders and borrowers of funds. In this respect, they are similar to interest-bearing banks. Shakil explains that the Islamic banks collect deposits, intermediate payments, and possibly cause systematic risks.[31] Therefore, the functions of Islamic banks, which are similar to interest-bearing banks, require us to treat them as banks.

The main question is: can we treat Islamic banks as pure trading companies instead of banks? Companies involved in trade act very much like Islamic banks. Islamic banks are intermediaries of actual trade. Trade companies operate for their own account and with their own funds. Therefore, if Islamic banks did not collect deposits and worked only with shareholder funds, they would be titled "Islamic trading companies." In cases where shareholder funds are inadequate, trade companies issue debt and Islamic banks collect deposits. The association of debt to a specific project can be achieved through debt covenants. While an Islamic bank

[31] Ibid.

may have to pool its funds and deal with a maturity mismatch problem, a corporation that issues project financing debt has no such risk. Thus, if Islamic banks are acting as agents of investment deposit holders, they are only representative bodies who evaluate and invest.

Even though it is easier to collect deposits by calling these entities Islamic banks, it is actually a representative agency. Organized exchange providers have many regulations and requirements for companies to be listed on their exchanges. This is to protect the rights of their investors and provide a platform in which investors can benefit from fair trade. In terms of investment accounts, Islamic banks are similar to exchange providers by making funds available for investment without making any profit or interest promise. In addition, Islamic banks act as investors' agents to actually make the investments.

PROBLEMS OF CORPORATE GOVERNANCE AT ISLAMIC BANKS

IFSB (2005) guidelines for corporate governance of Islamic banks are derived from the literature about corporate governance and experience at Islamic banks. The fact that the Islamic banking industry is a new and growing industry creates many complications. In most cases, countries do not have uniquely designed laws for Islamic banks. The same applies to lack of specialized accounting procedures for Islamic operations. For instance, lack of *shari'a* auditing by the supervisory authorities is a major obstacle. Centralization of *shari'a* boards is another issue. The IFSB (2005) suggests that "*fatawa* shopping" should be avoided. While leaving room for interpretation and consideration of rulings of different schools of thought, the underlying effort is to keep Islamic banks *shari'a* compliant. It is generally agreed that the reputation of each Islamic bank is of utmost importance for the entire Islamic banking industry.

Islamic banking is a new concept. Even though it has been around for decades now, the world financial markets are only recently noticing its importance. Islamic banking within the whole economic system needs further recognition. It is true that Islamic banking need not prove to anyone its necessity and sustainability. However, Islamic banks need to prove their uniqueness and novelty to both Muslims and non-Muslims.

The competitive advantage for Islamic banking is the religious aspect. Rational expectations theory shows that a rational investor will choose a higher yield for the same risk. Currently, Islamic banks are more risky and provide a higher rate of returns to their investors. Although religiosity provides them comparative advantage over conventional banks, they still need to improve efficiency. Otherwise, their survival will be at stake in the

world financial markets. One estimate shows that average cost of efficiency for Islamic banks is 74 percent while average profit efficiency is 84 percent.[32] Islamic banks are less cost-efficient but are more profit-efficient, leading to the conclusion that they are taking advantage of the religiosity of the Islamic banking customer, who is paying a premium for Islamic banking products due to a desire to adhere to an Islamic way of managing financial matters.[33] However, Islamic banks need to be inclusive rather than exclusive to better fit into the world financial market structure. However, under no circumstances should Islamic banks compromise their *shari'a* basis. It is expected that Islamic banks will be "*shari'a*-compliant" in the technical sense first, and then be "*shari'a*-based" in the broader sense. This is to say that the operations of Islamic banks need to strictly comply with *shari'a* as a prerequisite. However, it is also expected that Islamic banks are *shari'a*-based in their overall presence within the community. Islamic banks need to pay *zakat* and be ethical community members.

The question of whether adherence to *shari'a* will result in good governance still remains. We believe that *shari'a* is a necessary but not sufficient condition for good governance. *Shari'a* compliance needs to be complemented and supplemented by market discipline and regulatory supervision. It is not easy to comply with all aspects of *shari'a* in countries where the economic environment is not *shari'a* compliant. Islamic banks have to make a trade-off between completely *shari'a* -based products and market conditions. An external *shari'a* audit could improve the governance structure by increasing consistency of interpretation and application of *shari'a* across the Islamic financial services industry. One *shari'a* board per institution needs to be complemented by a *shari'a*-based rule for all institutions. A comprehensive system-based *shari'a* board consisting of scholars from different disciplines on a national and international level will bring a more level playing-field into this industry, and help it integrate with the world financial market.

[32] M. Kabir Hassan, "The X-Efficiency of Islamic Banks," *Islamic Economic Studies* 13 (February 2006): 49-77.
[33] Ibid.

Financial Engineering

The products that are in use today by Islamic banks have received much attention. Most of them have been discussed in this paper. These financial instruments are sometimes criticized for their application and usage. The legal systems that Islamic banks operate under may require them to alter the way they handle some of their products. However, the intent and the end results are acceptable. It is generally accepted that some of the procedures must be criticized in order to achieve the economic acceptance that Islamic banking needs.

In the early years of Islamic banking, the view was toward leniency. The system was new and needed to achieve sustainability. The idea was completely foreign to governments and legal systems, as well as to most customers. It was nearly impossible to divert customers from familiar interest-bearing commercial banking to Islamic banking. Therefore, it was acceptable to adopt familiar Islamic banking products such as *murabaha*. This is not to say that *murabaha* is a dubious product; it is only to acknowledge that it is similar to some of the popular banking products.

However, today the Islamic banking industry must recognize the need for international economic recognition. For that purpose, the criteria for *shari'a* compliance should be made more stringent. Standardization needs to be established, not only in accounting and other procedures, but also in *fatawa*. In this respect, some Islamic banking products need to be re-evaluated. The aim of such criticism should be to establish Islamic banking as an alternative within global financial markets. The level of compliance with stricter rules and regulations, pertaining to religion, will make the difference between Islamic banking and interest-bearing banking much more visible.

The main criticism of Islamic banking products is their similarity to interest-bearing commercial banking products. Islamic banks should refrain from engineering products similar to those used in the interest-bearing system. For instance, the most popular instrument of Islamic banks, *murabaha*, has several distinct characteristics. For instance, Islamic banks cannot sell what they do not posses. Islamic banks may appoint powers of attorney (*wakala*) to comply with the *shari'a*. However, if Islamic banks engineer a credit card using *murabaha* for each transaction and appoint the seller as the power of attorney, then the whole procedure will work very much like an interest-bearing credit card. The intent may be to engineer a product to compete with interest-bearing commercial banks. However, the economic system categorizes the new product as a credit card with a convenient label.

The IFSB (2005) refers to two distinct procedures that would smooth profits paid to investment account holders: "Investment Risk Reserve

(IRR)" and "Profit Equalization Reserve (PER)."[34] The idea is a simple and logical one. Islamic banks collect funds into investment accounts and invest in projects. The profits or losses realized from these projects are distributed to investment account holders. The IFSB (2005) explains the importance of handling these procedures correctly. This is because Islamic banks invest in projects with funds from equity and funds from investment accounts. Thus, if there is any collection into IRR and/or PER, it should be from profits distributed both to equity owners and investment account holders. The payments should also be made to both funds' owners. Apart from these consequences, IRR and PER involve other major issues. Even though the funds are invested in real projects through Islamic banking products, this is neither visible to account holders nor to economic observers. Unless Islamic banks adopt a strategy to be transparent about the individual investments and profit calculation/distribution procedures, outside observers only see an investment account with different maturities (similar to interest-bearing banks) and smoothed profits (no losses or fluctuations). Such extensive transparency is rarely achieved. The Islamic bank may also be tempted to smooth profits with reference to market interest rates in order to retain account holders. It can be argued that as long as the product conforms to *shari'a*, the smoothing technique may be employed. It can also be debated whether or not these products actually conform to *shari'a*. The IFSB (2005) provides some points of attention for IRR and PER that may need emphasis, such as the point that reserve funds may be collected from account holders who may never receive any smoothing payments. However, the main emphasis should be on the intent and the end result. The intent is the competition and desire to have continuous similar level profit payments for the account holders. While IRR and PER do not constitute a promise similar to interest, it may have an implied meaning for the account holder. The end result is a competitive product that is similar to an interest-paying account.

In terms of financial engineering, Islamic banks have two concerns: *shari'a* compliance and international economic recognition. Islamic banks are obligated to either make themselves as transparent as possible in many aspects, or be concerned about how the financial products look to outside observers. Otherwise, it is just the Islamic bank's and/or the *shari'a* board's word. This obligation is toward the Islamic banking industry and to all related stakeholders. Ideal corporate governance should ensure that above all operational concerns, Islamic banking is achieved.

[34] IFSB (2005).

Stakeholder Rights

As mentioned by IFSB (2005), the stakeholders of Islamic banks have a vote by hand or by feet. Shareholders can elect board members and, indirectly, executives. Account holders can influence the bank by simply withdrawing their funds and walking away. However, some stakeholders do not have a voting right, neither by hand nor by feet. Although the main instrument of Islamic banks is *murabaha* and customer structure is completely different for *mudaraba* and *musharaka*, it is necessary to define the rights of project partners of Islamic banks. A *musharaka* can have a maturity as long as five years, sometimes even more. During this period, *musharaka* partners may not walk away from the Islamic banks as easily as account holders. The same hardship applies to *mudaraba* partners. Their livelihood and capital may be tied up in the project, and they may be bound by an obligatory contract. Even though Islamic banks actively audit and interfere with their project partners, these partners have no right to do the same. This is of course the same for venture capital and other similar partnership schemes.

The lack of a mechanism to protect the rights of project partners within the Islamic bank leads to hesitation on the customer's side regarding entry into such partnerships. The same lack of mechanisms to protect the rights of investment account holders has captured much attention in the literature. It is contended that representation of investment account holders is not feasible. Therefore, two of the most important stakeholders are not represented within the Islamic bank management. They do not have voting rights and may not have the option to walk away. Basically, there are only three parties represented within an Islamic bank: shareholders, *shari'a* scholars, and the supervisory authority through regulations. It is assumed that the regulatory authority represents all unrepresented stakeholders.

An Islamic bank also is a stakeholder at another Islamic bank due to systemic financial and reputational risk. As long as the bank is labeled Islamic, any wrong-doing will affect all. Thus, if an Islamic bank declares bankruptcy, it is generally agreed that all other Islamic banks within the same country, or perhaps around the world, will be affected. The same principle applies to *shari'a* compliance. If an Islamic bank diverges from compliance, it will have an effect on the entire system. Representation of such groups is ensured by the existence of *shari'a* boards.

The representation of all stakeholders does not necessarily mean managerial power or voting rights. It may only mean adequate transparency. Through transparency, Islamic banks would declare their procedures and finances to allow stakeholders to make their own judgments. Through transparency, the differences between Islamic banks

and interest-bearing banks would be made clear. The transparency needed is not about the customer database or trade secrets. It is about procedures, financial structure, and *shari'a* compliance.

Convergence of Corporate Governance and the Islamic Financial Services Industry: Toward an Islamic Financial Services Securities Market

Ali Adnan Ibrahim[1]

Like most of the growing financial markets, capital markets in Muslim majority countries ("Muslim countries") are undergoing continuous regulatory standardization. With a view on making capital markets more attractive for domestic and foreign investment, Muslim countries are taking serious initiatives to ensure higher transparency and accountability within financial markets, particularly with respect to publicly traded firms. Issuance of regulatory guidelines and codes of corporate governance illustratively represent this process. In general, Muslim countries are pursuing a common regulatory policy of developing strong securities markets, and appear to be serious in upgrading the corporate governance regime.

Since the *shari'a* stands as either a binding or persuasive source of legislation in Muslim countries, its role in legislative and regulatory development in such countries is highly significant. Therefore, reliance on *shari'a* for any possible future implementation of corporate governance, whether in the form of codes or regulations, appears highly likely. Any future codifications of fiduciary duties and related ethical practices are most likely to be derived from *shari'a*. However, it remains to be seen if *shari'a*-based codes of corporate governance will help achieve the expected level of transparency and accountability with comparatively economical agency costs. This paper will attempt to explore, among other issues, whether designing *shari'a*-based codes of corporate governance is necessary in the first place.

Generally, Islamic finance scholars have discussed corporate governance from the perspective of transactional validity—primarily

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revolving around avoiding interest and related moral hazards—for the Islamic financial services industry (the "IFS industry"). Issues such as regulatory concerns over agency problems, investor protection, and contemporary debate over convergence or divergence of corporate governance have not received much attention from Islamic finance scholars. Appropriate response to such issues is crucial for the IFS industry not only for its global competitiveness, but also, as will be discussed below, for ensuring proper *shari'a* compliance.

This paper presents a new perspective to existing scholarly debate on corporate governance and the IFS industry, and seeks to briefly highlight aspects of the contemporary corporate governance debate by analyzing *shari'a* and investigating how the IFS industry may increase its potential.[2] It is argued here that convergence to modern corporate governance practices in Muslim countries, insofar as they seek to increase corporate accountability and transparency, to further investor protection, and to reduce agency costs, may be consistent with *shari'a*. It is argued that such convergence is highly likely. However, convergence to modern transactional practices may not be consistent with *shari'a*, primarily because modern transactions, despite their efficient role in the financial markets, may not prove valid under *shari'a*. Therefore, more transactional divergence will lead to more transactional innovation in the IFS industry. The paper further suggests that Islamic finance scholarship should analyze modern governance practices separately from the transactional aspect. Finally, the paper argues that establishment of an exclusive homogenous securities market is essential for the IFS industry, and briefly highlights the benefits of such a market.

Accordingly, this paper discusses (1) the available literature on agency problems and convergence or divergence of corporate governance, (2) corporate governance and the IFS industry, and (3) the need for an IFS Securities Market.

AGENCY PROBLEMS AND CONVERGENCE OR DIVERGENCE OF CORPORATE GOVERNANCE

Today, financial globalization enables international investors to better share risks, allows capital to flow toward the most productive markets, and

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[2] See Ali Adnan Ibrahim, "Developing Governance and Regulation for Emerging Capital and Securities Markets," (unpublished LL.M. supervised research paper, Washington University, May 19, 2006), http://lsr.nellco.org/cgi/viewcontent.cgi?article=1001&context=georgetown/gps. The paper surveys the issues involved and analyzes contemporary scholarship, highlighting well-informed legal reforms in contrast to unwise transplantation.

enables the participating countries to reap the benefits of their comparative advantages.[3] However, this requires a structure of corporate governance that not only recognizes property rights, but also provides effective enforcement to safeguard them. As discussed below, such safeguards emanate primarily from laws and regulatory and judicial enforcement mechanisms. Furthermore, confirming prior studies that financial development and development in debt and equity markets promote economic growth, empirical studies have established a link between the legal system and economic development.[4]

Agency Problems: Self-Dealing and Investor Protection

In general, the foundations of the market system include compelling transparency, prohibiting insider-dealing, and policing self-dealing.[5] Corporate governance "deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment," and it also "deals with the agency problem: separation of management and finance."[6] Investor protections and market development go hand in hand in the real world, and if protections are absent, "one-sided deals flourish, and outside equity capital either becomes more expensive or dries up altogether."[7]

To counter the agency problem, one argument is that small investors can only be attracted to the business of financing companies if legal protections against expropriation by managers and large investors are available.[8] Greater protections for shareholders strongly predict stock

[3] Rene M. Stulz, "The Limits of Financial Globalization," *Journal of Finance* 60 (2005): 1595.
[4] Rafael La Porta et al., "Law and Finance," *Journal of Political Economy* 106, no. 6 (1998): 1113, 1152. Although there were inconsistencies found in the data gathering and coding techniques, the study remains a pioneering work. See generally Holger Spamann, "On the Insignificance and/or Endogeneity of La Porta et al.'s 'Anti-Director Rights Index' under Consistent Coding," Harvard Law School Program on Corporate Governance, Discussion Paper No. 7 of 2006, http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Spamann_7.pdf.
[5] William W. Bratton and Joseph A. McCahery, "Comparative Corporate Governance and the Theory of the Firm: The Case against Global Cross Reference," *Columbia Journal of Transnational Law* 38, no. 2 (1999): 213, 296-297.
[6] Andrei Shleifer and Robert Vishny, "A Survey of Corporate Governance," *Journal of Finance* 52 (June 1997): 737, 773.
[7] Bratton and McCahery, "Comparative Corporate Governance," 297.
[8] Shleifer et al., "Survey of Corporate Governance," 737, 769.

market development.[9] Effective regulation of self-dealing is the fundamental element of shareholder protection[10] that also results in dispersion of ownership.[11]

On-going disclosure of self-dealing transactions benefits stock market development.[12] The best strategy for avoiding self-dealing appears to be the reliance on "extensive disclosure, approval by disinterested shareholders, and private enforcement."[13] Furthermore, quality of information regarding the value of a company's business and confidence about preventing self-dealing are preconditions to strong public securities markets.[14] Studies have examined anti-self-dealing measures and their relationship to financial markets development.[15]

Convergence or Divergence of Corporate Governance

Many scholars have proposed reform agendas for developing securities markets in economies in transition. The most debated approach is to introduce U.S. laws to such economies in order to develop a U.S.-style securities market, expecting that doing so would be essential to triggering economic growth.[16] While some scholars strongly suggest that convergence of the corporate governance regimes to the U.S. model is a good way forward, others argue against this notion, highlighting the point that the peculiar institutional make-up of the U.S. securities market cannot be exported merely by changing the laws on the books.[17] The scholars

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[9] Simeon Djankov et al., "The Law and Economics of Self-Dealing," National Bureau of Economic Research, Working Paper No. 11883 (2005), 34. http://papers.nber.org/papers/w11883.

[10] Ibid., 35.

[11] La Porta et al., "Corporate Ownership around the World," *Journal of Finance* 54, no. 2 (1999): 471, 496.

[12] Djankov et al., "Law and Economics of Self-Dealing," 37.

[13] Ibid., 38.

[14] Bernard S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets," *UCLA Law Review* 48 (2001): 781-855, 783.

[15] Djankov et al., "Law and Economics of Self-Dealing," 2.

[16] Troy A. Paredes, "A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer," *William and Mary Law Review* 45 (2004): 1055. (Quoting the works of La Porta et al.)

[17] See Katharina Pistor et al., "Law and Finance in Transition Economies," *Economics of Transition* 8 (2000): 325; Bernard S. Black et al., "Final Report and Legal Reform Recommendations to the Ministry of Justice of the Republic of Korea," *Journal of Corporate Law* 26 (2001): 546; Black, "Legal and Institutional Preconditions," 781; Cally Jordan, "The Conundrum of Corporate Governance," *Brooklyn Journal of International Law* 30 (2005): 983; Paredes, "A Systems Approach," 1055; Bratton and McCahery, "Comparative Corporate Governance," 213.

arguing against convergence also highlight significant socio-economic and political features of each society that may resist the transplanted reforms and continue to resist them even after the implementation of such reforms. Among these scholars, some have further suggested that it is important to recognize deep-rooted local culture before embarking upon reform initiatives.[18]

For transition economies, there is a desire to catch up with western standards, often leading to the wholesale transfer of commercial laws to the transition economies.[19] This practice generally follows the argument that laws matter for developing strong capital and securities markets. This argument is known as the "law matters thesis."[20] Many scholars suggest that convergence of this nature limits channels of corporate evolution.[21] Reforming corporate governance is a matter of comparative institutional analysis.[22] The indiscriminate mixing of legal rules may result in a dysfunctional or unbalanced system lacking certainty. Scholars have expressed serious doubt about the ability to succeed in transplanting reforms without developing "complementary institutions."[23]

As mentioned above, scholars arguing against convergence have highlighted the distinct features of societies that may resist transplanted reforms. A renowned scholar has noted an intermediate position.[24] This position predicts that "formal institutional variations in corporate law and practice will remain, but will be overshadowed by an increasing degree of functional convergence."[25] Unlike corporate laws, securities laws are more likely to functionally converge, by way of "stealth convergence."[26] Such convergence is generally achieved by modifications (or up-gradation) in the listing regulations by the front-line regulators. Amending corporate laws is a time-consuming process, and is less influenced by the regulatory competition and issuers' choice. Because the functional or stealth

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[18] Amir N. Licht, "The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance Systems," *Delaware Journal of Corporate Law* 26 (2001): 147, 203.
[19] Pistor et al., "Law and Finance in Transition Economies," 325, 327.
[20] Paredes, "A Systems Approach," 1055.
[21] John C. Coffee, Jr., "The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications," *Northwestern University Law Review* 93 (1999): 641, 646.
[22] Paredes, "A Systems Approach," 1155.
[23] See Ronald J. Gilson, "Globalizing Corporate Governance: Convergence of Form or Function," *American Journal of Comparative Law* 49 (2001): 329; and Paredes, "A Systems Approach," 1055.
[24] Gilson, "Globalizing Corporate Governance," 329.
[25] See the discussion of formal and functional convergence in Coffee, "The Future as History," 641, 646.
[26] Ibid., 705.

convergence may be the result of market efficiency, the emerging securities markets may have to rely more on formal convergence in order for them to achieve efficiency. However, the form of convergence that can promise efficiency to the emerging securities markets is an issue that remains largely unanswered. The market response will provide a good indication of whether and when to introduce any modern reforms.

As for the law matters thesis, it is about "strong shareholder property rights, as reflected in the control that shareholders are allocated over the enterprise and the legal limits that constrain managerial and directorial discretion, all pointing in the direction of ensuring that shareholders do not have their wealth expropriated." [27] The law matters thesis, therefore, suggests that minority shareholders will emerge pursuant to laws safeguarding their property rights. To this extent, the law matters thesis addresses the core issue, but transplanting foreign laws into an alien legal system does not appear to be the best way to achieve this goal. The legal systems in developing economies often have customary or religious preferences, and such customary or religious undercurrents may react negatively to the wholesale transplantation of the laws.

In order to achieve a legal framework that encourages entrepreneurs to raise capital from the securities market, modern reforms that deal with the agency problem, transparency, and other issues should take into consideration the customary or religious preference of a particular society. With respect to Muslim countries, the principles of Islamic finance serve as the people's customary or religious preference for doing business.

CORPORATE GOVERNANCE AND THE ISLAMIC FINANCIAL SERVICES INDUSTRY

Generally, developed financial markets work in a manner that encourages and supports entrepreneurial initiative by making available easy access to finance. Developed financial markets represent a set of institutions that complement each other, and thus support the financial superstructure of an economy. For instance, the legal system, including courts, lawyers, and financial intermediaries, works in a sophisticated harmony to complement the efficient market. The unprecedented growth of U.S. securities markets is a more specific example of the coordination between the legal system and market institutions.[28]

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[27] Paredes, "The Importance of Corporate Law: Some Thoughts on Developing Equity Markets in Developing Economies," *Global Business & Development Law Journal* 19 (2007): 401.

[28] Paredes, "A Systems Approach."

Continuing Growth and the Challenges Facing IFS

Recent scholars have emphasized resolving moral hazard issues facing the IFS industry in order to enhance and ensure *shari'a*-compliant governance.[29] The emergence of the moral hazard debate highlights the hybrid nature of the IFS industry, that is, the prevalence of religious and secular norms within the industry.

The future success of the IFS industry depends not only on its compliance with *shari'a,* but also on its global competitiveness. Reaching beyond the "core group of religious depositors"[30] appears inevitable and requires "ambitious innovation."[31] Another initiative to be taken includes "developing doctrines governing the creation and regulation of an Islamic public financial market."[32] For further growth, scholars now consider international and regional cooperation to be vital to enhance the efficiency of the IFS industry.[33] The development of supporting market institutions and standardization appears equally essential. As these institutions emerge and develop, standardization is likely to follow.

Defining Corporate Governance in *Shari'a*

According to *shari'a* scholars, the objective of corporate governance is "to ensure 'fairness' to all stakeholders to be attained through greater transparency and accountability."[34] Agreeing on the content of the definition, however, does not help us understand how corporate governance of a *shari'a*-compliant business differs from its secular counterpart. Secular governance practices are not relevant for the transactions that a firm would make in the ordinary course of business. However, *shari'a* would first look at the transactional structure to see whether the transaction involves elements that invalidate the gains or profits. Corporate law in the secular context does perform a similar

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[29] See Ibrahim Warde, "Corporate Governance and Islamic Moral Hazard," in *Islamic Finance: Current Legal and Regulatory Issues*, ed. S. Nazim Ali (Cambridge: Harvard Law School Islamic Finance Project, 2005), 15-25.
[30] Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Boston: Kluwer Law International, 1998), 293.
[31] Ibid., 295.
[32] Ibid., 293.
[33] Ahmad Mohamed Ali, "The Emerging Islamic Financial Architecture: The Way Ahead," in *Proceedings of the Fifth Harvard University Forum on Islamic Finance* (Cambridge: Harvard Law School Islamic Finance Project, 2002), 147, 155.
[34] See M. Umer Chapra and Habib Ahmad, *Corporate Governance in Islamic Financial Institutions* (IRTI Publication Management System, Jeddah, Saudi Arabia), http://www.irtipms.org/PubDetE.asp?pub=93.

function, in order to ensure that corporate transactions do not transgress the corporate charter and cross the line that the law has drawn. A general absence of codification that declares a non-*shari'a* practice or transaction to be illegal *ipso facto* broadens the role of *shari'a* governance to even review a firm's transactional conformity.

Without admitting that convergence of corporate governance is the most profound legal reform strategy, the IFS industry's ability to be internationally competitive relies, to a large extent, on recognizing international governance practices. In this context, the IFS industry is likely to adopt certain governance practices of the developed markets. It is therefore important to examine the scope of convergence, and also which areas are likely to stay divergent.

Corporate governance may have two-tier implications for its scope within *shari'a*. Since *shari'a* is concerned not only with the substance but also with the form of the business,[35] we may, for the sake of this discussion, term the objectives of a firm's business as the substance, and the ways of conducting the business as its form. While scholars have focused mainly on the substance of a *shari'a*-compliant business, guidance as to the use of contemporary corporate governance best practices in the IFS industry is not readily available. More specifically, the question would be whether the modern corporate governance practices are consistent with *shari'a*, and if so, whether a convergence to the modern regime is likely within the IFS industry.

Separating form (the governance structure in general) from substance (the objectives of the firm's business) will significantly further our understanding of the issues related to the IFS industry vis-à-vis modern corporate governance practices. Doing so, as discussed below, will also help us analyze an overall consistency between the objectives behind the modern corporate governance practices and the *shari'a* emphasis on business ethics.

As for governance structure, teachings of *shari'a* enjoin fairness and honesty as the primary principles for any conduct, including transactions.[36] The prohibition of fraud, misstatement, misappropriation and other forms of dealings that result in exploitation and deprive someone of her/his property without consent complements *shari'a*-compliant financial conduct.[37]

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[35] See Mahmoud El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge: Cambridge University Press, 2006).

[36] See Mushtaq Ahmad, *Business Ethics in Islam* (Islamabad: International Institute of. Islamic Thought, 1995), 143-147.

[37] Ibid.

Recent studies emphasize more disclosures to and rights of the shareholder, and firm enforcement of such rights.[38] Protection of minority interests is therefore considered essential for stronger capital markets. Substantive legal protections for minority shareholders and strict enforcement of such protections encourage local and international investors to invest in emerging securities markets. Thus the cornerstones of modern corporate governance regimes include safeguarding property rights, ensuring transparency, and bringing about effective accountability.

Shari'a has always attached similar or higher importance to such concerns in doing business. Incorporating higher standards of minority protection against expropriation, more disclosures and transparency, and effective accountability into *shari'a*-based corporate governance regimes will only help achieve compliance with *shari'a* injunctions and business ethics. With this perspective, and given that *shari'a* does not specify any upper limit for better regulation, the contemporary drive for accomplishing higher standards in corporate governance does not appear to be inconsistent with *shari'a*. Accordingly, convergence to the modern corporate governance regimes is highly likely within the IFS industry. However, a question needs to be explored: would such convergence be most beneficial if it occurred gradually or quickly?[39]

As of today, the IFS industry is largely comprised of the banking sector. Increased local and international participation in IFS products will provide greater business opportunities within financial markets in Muslim countries, and with adherence to the modern (or modernized) corporate governance practices, the IFS industry is likely to grow beyond the banking sector. Once that growth takes place and non-banking IFS firms become successful, the availability of equity financing is likely to increase substantially, which will not only provide entrepreneurs with comparatively easier access to financing, but would also cater to those who may view the legitimacy of earnings through the banking sector of the IFS industry with skepticism.

Financial Regulation: Objectives and Emerging Markets

Both non-governmental R&D support and governmental regulations have contributed significantly to the current growth of the IFS industry. Financial regulation benefited from non-governmental R&D initiatives that were often sponsored by various public sector agencies of Muslim

[38] Djankov et al., "Law and Economics of Self-Dealing," 1.

[39] In this regard, an indigenized analysis by each local/national IFS market appears to be a better way to move forward.

countries. However, financial regulation of the IFS industry is largely comprised of prudential banking regulation, and does not form part of securities regulation. The future growth of the IFS industry in the securities markets is likely to depend upon bridging this regulatory gap.

As stated above, the future growth of the IFS industry may also rest upon another factor: a securities market that is homogeneous and specializes in the IFS industry. Securities markets significantly help the growth of debt and equity markets, and the broader spectrum of financial regulation strengthens the financial markets. The discussion below offers illustration of this perspective.

The objectives of financial services regulation include protection of public investors, elimination of externalities from the failure of intermediaries, redistributive policies, equitable norms and consideration of political economy, [40] and "elimination of financial crime and international terrorism." [41] There are three fields of financial regulation: corporate governance, securities regulation, and regulation of financial institutions. [42] As for emerging markets, a combination of market institutions and regulations ensures effective corporate governance. [43] However, overregulation is likely to make raising capital costly. [44]

In a post-globalization scenario, with lowered barriers to capital and instantaneous information flow, securities markets are in competition with each other. Issuers choose the market on which to list their securities, and are then subject to one set of liability standards and enforcement remedies. [45] Taking advantage of this trend, issuers, particularly from transition economies, may raise equity capital from the market of their choice. [46] In this regard, listing at the London Stock Exchange or in the United States, for example, will subject IFS firms to higher standards to

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[40] Howell E. Jackson, "Regulation in a Multi-sectored Financial Services Industry," *Washington University Law Quarterly* 76 (1999): 319, 332-339.

[41] This has been added to the list recently. See Howell E. Jackson, "Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications," 12-14, Harvard Law School Program on Corporate Governance, Discussion Paper No. 521(2005),http://www.law.harvard.edu/programs/olin_center/papers/pdf/Jackson_521.pdf.

[42] Howell E. Jackson, "Centralization, Competition and Privatization in Financial Regulation," *Theoretical Inquiries Law* 2 (2001): 649.

[43] Black et al., "Final Report," 546.

[44] Ibid.

[45] John C. Coffee, Jr., "Racing Towards the Top?: The Impact of Cross-Listing and Stock Market Competition on International Corporate Governance," *Columbia Law Review* 102 (2002): 1757, 1759-60; and Hal S. Scott, "Internationalization of Primary Public Securities Markets," *Law & Contemporary Problems* 63, no. 3 (2000): 71.

[46] Coffee, "Racing Towards the Top?" 1759-1760.

corporate governance regimes, and thus make them more attractive for investment.

In addition to legislative and regulatory measures, the stock exchanges, as frontline regulators, may improve corporate governance practices by protecting investors and maintaining the integrity of the securities market.[47] Well-regulated stock exchanges may, therefore, make raising finance comparatively convenient in the emerging economies.

However, when IFS firms list abroad, neither the IFS industry in general nor the financial markets in Muslim countries are able to benefit from foreign investment. In the absence of sufficient legal and regulatory infrastructure, the transition economies cannot offer a sophisticated and internationally competitive securities market.[48] Owing to the lack of competitiveness of the emerging markets, foreign investors from developed economies might choose to stay home.[49] On the other hand, the lack of international competitiveness may prompt the issuers from the emerging markets to opt out of their home jurisdictions in favor of any developed market, making it more difficult for the emerging markets to develop such competitiveness.

Specialized markets

Scholars have highlighted the likelihood that different markets should specialize in trading securities of a particular type of firm.[50] This phenomenon may be developed in the emerging markets where firms eyeing particular incentives invest in specialized industrial sectors. Given the nature of incentives in various sectors offered by the transition economies, the emerging markets may develop specialized trading expertise in the securities of a particular sector or industry. A specialized IFS securities market could therefore be one that Muslim countries can develop.

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[47] Robert Todd Lang et al., "Special Study on Market Structure, Listing Standards, and Corporate Governance," *Business Law* 57 (2002): 1487, 1558. The article suggests that the stock exchanges should do this with the help of the stakeholders.

[48] This includes the use of technology for more optimal arrangements at the level of primary market. See Scott, "Internationalization of Primary Public Securities Markets," 71, 104.

[49] Frederick Tung, "Lost in Translation: From U.S. Corporate Charter Competition to Issuer Choice in International Securities Regulation," *Georgia Law Review* 39 (2005): 525, 532.

[50] Coffee, "The Future as History," 652.

Integration and regionalization

The prediction of specialized stock exchanges serving different clienteles of listed corporations may also occur at the regional level in emerging markets.[51] The divergence of investment opportunities in the transition economies may also lead to competition to attract foreign investment. Depending on the success of foreign investment policies in specific industrial sectors, regional securities markets may develop to attract listing in the specialized sectors. Empirical evidence in this regard remains to be explored.

The IFS industry shares a common customary law (that is, a set of rules that will have binding force in a society in the absence of any overriding legal system), although with juristic variations, within various Muslim schools. With *shari'a* as a valid source of law in many Muslim countries, the capital and securities markets of those countries may simultaneously benefit from the growth of IFS products, and therefore pursuant interactions among various Muslim countries could lead to an integrated securities market in Muslim countries.

The law of one price provides another possibility for the emerging markets to have integrated arrangements.[52] Before achieving regionalization or integration, emerging markets may also consider harmonization, multi-jurisdictional disclosure systems, and an offshore free zone to increase their competitiveness.[53]

Scholars have recommended regional cooperation among the emerging securities markets, focusing specifically on Latin America,[54] Sub-Saharan Africa,[55] and Eastern Europe.[56] Likewise, Middle-Eastern

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[51] Coffee, "Racing Towards the Top?" 1830.

[52] Amir N. Licht, "David's Dilemma: A Case Study of Securities Regulation in a Small Open Market," *Theoretical Inquiries in Law* 2 (2001): 673, 687. Licht argues that the law of one price curbs arbitrage profits—under-priced buying and overpriced selling.

[53] Scott, "The Future as History," 78, 92. Scott argues against the viability of harmonization and a multi-jurisdictional disclosure system for the international securities market, but recommends establishing an offshore free zone.

[54] Les Riordan, "Three Proposals for a Latin American Stock Exchange, Private Offshore Market, or a Computerized Financial Information Service," *University of Miami Inter-American Law Review* 27 (1996): 585.

[55] Evelyn Bradley, "A Regional Stock Exchange: Hope for Sub-Saharan Africa Stock Markets," *MSU-DCL Journal of International Law* 8 (1999): 305. For a criticism of the strategy in this regard, see Charles R. P. Pouncy, "Stock Markets in Sub-Saharan Africa: Western Legal Institutions as a Component of the Neo-Colonial Project," *University of Pennsylvania Journal of International Economics* 23 (2002): 85. On economic cooperative initiatives in Africa, see Claire Moore Dickerson, "Harmonizing Business Laws in Africa: OHADA Calls the Tune," *Columbia Journal of Transnational Law* 44 (2005): 17.

economies are on their way to a regional securities market.[57] Furthermore, to launch a world-class financial center in the Middle East, Dubai established the Dubai International Financing Centre, a free-trade zone with an independent regulatory authority to oversee the activities related to the Centre.[58] In addition to international sponsorship, a culturally sensitive regulatory framework and regional cooperation could promote the success of a securities market in a developing country.[59]

Specialization, regional cooperation, and integration of securities markets may be achieved by establishing a securities market exclusively for the IFS industry, which is elaborated upon in the third section of this paper.

Financial Regulation: Regulation of the IFS Industry Today

Standardized regulation of Islamic finance is one of the main issues facing the IFS industry today. No single regulator exists to perform the task of standardized regulation. Therefore, the regulation of the IFS industry takes place at two levels: by the respective national regulators where the IFS firms are domiciled, and by various industry-sponsored or industry-specific entities.

The governments of various Muslim countries and the industry have taken numerous initiatives. Malaysia established its National Syariah

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[56] William C. Philbrick, "The Paving of Wall Street in Eastern Europe: Establishing Infrastructure for Stock Markets in the Formerly Centrally Planned Economies," *Law & Policy in International Business* 25 (1994): 565.

[57] Paul A. Mackey et al., "Internal Securities and Capital Markets," *International Law* 39 (2005): 373. These economies are also committed to reforming their capital markets and continue to look for the right guideline for the reforms. For instance, the Director General of the Dubai International Finance Centre announced the establishment of a Regional Institute of Corporate Governance to improve the regional securities and financial markets. Dr. Omar Bin Sulaiman maintained:

> Transparency and governance is critical in delivering the knowledge, capital, and skills that will enable the region to diversify its economies away from oil and gas, and to grow the wealth of its people, which will lead to political and social stability. As we raise our corporate governance levels, it will increase trust in the region's financial sector, and contribute to attracting foreign direct investment, as well as encouraging local and regional banks to provide financing to SMEs and entrepreneurs.

For complete coverage of the above announcement by Dr. Omar Bin Sulaiman, see http://www.ameinfo.com/73238.html.

[58] Mackey et al., "Internal Securities and Capital Markets," 373-374.

[59] Jason Gottlieb, "Launching the Phnom Penh Stock Exchange: Toward a Legal Framework for Launching a Stock Exchange in an Underdeveloped Country," *Columbia Journal of Asian Law* 14 (2000): 235, 275.

(*Shari'a*) Board to harmonize Islamic finance practices and advise the Malaysian Central Bank.[60] Pakistan also established a *shari'a* board within the State Bank of Pakistan for similar objectives, and the UAE, Bahrain, and others followed suit. In general, the IFS industry in Muslim countries is governed by a special regulatory regime, while conventional banking continues to be regulated under a different regime. The Muslim countries thus have a dual regulatory system catering to both Islamic banks and conventional banks.[61]

As for industry-oriented non-governmental initiatives, advisory bodies have been established that include the Institute of Islamic Research at Al-Azhar University (established in Cairo in 1961), the Islamic Jurisprudence Council of the Muslim World League (established in Makkah in 1979), and the Fiqh Academy of the Organization of the Islamic Conference (established in Jeddah in 1984).[62] Although it does not play any formal role in regulating the IFS industry, the practices of the Islamic Development Bank are also taken as industry standards.[63] Such industry-oriented bodies include the International Association of Islamic Banks (which requires every financial institution offering Islamic financial services to have a board of *shari'a* scholars[64]), the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI),[65] the Islamic Financial Services Board (IFSB),[66] the International Islamic

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[60] Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh: Edinburgh University Press, 2000), 230.
[61] Philip Molyneux and Munawar Iqbal, *Banking and Financial System in the Arab World* (New York: Palgrave McMillan, 2005), 162-63.
[62] El-Gamal, *Islamic Finance,* 32.
[63] See Mohamed Rafe Md. Haneef, "Recent Trends and Innovations in Islamic Debt Securities: Prospects for Islamic Profit and Loss Sharing Securities," in *Islamic Finance: Current Legal and Regulatory Issues*, 29-60.
[64] Warde, *Islamic Finance*, 226-227. Warde quotes the International Association of Islamic Banks to have required: "It is formed of a number of members chosen from among jurists and men of Islamic jurisprudence and of comparative law who have conviction and firm belief in the idea of Islamic Banks. To ensure freedom of initiating their opinion the following are taken into account: (a) They must not be working as personnel in the bank. That means: They are not subject to the authority of the board of directors; (b) They are appointed by the general assembly as it is the case of the auditors of accounts; (c) The general assembly fixes their remunerations; (d) The Legitimate Control Body has the same means and jurisdictions as the auditors of accounts."
[65] El-Gamal, *Islamic Finance*, 9; Molyneux and Iqbal, *Banking and Financial System*, 149-151. Molyneux and Iqbal explain that the role of the Organization includes adapting international standards that are relevant to the IFS industry.
[66] See www.ifsb.org; and Molyneux and Iqbal, 149-151, noting that the primary role of the Board includes prudential regulation for Islamic financial institutions.

Financial Market,[67] the Liquidity Management Centre,[68] and the International Islamic Rating Agency.[69] Despite the emergence of these institutions, no single institution could be regarded as the central point of reference for guidance on the issues of compliance with Islamic law. Therefore, the central role of the *shari'a* board of each IFS institution continues to drive the bulk of industry innovation. However, opinions from Al-Azhar University, the Islamic Jurisprudence Council of the Muslim World League, and the OIC Fiqh Academy have been decisive on various controversial transactional issues.[70] If any IFS institution has launched a product relying on any opinion of its *shari'a* board or any of the above institutions, competitor IFS institutions invariably adopt the same structure,[71] thereby extending the opinion and implicitly confirming its validity. This also signifies the cardinal role that an Islamic legal opinion plays in the IFS industry today. These industry-sponsored or industry-specific entities collectively represent a *de facto* quasi-regulatory body.

Additionally, *sukuk* issued at the international markets have usually been in the conventional global bond format. U.S. Regulation S and Rule 144A have been particularly preferred recently.[72] This trend is growing and presents a pronounced effort by the IFS industry to comply with modern corporate governance practices. This trend also underscores "*de facto*,"[73] "functional" or "stealth convergence," as noted above.

ISLAMIC FINANCIAL SERVICES SECURITIES EXCHANGE

The establishment of an IFS securities exchange will ensure a specialized provision of services and uniformity of transaction costs. Being a homogeneous market place, the securities listed at the exchange will not be affected by the liquidity and other constraints faced by any single stock

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[67] See www.iifm.net; and Molyneux and Iqbal, 149-151, explaining that the need for establishing the market includes research for strategizing the liquidity issues facing IFS institutions.

[68] See Molyneux and Iqbal, 149-151. The Center was established by the International Islamic Financial Market with the aim of efficiently managing the short term liquidity needs of IFS institutions.

[69] Ibid. The authors explain that the Agency supplements the conventional rating industry by providing the Islamic law compliance of the rated IFS products.

[70] See El-Gamal, *Islamic Finance*, 9, 15, 33, 34, 41.

[71] Ibid., 11-13.

[72] Haneef, "Recent Trends," 31. Haneef notes that Regulation S format *sukuk* include the Islamic Development Bank's issue of $400 million in 2003, the State of Qatar's $700 million in 2003, and the Kingdom of Bahrain's $250 million in 2004.

[73] Prof. Jackson employed this term while discussing various aspects of regulatory convergence. See Jackson, "Centralization, Competition and Privatization," 30-31.

exchange. The homogeneous nature of the IFS securities exchange will facilitate consistent growth within the IFS industry. At the IFS exchange, entrepreneurs and suppliers of finance would be able to make transactions in accordance with the principles of Islamic finance.

Facilitated by modern information technology, the IFC securities exchange could be connected to the specialized secondary market open to the investors world-wide. However, a sophisticated cross-jurisdictional dispute resolution mechanism would need to be in place to avoid any legal uncertainty with regard to the functioning of the exchange. The IFS securities exchange may be incorporated by the stock exchanges that list the IFS products or, alternatively, set up by any number of willing regional exchanges. The IFS Securities Exchange will serve to provide capital sources within the IFS product region, in line with the investment policies of various Muslim countries. Governmental support is also essential in this regard.[74] Collaboration with the international organization will provide the requisite expertise required to develop the foundational regime.

Modern business institutions, including the securities markets, do not necessarily conflict with *shari'a*. Rather, if their role facilitates the curbing and alleviation of poverty and promotes economic welfare by enhancing purchasing power in an economy, they serve a noble purpose.[75] It is often argued that stock exchanges favor the rich and encourage monopoly by corporations while discouraging small enterprise,[76] and that they present a place for insider trading and excessive transaction costs. While agreeing that insider trading is a form of exploitation—and that no financial market can prosper in its presence—it is essentially a regulatory issue and a regulatory response could effectively counter this practice. Furthermore, transaction costs (in particular, service charges for financial intermediation) represent someone's labor and expertise, attaching credibility to an issue and maximizing chances of success in the market. The agreed price for service or labor appears in accordance with *shari'a*. However, there may be discouraging effects of excessive transaction costs for small enterprises. But that too would be an economic policy and regulatory issue, and not one that would affect the transaction costs' legitimacy according to *shari'a*. As a measure to promote the small enterprise, suggesting a specialized market or a stock market for small businesses is appropriate at this time.[77]

[74] Bradley, "A Regional Stock Exchange," Governmental support was regarded as essential for the Sub-Saharan African regional stock market as well.
[75] Ahmad, *Business Ethics in Islam*.
[76] Saad Al-Harran, ed., *Leading Issues in Islamic Banking and Finance* (Petaling Jaya: Pelanduk Publications, 1995), 143-151.
[77] Ibid.

For an Islamic stock market, transactional transparency and the absence of market manipulations, short selling, insider trading, contra deals, and excessive financial exposure are essential. Scholars view such practices as immoral or unethical.[78] Transactional transparency and compliance with *shari'a* also applies to market participants, and as argued, includes the fair intention to carry out the transaction.[79]

The establishment of an IFS securities exchange may also seem closer to the objectives of *shari'a* for its potential to spread the financial benefits to a greater portion of the population.

CONCLUSION

This paper has discussed the significance of corporate governance for the IFS industry. Furthermore, it has predicted that the IFS industry is likely to converge to modern governance practices. The paper has also argued that the industry needs to have a homogenous and specialized regional IFS securities market for the IFS industry to realize its full potential.

The IFS industry is successfully crossing the conceptual barriers and will, hopefully, attain the market efficiency that comes with the continuation of a business entity, despite the fact that continued business entities have not existed in Muslim countries.[80] Scholars have provided guidelines for organizing limited liability business organizations including the form of a modern corporation.[81] However, the role of a corporation in society still needs further examination in light of *shari'a*. The question of whether a corporation serves the society from its profits, or serves solely the interests of its shareholders, needs scholarly response. A socially responsible corporation may yield lesser profit to the shareholders, and this feature is likely to affect its competitiveness. Without fully resolving such issues, the Islamic financial markets are far from a reality.

The findings of the Islamic Capital Task Force noted that the Islamic capital market is a part of the global securities markets, and its regulation is needed in order to nurture and support its growth. The findings also noted that for its regulation, it should comply with IOSCO's Objectives

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[78] Syed Othman Al-Habshi, "Towards an Islamic Capital Market," http://vlib.unitarklj1.edu.my/staff-publications/datuk/Nst19feb93.pdf.
[79] Ibid.
[80] Timur Kuran, "The Absence of the Corporation in Islamic Law: Origins and Persistence," *American Journal of Comparative Law* 53 (2005): 785-834.
[81] Imran Ahsan Khan Nyazee, *Islamic Law of Business Organizations: Corporations* (Islamabad: The Islamic Research Institute Press, 1998).

and Principles of Securities Regulation.[82] The findings noted the absence of any international body providing directions on the Islamic capital markets issues, and emphasized the convergence of divergent *shari'a* interpretations.[83] Efforts to streamline the divergence are under way. It remains to be empirically examined whether or not a particular school of *shari'a* interpretation is becoming more popular than the others, and what might be the repercussions of such preferences.

No single regulatory authority exists for the regulation of the IFS industry, which continues to be regulated by the dual regulatory structure. That is to say, the industry is subject to the regulatory regime of the respective national laws where IFS firms are domiciled, and the IFS-specific international quasi-regulatory entities, as described above. Thus, it is difficult to analyze the extent of actual regulatory convergence within the industry. However, the principles and standards issued by the AAOIFI and the IFSB are becoming increasingly significant in the industry. Examining the degree of convergence in such principles and standards would be an important follow-up study, and a future work will analyze whether the principles and standards sponsored by the aforesaid institutions support the arguments of convergence, as discussed here, and, if so, to what extent.

As noted above, functional, *de facto,* or stealth convergence in the form of the issuance of *sukuk* in accordance with the U.S. regulatory formats confirms the scholarly predictions on regulatory convergence. The voluntary adoption of U.S. regulatory formats also supports the argument made here.

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[82] "International Organization for Securities Commissions," Report of the Islamic Capital Market Task Force, July 2004, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD170.pdf.

[83] Ibid.

Regulation, Supervision, and their Role in the Development of Efficient Islamic Insurance Markets

Philipp Wackerbeck[1]

In recent years, the development of Islamic financial markets, institutions, and products has accelerated to a remarkable pace. Among the reasons for this development are not only the strong demand for *shari'a*-compliant financial services—particularly in connection with growing oil wealth in the Gulf region but also in non-Muslim countries as well—but also the competitiveness of some Islamic financial products, which attract both Muslim and non-Muslim investors.[2] Much of the debate on the development of Islamic finance is about the role of Islamic banking and the Islamic banking system. It seems that the role of insurance in economic development and financial deepening is often underestimated. However, insurance can play a vital role in the development of an economy.[3]

On the other hand, because of the specific business model of an insurance company, the failure of an insurer to meet its obligations can have severe consequences for the whole economy. Additionally, the interests of the insured need to be especially protected, as—unlike in other industries—premiums are paid up-front for an uncertain event, with many contracts including long-term saving components. That is why a sound regulatory framework is generally needed for insurers to operate. In

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[2] M. El Qorchi, "Islamic Finance Gears Up: While Gaining Ground, the Industry Faces Unique Regulatory Challenges," *Finance & Development* 42, no. 4 (December 2005).

[3] For an extensive discussion of the economic role of Islamic insurance for economic development and poverty alleviation in Muslim countries, see Philipp Wackerbeck, "The Role of (Islamic) Insurance in Economic Development and Poverty Alleviation in Muslim countries". Paper presented at the Seventh International Conference on the Economics and Finance of the Middle East and Northern Africa, Byblos, Lebanon, May 30 – June 1, 2005.

ensuring that business is done according to these regulations, insurance supervision plays a very important role.

As Islamic finance is a fairly new discipline and its products, structures, and processes are usually more complex than those in conventional finance, it is even more necessary to build confidence in the new industry. Particularly in insurance, which even in conventional finance relies heavily on a sound regulatory and supervisory framework, such a framework is very much needed.

It is the aim of this paper to analyze the regulatory and supervisory challenges for Islamic insurance (*takaful*) markets, as the need for *shari'a* compliance increases the complexity of both regulation and supervision. Special attention is given to how Islamic insurers can approach intensified solvency requirements.

PRINCIPLES OF ISLAMIC INSURANCE (*TAKAFUL*)

As opposed to the Western economic system, the concept of Islamic economics defines and prescribes specific patterns of economic and social behavior for all individuals. While the Western system only tries to explain the mechanisms of the economic system, as well as explain and partly predict the behavior of individuals, the system of Islamic economics actually gives guidance to individuals on how to behave.

While the principles of Islamic finance and Islamic banking are widely known, there is a lack of knowledge of Islamic insurance, or *takaful*. One reason for this is that insurance is more complex than banking, and its importance in financial intermediation is also often underestimated. Additionally, Islamic insurance has been widely neglected in literature and research.[4]

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[4] Major contributors to Islamic insurance literature are Muslehuddin (1982) and Siddiqi (1985). A later commentary is provided by Anwar (1994) including a critique. Wahib (1999) gives a practitioner's guide while the publication of the Institute of Islamic Banking & Insurance (1999) focuses on organizational aspects. See M. Muslehuddin, *Insurance and Islamic Law* (Delhi: Markazi Maktaba Islami, 1982); M. N. Siddiqi, *Insurance in an Islamic Economy* (Leicester: The Islamic Foundation, 1985); M. Anwar, "Comparative Study of Insurance and *Takaful* (Islamic Insurance)," *The Pakistan Development Review* 33, Part 2 (Winter 1994): 1315-30; R. B. Wahib, "Islamic Takaful Insurance," *New Horizon* (1999) Part 1, 86, (pp. 10-12), Part 2, 87 (pp. 16-17), Part 3, 88 (pp. 10-12); and Institute of Islamic Banking & Insurance, ed., *Directory of Islamic Insurance (Takaful) 2000* (London: Institute of Islamic Banking & Insurance, 1999).

Islamic insurance is compliant with Islamic law ("*shari'a* compliant"). The insurance business is relatively complex, but becomes even more so when practised in compliance with *shari'a*. Let us first take a look at the problems arising with conventional insurance in Islam. From this point of view, there are three main problems with conventional insurance, particularly with life insurance: *gharar* (uncertainty), *maisir* (gambling), and *riba* (interest).

First, the prohibition of *gharar* is violated, because the benefits depend on future events that are not known when signing the insurance contract. This prohibition nullifies the whole-life insurance contract since this type of policy is based on a time frame (the lifetime of the insured person) that is not known in advance and cannot be known until the event itself (death) occurs. The same principle applies to property and casualty insurance, because losses and damages are also stochastic variables. Second, because policyholders are held to be betting premiums on the condition that the insurer will make payment consequent upon the circumstance of a certain event, insurance is also regarded as *maisir*. By taking out a pure life endowment policy, policyholders are taking a gamble that they will still be alive by the end of the term of the policy to receive the benefits settled in the contract.[5] Third, all types of insurance—life insurance as well as non-life insurance—are constructed such that significant elements of savings are built into them. The insurer invests the pre-paid premiums on behalf of those insured. But because many of these investments are made into interest-bearing securities, conventional insurance policies contravene Islamic law regarding the prohibition of *riba*.[6]

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[5] Criteria for how to determine the presence of the element of gambling in any current practice has been evolved by scientific analysis. This analysis can be summarized in a way that the criterion requires that only those individuals likely to suffer a loss should be entitled to insure themselves and to receive the compensation accruing from insurance. These people should have the right to get insurance by paying the premiums, but those who are not likely to face any loss should not be entitled to buy insurance. If they do, this will be regarded as gambling because they are seeking out risks that normally are not present in their situation. See Siddiqi, *Insurance in an Islamic Economy*.

[6] Probably the most familiar association with Islamic finance is the prohibition of interest (*riba*), which can be found in the Qur'an 2:275: "Those who devour *riba* will not stand except as stands one whom the devil hath driven to madness by (his) touch." In the same verse, we find: "God permits trading and forbids *riba*." This strict prohibition of interest has to be taken as axiomatic. As the Qur'an does not explicitly talk about interest but about *riba*, it first of all needs to be specified what exactly *riba* means. As an Arabic word, *riba* stands for the predetermined return on the use of money. Nowadays, it is widely agreed that this means not only excessive interest (usury), but any interest at all. Some scholars have tried to interpret *riba* only as a

Insurance is controversially discussed within the Muslim communities, and scholars differ as to whether it is possible to create insurance policies compliant with the *shari'a*. It is sometimes argued that the necessary calculations of probability, one of the insurer's core competencies, might be regarded as an act of defiance against *taqdir*, or the predestination of events by God.[7] That is why some scholars declare all forms of life insurance to be prohibited entirely.[8] But apparently the majority of scholars and researchers are of the opinion that a system of life insurance that does not contravene Islamic law can in fact be worked out. When it is based on mutuality it avoids the presence of *gharar*, *maisir,* and *riba* in conventional life insurance. This mutually or cooperatively organized form of insurance is the basis for *takaful* insurance.

Takaful is drawn from the Arabic verb *kafala*, which means to take care of one's needs. It describes a practice whereby members of a group of people jointly agree to guarantee themselves against loss or damage. If one of these members suffers a catastrophe or disaster, this person receives a financial compensation for his damage or loss from a special fund set up by the group. The concept of *takaful* is essentially based on responsibility, solidarity, and brotherhood among the group members who have agreed to share predefined losses to be paid out of predefined assets. This is quite similar to the theoretical conception of a mutual insurance company, where the insured are at least the owners of the insurance company, if not the insurers as well.

Takaful insurance can be put into a systematic order similar to that of conventional insurance. First of all, there is the distinction between primary *takaful* and *retakaful*, as with primary insurance and reinsurance respectively. Primary *takaful* can be divided into general *takaful* (Islamic general insurance) and family *takaful* (Islamic life insurance). There are very few *retakaful* companies operating in the market, and *retakaful*, like reinsurance, can be regarded as insurance for insurers.[9]

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prohibition of usury, but it is now widely accepted that *riba* has to be seen as every type of interest.

[7] This is why home insurance, for example, is widely unknown in many Muslim countries.

[8] For an overview of the discussion, naming the opponents against the validity of life insurance, see Ma'sum Billah, "Life Insurance: An Islamic Paradigm," in *Directory of Islamic Insurance 2000*, 80-84.

[9] The lack of *retakaful* coverage is one of the major problems of the *takaful* industry. With few primary *takaful* insurers available, it is difficult for *retakaful* companies to do a risk transformation with the risks they receive from primary *takaful* insurance companies. Since they cannot operate with the law of large numbers, the technical risk is difficult to calculate.

General *takaful* offers coverage of risks of a general nature for companies or individuals (participants).[10] Among those products are automobile insurance, fire and allied perils, property, transportation, marine cargo, engineering insurance, and workers' compensation. General *takaful* policies are normally short-term contracts for the protection of potential material losses from specified perils. Premiums paid by the members are called *tabarru*' (contribution, donation). The premiums are invested on a *mudaraba*[11] basis by the *takaful* operator. Profits are afterwards allocated between the *tabarru*' fund and the management. If there is any surplus left after the deduction of indemnity, reserves, and operational costs, it is either shared between all participants, or shared specifically among those who did not make a claim, depending on the company concerned. General *takaful* is similar to conventional insurance because members' contributions are entirely invested like the premiums in a *tabarru*' fund. However, it is different in that investments are done on a *mudaraba* basis, and the participants are entitled to share any surplus in the *tabarru*' fund.

Family *takaful*, or Islamic life insurance, has the objective of paying for a defined loss from a defined fund. This fund is managed by a *takaful* company, but it is mutually set up by the policyholders. The idea behind a life insurance policy is not to insure one's life, but to make sure that the dependents of the insured can care for themselves if the insured dies. Additionally, it is often used for building up capital to financially secure one's retirement. Family *takaful* schemes provide coverage for individuals on a long-term basis. The maturity of these policies normally ranges from 10 to 30 years. Elements of *gharar* can be avoided if the policy is operated on the principles of *mudaraba*, that is, as a profit-sharing contract between the providers of the fund (policyholders) and the manager of the fund (the *takaful* company). The share of profit of each party has to be predefined. The uncertainty in the contract period is banned by the fixed period or term of the policy.[12] The principle of *takaful* life insurance is fairly similar to investment-linked (unit-linked) life insurance, where premiums are

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[10] The following description is based on a discussion in D. M. F. Yusof, "The Concept & Working System of *Takaful*," in *Directory of Islamic Insurance 2000*, 17-24.

[11] A *mudaraba* can briefly be described as a financial partnership. After receiving the deposits of the investors, the *mudarib* manages the investment of the funds to businesses or trade activities of an entrepreneur. After a previously agreed upon period of time, the principal is paid back to the investor. In addition to that, the investor receives a previously agreed upon share of the profit the entrepreneur has made by using the funds paid by the investor. The *mudarib* also receives a share of the profit for his labor and entrepreneurship.

[12] In fact, if the term is long enough, this could lead to a whole-of-life policy as well. Otherwise it remains a term insurance.

invested into a mutual fund (unit trust) after the insurer's expenses have been deducted. Premiums paid by the insured are split up and paid into two different accounts: the *tabarru*‘ account and the participants' *mudaraba* investment portfolio. Out of the *tabarru*‘ fund, benefits for the insured are paid, while profits from the *mudaraba* investments are shared between the participants and the companies in pre-agreed upon ratios.

As explained above, *takaful* is theoretically perceived as cooperative insurance, where members contribute their premiums to a common pool. The original intention is a non-profit system, but the commercialization of *takaful* has led to different models of organization of Islamic insurance schemes, each of them reflecting different experiences and environments. There are actually four different models in practice: the *ta‘awuni* model, the non-profit model, the *al-mudaraba* model, and the *al-wakala* model.

The *ta‘awuni* model can be regarded as a cooperative insurance model. The concept of pure *mudaraba* is practiced in daily transactions. It encourages Islamic values like solidarity, brotherhood, unity, and mutual cooperation. In this model, the *takaful* company and the policyholders will share only the direct investment income, while the policyholders are entitled to all of the surplus with no deduction made prior to the distribution. The *ta‘awuni* model is applicable to life *takaful* (family *takaful*), because the fund is entirely distributed to the participants. The non-profit model includes government-owned enterprises and programs operated on a non-profit basis. The *tabarru*‘ fund is made up completely by donations, either by participants who are willing to give to the less fortunate members of their community, or by social and governmental institutions. In the *al-mudaraba* model the surplus is shared between policyholders and the *takaful* operator at a pre-agreed ratio. In general, this model of risk sharing allows the *takaful* operator to share the underwriting results from insurance operations as well as favorable performance returns on invested premiums. In the *al-wakala* model, the *takaful* operator's role is more an administrative one, rather than a risk taking one. The risks are shared cooperatively among the participants while the *takaful* operator earns a fee for its services as a *wakil* (agent). The operator does not share in any underwriting results, which solely belong either as surplus or deficit to the participants. In addition to the arranging fee, the operator may also charge a fund management fee and a performance incentive fee.

Apparently only the *al-mudaraba* model and the *al-wakala* model can be attractive for commercial insurers willing to set up Islamic insurance windows. However, mutual or cooperative forms of insurance do have some severe disadvantages over joint stock insurers. Among these disadvantages are the inability to raise capital by rights issues, difficulties

in corporate consolidation, and problems with corporate governance.[13] This needs to be remembered when finding insurers willing to do *takaful* business themselves, or operating Islamic insurance windows. In the long run it probably will not be large multinational insurance companies that offer *takaful* services, but smaller and locally operating cooperative or non-profit organizations.

Theoretically, Islamic insurance should be more expensive than conventional insurance because it includes more restrictions. There is a trade-off between conformity with Islam and the yield of a life policy or the price of a non-life policy. For example, in property and casualty insurance, the Islamic components can influence two different variables of the insurance decision model: the costs and possibly the planned profit of the insurer. The latter is added to the gross premium in order to make up the price for which insurance is sold. In general *takaful*, especially in property and casualty insurance, it is not possible to price an Islamic insurance policy at a lower price than a conventional one, because all the necessary modifications have a negative impact on the price:

$$P_I = E(\tilde{S}) + R(\tilde{S}) + K_I \quad \text{with } K_I > K$$

P_I Premium of Islamic insurance policy

$E(\tilde{S})$ Expected Loss

$R(\tilde{S})$ Risk Premium

K_I Costs

K_I is the cost component for production and administration of an insurance policy in accordance with the *shari'a*. Who is willing to pay for these additional costs of religious conformity: the insurer, the insured, or both? This depends on the utility functions of the participants. If the insurance buyer's utility function contains an Islamic component (that is, the religious conformity of a financial product has a positive impact on the utility function), then he will pay a higher premium for the policy. If the additional cost of conformity is paid by the insurance buyer, it does not influence the profit of the insurer, because additional costs are transferred

[13] For extensive analysis of the pros and cons of different legal forms of insurance companies, see Wackerbeck, "Demutualisierung auf Deutsch: Zur ökonomischen Rationalität eines Modethemas," *Versicherungswirtschaft* 57 (2002): 716-721 (hereafter cited as Wackerbeck 2002a); and Wackerbeck, *Strategische Optionen für Versicherungsvereine auf Gegenseitigkeit: eine betriebswirtschaftliche Analyse der Demutualisierung* (Berlin: Logos, 2002) (hereafter cited as Wackerbeck 2002b).

to the buyer. Depending on the utility function of the insurance buyers, it might also be the case that the utility is increased over-proportionally due to desire for conformity with the *shari'a*. The question is, how much more does it cost to produce *shari'a*-compliant insurance coverage, and how much more are insurance buyers willing to pay for it? Up to now, it has been assumed that *shari'a* conformity has a positive influence on the insurance buyer's utility function. That would be the case with a conventional insurance company offering Islamic insurance. But the conformity can also have a positive impact on the insurer's utility function, if it is not operated under conventional rules, but under Islamic rules. Then the insurer would accept a discount on his profit surcharge. This is why Islamic insurance is organized as a cooperative form of insurance, similar to mutual insurance companies, where the policyholders own the company just by signing an insurance contract instead of buying shares in the insurer. The discount cannot reduce the profit surcharge completely, because even in cooperative forms of insurance, profit is needed to fulfill increasing capital requirements and to build up financial reserves. By integrating this concept of Islamic insurance into the model, it allows one to consider the effects of religious boundaries in economic development, and to give a more precise forecast of the influence of insurance on economic growth, particularly in Muslim countries.

ISLAMIC INSURANCE MARKETS AND ECONOMIC DEVELOPMENT

The insurance sector can contribute to the development of capital markets, because a pool of funds is made accessible to both borrowers and issuers of securities. It might seem difficult within an Islamic financial system to supply borrowers with these funds, but with instruments like *sukuks*[14] it is possible to avoid investing in interest-bearing securities without having to increase the risk of the asset portfolio by only shares. In developed countries insurers are among the largest investors in local capital markets. In order to eliminate the risk of exchange rate movements, they have to invest their funds in the same currency as they receive their premiums. By doing so, they support the development of local capital markets, which is a crucial factor for the development of the whole economy. This positive aspect of insurance for economic growth can be reached especially by selling life insurance or family *takaful* products. This is because these

[14] *Sukuks* are Islamic bonds that are constructed as asset-backed securities. Capital is raised by securitizing assets such as a real estate portfolio, and the rental income is paid to the bondholders instead of interest.

policies on the one hand contain a savings element, and on the other hand are long term business, offering insurers greater flexibility in investing the funds. The lack of a diversified financial market in combination with a high propensity to save could encourage life insurance penetration. Similar to that, an increased life expectancy would increase the demand for savings-based insurance products and annuity income streams.[15]

When societies become more industrialized and urbanized, their vulnerability to losses is enlarged and their demand for insurance increases. Another factor closely linked to this is exposure to natural catastrophes. In the case of disasters such as floods or earthquakes, much wealth can be destroyed. If that wealth is not insured, its loss will either result in a step backwards in development, or force the government to support the victims. In the latter case, there will be a resulting lack of funds for other activities.

Cultural and religious factors could, as in some Muslim countries, discourage traditional insurance while encouraging product innovation, which could be conducive to the growth of the insurance industry. In general, insurance for private households and smaller firms is sold and not bought, while the reverse is true for larger companies. Where insurance has been declined so far, especially in rural areas or among private households in general, *takaful* could be the solution. Whether a broad introduction of *takaful* necessarily leads to a significant increase in insurance penetration still needs to be empirically tested.[16]

The implementation of *takaful* operations is still facing some major difficulties that must be solved in order to compete with conventional insurance. Many risks being addressed by the various supervisory agencies are often unique to *takaful*. Among others, operational risks are especially problematic due to the complex administration of profit and loss sharing modes of financing and the non-standardized nature of some Islamic products. Risks in Islamic contracts could be viewed as more heterogeneous and complex than those carried by conventional insurers. That is why it is important for policymakers to foster the implementation of regulatory and supervisory bodies not just for conventional insurance in Muslim countries, but especially for *takaful* operations. Only if individuals can rely on an insurer's promise to pay in case of a loss, and believe in its financial stability, will they consider buying the insurance at all.[17]

It is necessary to carry out more research on the impact of the desire for the religious conformity of financial products. For instance, although Pakistan as a Muslim country is ranked 135th in the Human Development

[15] Wackerbeck, "The Role of (Islamic) Insurance," 23.
[16] Ibid.
[17] Ibid., 24.

Index, it has an insurance penetration of only 0.66 percent and an insurance density of only USD 2.9. Kenya as a non-Muslim country is ranked 138th, but has an insurance penetration of 3.48 percent and an insurance density of USD 9.5.[18]

THE NEED FOR REGULATION IN INSURANCE MARKETS

Insurance regulation and supervision is primarily aimed at the protection of the insurance purchaser, as he is generally regarded to be in a weaker position compared to the insurer. But this is not always the case. Under certain conditions, the opposite is true. From a theoretical perspective, the weaker position of the insurance buyer can lead to exploitation of individuals by the insurer, while the weaker position of an insurer can lead to a collapse of the insurance market. In order to promote the efficiency of the insurance market and use insurance as an important means in financial and economic development, insurance regulation is necessary in order to solve problems resulting from market failures.

MARKET FAILURE IN INSURANCE MARKETS DUE TO INFORMATION ASYMMETRY

The simple model of insurance market equilibrium of insurance supply and demand, which has been presented above, is based on the assumption of information efficiency. This means that the insurer is able to differentiate between “good” and “bad” risks. The insurer thus offers to each person demanding insurance coverage a policy that is individually priced with regard to the respective risk situation of the demander. If this unrealistic assumption is skipped, the insurance market will produce an imperfect result. Fully transparent information is unrealistic because the demander is able to withhold information that is relevant to the insurer’s pricing decision. Because of this inefficiency, the market process can only lead to a second-best solution. There are two different types of information asymmetries in insurance markets: adverse selection and moral hazard.

[18] Figures are for the year 1998. See United Nations Development Programme, *Human Development Report 2000* (Oxford: Oxford University Press 2000); Sigma, “World Insurance in 1998: Deregulation, Overcapacity, and Financial Crisis Curb Premium Growth” (Sigma Series, No. 7, Swiss Re 1999); and Sigma, “World Insurance in 2000: Another Boom Year for Life Insurance; Return to Normal Growth for Non-life Insurance” (Sigma Series, No. 6, Swiss Re 2001).

Both of them appear in insurance markets to a certain degree. Although they usually appear simultaneously, they are discussed separately here.

Adverse Selection

The problem of adverse selection was first described by Akerlof (1970).[19] In an insurance context, the insurer does not have sufficient information about qualities of the insured at the time before the contract is signed. The insurance buyer has an information advantage regarding his individual risk situation. As the insurer has an information deficit, the premium can only be calculated as an average of the accurate premiums for "good" and "bad" risks. This average premium is seen as too high by the good risks, who do not buy the insurance. Meanwhile the bad risks do buy, because their respective risks are actually worse than the average (that is, they actually would have had to pay a premium higher than the average if the information was revealed).[20] If the insurance is not mandatory, it can be expected that the insurance pool contains more bad risks, on average, than the total population. The more that good risks decide not to insure themselves at the average premium, the more the insurer must increase its premiums in order to avoid losses. By doing so, even more good risks leave the insurance pool and eventually the system will collapse. That leads to a situation in which no market equilibrium can be reached if the same averagely priced policy is offered to individuals with different loss probabilities.[21] In order to avoid the adverse selection phenomenon, certain signals must be defined that allow the determination of the differences in the actual risk situation.[22]

There are different instruments used by regulatory/supervisory bodies to avoid adverse selection and to reduce its negative consequences. First,

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[19] From a theoretical point of view, it is part of the principal-agent theory, which itself is part of the wider framework of the new institutional economics. G. A. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics* 84 (1970), 488-500.

[20] "What this means is that if the insurer sets a premium based on average probability of a loss using the entire population as a basis of this estimate, only the poorer risks want to purchase coverage. As a result, the insurer expects to lose money on each policy sold." See P. K. Freeman and H. Kunreuther, *Managing Environmental Risk through Insurance* (Boston: Kluwer Academic Publishers, 1997), 43.

[21] See Michael Rothschild and Joseph Stiglitz, "Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information," *The Quarterly Journal of Economics* 90, no. 4 (1976), 639.

[22] For other solutions to avoid adverse selection problems, see Rothschild and Stiglitz, "Equilibrium in Competitive Insurance Markets," 643; and Freeman and Kunreuther, *Managing Environmental Risk*, 43.

the state can act as a monopoly insurer. The demand for insurance is rationed, which prevents the bad risks from purchasing too much insurance coverage. Second, the purchase of supplementary insurance can be prohibited. The worse the risk, the higher the demand for insurance coverage becomes. If supplementary insurance is prohibited, the insurer will always be informed about the total insurance purchasing of each individual. Additionally, a Pigou-tax can be implemented, which leads to an additional taxation, and therefore a reduction of the insurance demand.[23] Fourth, the insurance buyers can be forced to disclose all relevant information. Otherwise, they lose their claims for compensation. Fifth, all measures taken by individuals to avoid losses can be subsidized. By doing so, the spread between good and bad risks can be lowered. Sixth, a mandatory experience rating leads to a premium increase for historically bad risks.[24]

Moral Hazard

Another form of asymmetric information is moral hazard. The term "moral hazard" was originally introduced by Arrow (1963).[25] It describes a phenomenon frequently observed in insurance markets. Moral hazard is the danger that the behavior of an individual may change after having purchased insurance coverage for a certain risk. Because of this coverage, the insured increases either the probability of a loss (risk-increasing moral hazard) or potential loss itself (loss-amount-increasing moral hazard). The insurer is unable to monitor the behavior of the insured, for example, with respect to his initiatives in loss prevention. Only if the change in behavior cannot be monitored by the insurer can it be considered as moral hazard. If the change in behavior could be monitored, the problem could easily be solved by the insurer by advising the client to change his behavior again, or by threatening to increase the premium otherwise. As most measures taken by the insured to avoid losses or to reduce negative financial consequences are not visible for the insurer, moral hazard can lead to the non-insurability of certain risks.[26] Because of the existing insurance

[23] See Schulenburg, *Versicherungsökonomik* (Karlsruhe: VVW, 2004), 295 for a description of such taxation.
[24] Ibid., 306.
[25] K. J. Arrow, "Uncertainty and the Welfare Economics of Medical Care," *American Economic Review* 53 (1963): 941-973.
[26] See K. J. Arrow and Mordecai Kurz, *Public Investment, The Rate of Return, and Optimal Fiscal Policy* (Baltimore: The Johns Hopkins University Press, 1970), 142; and Arrow, "The Economics of Moral Hazard: Further Comment," *American Economic Review* 58 (1968): 538.

coverage, the insured generally has no incentive to implement measures to avoid losses. This is why moral hazard leads to additional costs. The instruments used by the regulatory/supervisory bodies are similar to those explained above for the problem of adverse selection.[27]

CONSEQUENCES FOR REGULATORS

The information problems in insurance markets described above may lead to a situation in which insurance as a means of risk consolidation is not used to a desired degree. The consequence is market failure, and the efficiency of allocation is reduced by asymmetric information. While the insurance buyer knows about his personal behavior, the insurer does not. Instead, it can only evaluate the average behavior of its risk collective. This leads to additional costs due to adverse selection and moral hazard. This is why state regulation of insurance supply and demand is necessary. The aim of regulation can be seen in the improvement of the allocation process by reducing its inefficiencies.[28]

Additionally, there are other reasons why the risk allocation process cannot be fully organized by the market itself and its participants. Among these reasons are certain limits of indemnity, economies of scale when consolidating risks, and an underestimation of the future needs of people. Limits of indemnity, which may be prescribed by corporate law, for example, can lead to a situation in which the demand for severe but rare claims and losses is lower than necessary. Economies of scale from the risk consolidation are the result of the risk transformation process. The more independent risks are pooled together, the lower the total risk of an insurer. This, in fact, would support consolidation tendencies. The future needs of people are often underestimated, especially those resulting from the risks of illness or aging. It would therefore be important to build up sufficient funds to cover the financial consequences of these risks. But this is often not done sufficiently.[29]

Regulation is aimed at solving the negative consequences of market failure and allocative inefficiencies. But to a certain degree, the market is often able to help itself. For example, insurance companies can use certain instruments like deductibles or risk-adequate pricing in order to avoid the negative effects of moral hazard on the market. Nevertheless, in many economies the state has implemented various regulatory measures, on both the supply and demand side of the insurance market. Regulation and

[27] Schulenburg, *Versicherungsökonomik*, 294-296.
[28] Ibid., 350.
[29] Ibid., 91.

supervision of insurers are the appropriate means to protect the interests of insurance buyers, while the introduction of mandatory insurance schemes (for example in health or automobile insurance) can promote the interests of insurance companies.

On the other hand, it cannot be taken for granted that regulation and supervision always have a positive effect on the efficiency of allocation. Similar to market failure, there is also the chance of state failure, leading to a decrease of efficiency as well.[30]

FRAMEWORK OF INSURANCE SUPERVISION

After describing the need for insurance regulation, attention is now drawn to the supervision of insurance companies. While regulation is about the institutional and legal framework of insurance operation and supervision, supervision itself is about the continuous application of the regulation. The description of the framework of insurance supervision will be conducted in two steps. First, a general theory of insurance supervision is presented. This is followed by an internationally agreed upon framework for insurance supervision.

Insurance Supervision Theory

Supervision by the state can be executed either by a general state authority, such as a monetary authority, or by a specialized insurance supervisor.[31] The supervisory body has certain aims, and to reach these aims it may use various means or instruments. By doing so, it influences insurance companies and the way they do business.

The most important aim of insurance supervision is protecting the interests of the insured (protection theory of insurance).[32] The insurance buyer generally has little transparency regarding what happens with his premiums after they have been paid. He relies on the insurer's promise to pay in case of a loss. In some types of insurance, as in life insurance, where the premium includes a large savings component and the contract is for a long period, it is important to ensure the financial stability of the insurer to avoid negative consequences for the insurance purchaser.

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[30] Ibid., 352.

[31] In this paper, supervision refers only to insurance supervision, and not to *shari'a* supervision. It is the duty of the latter to monitor the Islamic company's operations both at the time of setting up the company and also during further operations.

[32] D. Farny, *Versicherungsbetriebslehre* (Karlsruhe: 2000), 108.

Another very important aim is the avoidance or removal of market failures. Among these are the problems of adverse selection and moral hazard, which could lead to the collapse of the insurance market.[33] It is the duty of the regulator to create a legal framework that helps to avoid these market failures as much as possible, and it is the duty of the supervisor to ensure that insurance companies do their part in the implementation of such regulations.

In addition, the supervisory body must promote the efficiency of insurance markets. If the insurance system was operating within a fully liberalized market economy, the results would be below the optimum because of structural specialties in the process of insurance production. It is the duty of the supervisor to compensate for the inefficiencies caused by these structural specialties.

Moreover, in many economies the operations of the supervisory body are embedded in the overall political economy, and supervision is aimed at promoting the general economic and financial policies of the government or the state.[34]

The insurance supervision process is typically structured as follows:

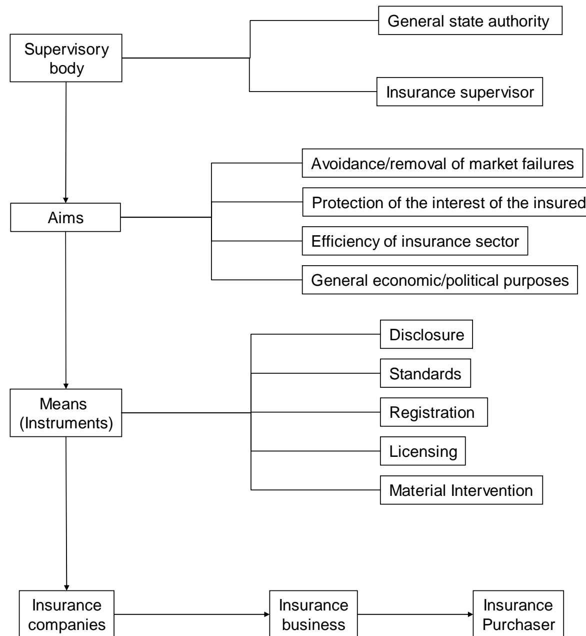

Figure 1: Insurance supervision theory model

[33] Both these issues are discussed above in this paper.
[34] Farny, *Versicherungsbetriebslehre,* 109.

To reach these aims, the supervisory body uses a range of means or instruments. Among these instruments are disclosure rules, the setting of standards, registration and licensing of insurance companies, and material interventions. Disclosure of business results is a common procedure in every industry, but the supervisor has the special duty to monitor that the insurance companies actually disclose the required information on time. A more powerful instrument is the setting of standards for insurance companies and the way they conduct business. These standards cover areas such as the creation of insurance companies, the content of corporate statutes and business plans, capital requirements, and instructions on investments and accounting. The supervisory body also monitors that the capital adequacy requirements are followed by the insurances companies. Even more powerful is the instrument of registration. Only if all the standards set by the supervisor are met, will the insurer be entered in the register. The registration itself does not allow the insurer to start operations. To do so, it needs to be licensed by the supervisory body. The licensing procedure goes into far more detail regarding the fulfilment of all requirements of the standards. Finally, the strongest forms of supervision are material interventions in running the business processes of an insurer.[35] Generally, this is only necessary if an insurer is likely to fail and might become unable to fulfil its insurance promises. In order to protect the interests of the insured, the supervisory body can take control of the insurer and try to avoid the financial collapse of the company.

An Internationally Agreed Upon framework of Insurance Supervision

In late 2005 the International Association of Insurance Supervisors (IAIS) issued a new framework for insurance supervision to harmonize and standardize the many different frameworks currently in effect in various countries.[36] It is important to note that within this framework the solvency of an insurer plays a central role in the risk management of insurers and in insurance supervision, but it is integrated into an overarching framework

[35] Ibid., 111.

[36] See IAIS, "A New Framework for Insurance Supervision: Towards a Common Structure and Common Standards for the Assessment of Insurer Solvency" (October 2005), 1 (hereafter cited as "IAIS (2005a)"). The IAIS was founded in 1994. Its objectives are the improvement of insurance supervision on the domestic and international levels to maintain efficient, fair, safe, and stable insurance markets in order to protect policyholders and to increase the utility of buying insurance. Moreover, the IAIS aims at promoting the development of well-regulated insurance markets and contributing to global financial stability.

for insurance supervision that is globally acceptable and applicable.[37] The framework is designed as a three-level approach. The first level describes the necessary preconditions for effective insurance supervision, the second level contains regulatory requirements, and the third level the supervisory action.[38]

On the first level, there are two different sets of basic conditions for the functions of the insurance sector and insurance supervision, as well as of the insurance supervisory authority. First the effectiveness of insurance supervision depends on the condition of its environment. There needs to be an institutional and legal framework for the whole financial sector and for its supervision. Additionally, the infrastructure of the financial market should be fairly developed and effective as well. This includes the need for efficiency of the market with the availability of all the relevant information.[39] Secondly, it is important for the effectiveness of insurance supervision that there be a set of clearly defined principal supervisory objectives. Moreover, a supervisory authority is needed that has the capabilities to exercise its functions and powers. Besides the adequate powers, the authority must have sound legal protections as well as the necessary financial resources. It has to be independent in its operations, especially from political institutions and insurance companies. The supervisory authority must be transparent in using its powers and accountable for its actions.[40] This set of basic preconditions is the basis for a sound regulation and supervision system.

Based on these preconditions, there are three major issues that make up the regulatory requirements for insurance companies. Among these are financial issues, governance issues, and market conduct issues. These three issues can be viewed from two different perspectives. First of all, they can either be viewed with respect to the regulatory requirements, which address an insurer's operations. Secondly, they can be viewed with respect to the supervisory action, which is focused on the responsibilities and actions of the supervisory authority.

The regulatory requirements imposed by the regulating body, which include quantitative and qualitative requirements, must be met by every

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[37] IAIS (2005a), 4.

[38] The Bahrain Monetary Agency, the regulating body of Bahrain, has introduced a regulation system that is relevant for all insurance companies operating in the country, no matter if they are conventional or Islamic. These regulations are in line with the standards of the IAIS.

[39] These conditions are general conditions for the functioning of the insurance industry in a jurisdiction and are usually not under the control of the supervising authority. See IAIS (2005a), 5.

[40] IAIS (2005a), 6. In addition, the supervisory authority should maintain sufficient staff for its duties with high-level professional standards.

insurer when pursuing its business activities. With regard to the regulation and supervision of Islamic insurance companies, it is important to note that the recommendations of the IAIS explicitly call for such requirements to be "broad enough to deal with the full range of insurers in the market."[41] This should include Islamic insurers as well as conventional ones.[42]

The financial aspects of an insurer's operations are among the most important regulatory and supervisory issues. This includes questions of solvency and capital adequacy, the valuation and adequacy of technical provisions, the forms of capital, the investments, and complete financial reporting and disclosure.

The second set of issues concerns governance, such as the processes and controls of the board of directors, and senior management, as well as some other organizational aspects. It also involves administrative and internal controls such as the risk management of the insurer. Moreover, it must be ensured that governance structures are compliant with legislative requirements. Governance structures also include the question of how to manage shareholder relationships and special governance risks resulting from diversified group structures.

The third issue is how an insurance company is to conduct its business and present itself to the market. This concerns the relationship between the company and its customers, including the sale of insurance policies and the management of policies. Additionally, it concerns the integrity of an insurer's conduct as an institutional investor. This includes requirements on the disclosure of information to the capital market as well as to the policy holders.[43]

After the regulatory framework has been set up, it is up to the supervisory body to ensure that the requirements are constantly fulfilled by the insurance companies (supervisory action). Among the duties of the supervisor is the assessment of the insurer's risk profile, control systems, and available support. These elements are constantly reviewed. The supervisory authority has to be able to handle the case of each insurance company individually, meaning that the specific circumstances of each company have to be considered. This means that the review is more or less tailor-made for the risk profile and specificities of each insurer, as is any

[41] IAIS (2005a), 6.
[42] Those regulations can either be enshrined in law and regulation or be compelled by the supervisory body.
[43] IAIS (2005a), 6. The Insurance Committee Secretariat of the Organization for Economic Co-operation and Development has also issued some twenty insurance guidelines for insurance regulation and supervision in emerging economies, which build up a rudimentary framework of insurance regulation. As opposed to the IAIS version, these guidelines are very much focused on emerging economies that lack sufficient regulation.

remedial action taken. Nevertheless, the principles of legal certainty and equal treatment are to be obeyed. On the level of supervisory action it is the supervisory authority's responsibility to take any action if applicable.[44]

There are interdependencies among all elements of this framework. For the provision of a solid overall framework, it is not necessary that all requirements be completely fulfilled by an insurer. In order to keep an effective and stable framework, stronger measures in one element are needed if there are less stringent requirements in another.

APPROACHES IN REGULATION AND SUPERVISION OF ISLAMIC INSURANCE

Among the biggest challenges for the future development of Islamic finance, and particularly the development of Islamic insurance, is the establishment of a sound framework for governing, regulating, and supervising Islamic financial and insurance institutions. Those countries with Islamic insurance companies operating do not have a common approach to handling this problem. Currently, there are two different approaches to regulating and supervising Islamic insurance markets and businesses. First, as in Malaysia, regulation and supervision of Islamic insurance companies are separated from that of conventional insurance.[45] Second, as in Bahrain, the regulatory and supervisory framework of conventional insurance is modified, but there is no separate legal framework for Islamic insurance.

Separation of Conventional and Islamic Insurance Regulation

First of all, it needs to be discussed whether a single regulation for all types of insurance is really sufficient, or if a separate one for Islamic insurance is needed. Both in the literature and in practice, there are different opinions on this issue. The introduction of a different set of regulations for Islamic insurance is illustrated in the case of Malaysia. In 1984, a *Takaful* Act was implemented, which was engineered similarly to the conventional insurance act, but accommodated concepts of Islamic insurance. This act was aimed primarily at supporting the development of Islamic insurance and encouraging investments in the *takaful* industry by improving the quality of the Islamic insurance business. While the

[44] IAIS (2005a), 7.

[45] Regulation and supervision of Islamic insurance companies in Malaysia is based on the Takaful Act of 1984.

conventional insurance business in Malaysia at that time was considered developed, the Islamic insurance business was completely new. Particularly in order to protect the interests of the *takaful* participants (policyholders), the government decided to introduce a separate regulation for this new type of insurance.[46]

In contrast to the Malaysian example, Bahrain as another big hub of Islamic finance has integrated the regulation of Islamic insurance into its regulatory framework for conventional insurance. In addition to the regulatory requirements for conventional insurance, the rulebook of the Bahrain Monetary Authority (BMA)—the regulatory and supervisory body of Bahrain—contains a special section of sector guides under which *takaful* and *retakaful* regulation issues are handled.[47] The *takaful* module summarizes the key aspects of regulations applicable to *takaful* and *retakaful* firms, and is structured similarly to the conventional regulation. It contains high-level standards (such as regulations on the authorization, principles of business, high level controls, auditors, and actuaries), business standards (such as regulations on capital adequacy, business conduct, risk management, financial crime, training, and competency), reporting requirements (such as BMA reporting and public disclosure), and rules on enforcement and redress. As opposed to the *Takaful* Act of Malaysia, the *takaful* module of the BMA rulebook on insurance regulation contains only guidance material. If any discrepancy between the *takaful* module and the rules of the rulebook occurs, the latter will always prevail.[48]

In order to determine which model is favorable, it first needs to be stated that both countries can be considered Muslim countries, as the vast majority of inhabitants are of Muslim background. It might be easier to decide between the two models of regulation if the decision is to be made for a non-Muslim country, as increasingly Islamic financial institutions are established in non-Muslim countries such as the United Kingdom and the United States. In the United Kingdom, for example, Islamic insurance is likely to fall within the regulatory net of the Financial Services Authority (FSA), but gives rise to various regulatory issues. In Islamic insurance, resources are pooled in order to settle claims. The contribution of the policyholders in Islamic insurance can more or less be interpreted as donations with a condition of compensation, rather than as payments of a

[46] A. M. K. Zainal, "Should Countries Follow the Malaysia Approach of Having a Specific *Takaful* Act for Regulating *Takaful* business?" Paper presented at the Institute of Islamic Banking & Insurance Conference on *Takaful*, London, September 26-27, 2003, 3-4.

[47] Other sector guides are on captive insurance and insurance intermediaries and managers.

[48] Bahrain Monetary Agency, "Insurance," in *BMA Rulebook,* vol. 3 (2005), 1.

premium. Despite this, it is probable that Islamic insurance has all the essential hallmarks of an insurance contract for U.K. purposes.[49]

Among the possible regulatory issues is the legal status of an Islamic insurance company, its financial and human resources, its systems and controls, and its transparency. This is not a problem specific to insurance regulation in non-Muslim countries. Any regulation of insurance activity is focussed on a legal entity doing insurance business, generally a corporation or a mutual society.[50] A problem then occurs with *takaful* insurance, when the insured and the insurer are themselves the participants. This is the case if the *takaful* insurance is operated as an *al-wakala* model, because the *takaful* operator only acts as an agent. In contrast to that, no regulatory issue would be raised if it is operated under the *al-mudaraba* model, because the *takaful* operator shares in both the underwriting results from the operations as well as any favorable investment performance on the invested contributions. In Bahrain, for example, no other form of *takaful* than the *al-wakala* model is permitted. In this case, it would actually be difficult to apply the conventional insurance regulation on the Islamic one.

As a conclusion, it can be argued that the need for a separate Islamic insurance regulation depends on the exact content and structure of the regulatory framework for conventional insurance. The most important factor influencing the decision to introduce a separate regulation is whether the term insurance is clearly specified in the conventional framework. If it is not, *takaful* can be regarded as a competing alternative to conventional insurance. This means that the regulations on conventional insurance should be amenable to *takaful* insurance, too. Although there are certainly structural differences between the two concepts, a single regulation with the necessary modifications for *takaful* seems appropriate. Under these circumstances, *takaful* could therefore be regarded as a sub-set of insurance rather than a separate category of financial product, meaning that no separate regulation for *takaful* is necessary.

Different Set of Rules for Islamic Insurance?

In addition to the issue of a separate regulation for Islamic insurance, there is also the question of whether conventional and Islamic insurance businesses should be treated equally in regulatory matters. Again, opinions

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[49] M. Mankabady, "Takaful Insurance: UK Regulatory Issues," Paper presented at the Institute of Islamic Banking & Insurance Conference on Takaful, London September 26-27, 2003, 2.

[50] In the United Kingdom it could also be a member of Lloyd's.

differ between supporters and opponents of a separate regulation for Islamic insurance. This can be illustrated again by comparing the Malaysian and the Bahraini regulatory frameworks.

Concerning the requirements of capital adequacy, for example, regulation in Bahrain prescribes minimum funds that must be maintained by each *takaful* fund at all times. These minimum requirements are fully equivalent to those amounts for conventional insurance companies.[51] This means that the regulation does not differ between the risk structures of Islamic and conventional insurers.

In contrast, in Malaysia the capital requirements for *takaful* operators are less stringent than they are for conventional insurers. While the minimum capital required for a conventional insurance company is RM 100 million, it is only RM 30 million for an Islamic insurer. The rationale for this inequality lies in the different risks involved in the two types of insurance. In general, the risk exposure of *takaful* companies is considered to be lower than that of conventional insurers for the following three reasons.

First, as the participants (policyholders) by and large carry the investment risk, this risk is lower for the *takaful* operator.[52] In conventional insurance this could also be the case where unit-linked life insurance is concerned. Second, the *takaful* operator is exposed to a lower mortality and morbidity risk, because most, if not all, of these risks are either passed back to the participants or to a *retakaful* operator.[53] Actually, this depends on the *takaful* model used. In the *al-wakala* model, the *takaful* operator bears neither the investment nor the underwriting risk (including mortality and morbidity). In the *al-mudaraba* model, the risk is primarily carried by the pool, and can be partly or completely reinsured. However, this is also possible in conventional insurance, especially when organized in the mutual insurance structure. This means that only in the *al-wakala* structure is the risk of an Islamic insurer lower. Third, the operational risk for the *takaful* operator might on the other hand be higher than for conventional insurers, because most of the risks (investment and underwriting risks in the *al-wakala* model) are borne by the participants. This could lead to agency costs, as the *takaful* operator has less to lose in any failure.[54] Regarding the different risk profiles of Islamic and conventional insurance, a differentiated regulation seems to be appropriate. In the following section, a more detailed look at the capital requirements as well as the different risk exposures will be taken.

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[51] BMA, *BMA Rulebook*, 1 (see section 3.1).
[52] Zainal, "Should Countries Follow the Malaysia Approach?" 4.
[53] Ibid.
[54] Ibid.

REGULATORY CHALLENGES FOR ISLAMIC INSURANCE

There are three main areas of regulatory challenges for Islamic insurance. First, capital requirements have to be discussed and special attention has to be drawn to recent developments of solvency issues in conventional insurance. After that, governance issues as well as the protection of consumers from misinterpretation in Islamic insurance will be discussed.

Capital Requirements

The IAIS has issued some cornerstones for the formulation of regulatory financial requirements, which are intended to build up a common structure and common standards for the assessment of insurer solvency. [55] The solvency of an insurer has a central position in its risk management and in the supervision of insurance activities. To determine the capital requirements for an Islamic insurer it is important to enhance the transparency of the risks that Islamic insurers face and encourage the improvement of insurers' risk management. The IAIS demands the individual solvency regime to define solvency requirements for insurers in a group context. Therefore, both the required level as well as suitable constituents of solvency should be viewed. Avoiding multiple gearing, as well as unsound intra-group creation of capital, are among the major objectives of the solvency regime. Additionally, any scope for unwanted regulatory arbitrage should be eliminated.[56]

Risk-based regulation of financial services, especially of insurance businesses, is becoming increasingly important. In Islamic insurance markets, the regulator has to ensure that the applied regulation properly fits the asset and liability profiles of *takaful* insurers. As already mentioned, the risk profiles of Islamic and conventional insurance are somewhat different. While Islamic insurance might be subject to additional operational risks, the structure of their business model might avoid other

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[55] The recommendations are aimed at supporting transparency and convergence in international insurance regulation. In a two-step approach it is designed firstly to substantially increase the transparency of the existing solvency regimes and improve the financial condition of individual insurers, and secondly, to increase the convergence of solvency regimes.

[56] The recommendations on common standards for the assessment of insurer solvency are based on the principles on capital adequacy and solvency issued by the IAIS, too. There, the IAIS sets out fourteen principles for a capital adequacy and solvency regime. These principles form the basis for an assessment of an insurer's solvency. See IAIS, "Towards a Common Structure and Common Standards for the Assessment of Insurer Solvency: Cornerstones for the Formulation of Regulatory Financial Requirements," October 2005, 7-8 (hereafter cited as "IAIS (2005b)."

risks usually embedded in conventional insurance. This makes modification of the common standards of capital adequacy of conventional insurers necessary. Therefore what is needed is a deeper understanding of the economic substance of the transactions and instruments of Islamic insurers.[57]

Due to its mutual and co-operative basis, Islamic insurance is often understood to be similar to conventional mutual or co-operative insurance. However, this is only true to a certain degree, because in Islamic insurance, shareholder capital is available to finance its development and to invest in the market to build up further capital. But this is only the case if Islamic insurance is structured on the *al-mudaraba* model, and not if it is structured on the *al-wakala* model. Although there are shareholders involved in the *al-wakala* model, they only finance the activity of the Islamic insurer as an agent (*wakil*), and do not fund the insurance operations of the participants. In the case of financial difficulties of the insurance pool, whether caused by an unfortunate occurrence of risks or by losses in its investments of the contributions, the options for raising the new capital required are very limited. In some countries only the *al-wakala* model is permitted, thus imposing a challenge for regulation and supervision. Regulation can only ensure that those financial difficulties resulting from unfortunate investment activities are avoided, and not those of the insurance business itself. But neither regulation nor prudent supervision can ensure that the financial distress resulting from severe losses that have not been reinsured by the insurance operator can be avoided. In such a critical situation, the *takaful* company has massive problems in raising new capital. As a rights issue does not help the insurance pool, the required funds can only be brought up either from the company's financial reserves or by interest-free loans of the participants.[58] If the reserves are not sufficient, interest-free loans could—even if such an event is more or less unlikely—be the only option for the insurer to increase its capital base in this situation. As interest-free loans do not seem to be very attractive for the participants, and additionally impose massive free-rider problems, the insurer faces a tremendous financial problem.[59] In order to avoid such a situation, it is very important for the regulator to ensure that a *takaful* insurer operating under the *al-wakala* model has a sound financial basis. Concerning the capital requirements, regulation

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[57] See James Smith, "Regulatory Challenges for Islamic Insurance," in *Ernst & Young Financial Services Brief* (Spring 2005), 44.

[58] Such a situation might trigger a need for the shareholders' fund to make a transfer to the *takaful* fund, but this transfer has to be repaid.

[59] For extensive discussion of the problems of mutual or co-operative conventional insurers in raising capital, and for possible solutions these problems, see Wackerbeck (2002a) and Wackerbeck (2002b).

therefore has to differentiate between the different *takaful* models because of the difference in the ability to raise capital if needed.

Governance Issues

The development and application of sound risk management and governance practices by the Islamic insurance industry is for the benefit of not only the industry, but also other stakeholders such as policyholders, supervisors, and other parties involved. To a certain degree, among these stakeholders there is a parallel interest in appropriate standards and structures with regard to the practicability and costs of supervision.[60]

In particular, the financial requirements imposed by regulation must be understood within a wider context of adequate risk management and control by the insurer. That is why the solvency regime requires the existence of adequate governance structures among insurers, including risk management and internal control processes with reliable administrative, accounting, and reporting procedures. Good governance includes the periodic review of decision making processes, strategies, and policies by a suitable governing body of the insurance company with respect to all the risks that the insurer assumes. Special attention must be drawn to management of the company at the solvency level in order to anticipate the potential impact of the insurer's business strategy on both its risk profile and solvency position. Additionally, risk management systems should be properly integrated into the organization. In order to ensure consistent measuring, assessment, monitoring, and reporting, appropriate measures must be taken.[61]

If conventional insurance is organized in a mutual or co-operative form, there is an increased risk of poor governance due to the fact that the linkage between the policyholders and the management is tenuous and diffused. That is why it is fairly difficult to enforce accountability. As the governance structure of Islamic insurance is similar to conventional mutual insurance, Islamic insurance companies are likely to suffer from the vulnerability of the governance structures.[62] As explained above, especially if Islamic insurance is structured on the *al-wakala* model, the supervision of risk management and governance structures are important, as the ability to refinance the insurance pool in case of financial distress is limited.

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[60] IAIS (2005b), 6.
[61] Ibid., 8.
[62] Smith, "Regulatory Challenges," 44.

Additionally, the quality of the *takaful* operator's management can have a strong influence on the underwriting result of the insurer. However, the participants of the pool who are the beneficiaries of any underwriting surplus, yet also carry the consequences of any underwriting losses, might have difficulties in holding the managers to account.[63]

It is therefore necessary for regulators to ensure prudent supervision of the management's activities, as well as the availability of appropriate systems and controls that will produce a culture of accountability. It is recommended for Islamic insurance regulators to promote the scrutinizing of the systems and controls of an insurer by non-executive directors, actuaries, and accountants, or even independent regulatory officers. Additionally, even the *shari'a* board might take part in the supervision of the management to a certain degree.

Protection of Consumers from Misinterpretation

Another challenge for insurance regulation and supervision is to ensure that the public is not misled in a matter that is significant to their decision to buy a specific insurance product. This is especially relevant for insurers that claim to be Islamic. If an Islamic insurer promises customers that its products and operations are compliant with *shari'a*, then these customers will be annoyed if they discover that this statement was incorrect. In order to avoid the consequences of mis-selling, the supervisor must ensure that a compliance claim of an Islamic insurer is valid. The responsibility for the *shari'a* compliance of products and operations lies with the *shari'a* board of each Islamic insurer, which consists of recognized Islamic religious scholars. The religious board issues a statement on the *shari'a* compliance of the products and relevant operations, which the customers must rely on. However, some authors argue that the opinion expressed by the *shari'a* board is not sufficient for the regulator.[64] As the protection of the interests of the consumers is one of the major aims of the regulator, there needs to be some form of supervision of the *shari'a* board as well. Only in the case where there is a national *shari'a* board that sets standards for *shari'a* boards of various Islamic insurers and ensures that they are complying with these standards, can the insurance regulator assume that consumers are being protected from misinterpretation. If there is no national *shari'a* body, then the regulator should require Islamic insurers to prove that their

[63] Ibid.
[64] Ibid., 45.

systems and controls are adequate, in order to make sure that both the products and relevant processes are *shari'a* compliant.[65]

CONCLUSION

This paper has analyzed the need for regulation and supervision for the sake of developing Islamic insurance markets. The insurance market equilibrium is reached—as in any other market—when insurance demand is equal to insurance supply. But there are certain specifics of the insurance market that often lead to market failures. The worst-case scenario is that these market failures lead to a complete breakdown of the insurance market with severe consequences for the whole financial system of a country. From a theoretical point of view, the reason for market failures in insurance markets is asymmetric information between the insured and the insurers. Asymmetric information generally leads to two major problems: adverse selection and moral hazard. In order to avoid such a breakdown and make insurance markets work efficiently, insurance regulation and supervision is needed. Additionally, it is necessary to protect the interests of the insured.

Conventional insurance is not compliant with the *shari'a*, as it contains elements of *riba*, *gharar,* and *maisir*. The concept of Islamic insurance (*takaful*) eliminates these elements. Insurance may generally promote economic growth, because it increases the ability to undertake ventures. Especially in Muslim countries with a low degree of insurance penetration and insurance density, Islamic insurance could potentially initiate economic growth.

In general, insurance is a highly regulated industry. As the legal frameworks of various countries more or less differ, there has been no single regulatory framework for different countries. However, the International Association of Insurance Supervisors is working on the harmonization and standardization of the regulatory framework. In most Muslim countries, with the exception of Iran and Sudan, *takaful* competes with conventional insurance. As the concept of Islamic insurance differs in many aspects from conventional insurance, a different regulatory and supervisory framework is needed. In Muslim countries, different approaches on regulation and supervision of insurance have been chosen. While some countries prefer to have a specific *takaful* regulation, others have modified their existing regulation for conventional insurance. This paper suggests that a separate *takaful* regulatory framework is only

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[65] See Ibid., 45 for the requirements for *shari'a* boards of the insurance regulator in non-Muslim countries.

necessary if conventional insurance is clearly specified in the existing regulation, and if the concept of *takaful* does not fit into this existing framework. Nevertheless, some rules within the regulatory framework need to be different for *takaful* than what they are for conventional insurance. It has to be taken into consideration that the risk profile of Islamic insurance is different than that of conventional insurance, depending on the *takaful* model chosen. Capital requirements should be lower for a *takaful* structured as an *al-wakala* model than for the *al-mudaraba* model and for conventional insurance. It will be a task for future research to systemize the different risk profiles of conventional insurance and the various *takaful* models in order to make recommendations on the capital requirements for each model.

It is important to mention that regulators and supervisors, now more than ever before, must look beyond the traditional boundaries of their industries. As more and more large financial institutions diversify their operations, there are more specific types of risks that supervisors must analyze. This development also applies to Islamic insurance. In future research special attention should be drawn to a holistic regulation and supervision of Islamic financial services conglomerates.

Part II

Religious, Legal, Economic, and Political Perspectives

Shari'a, Economics, and the Progress of Islamic Finance: The Role of *Shari'a* Experts

M. Nejatullah Siddiqi[1]

Discussing the role of *shari'a* experts in the development of Islamic economics and Islamic finance calls for a look at the nature of economics and the focus of *shari'a*. The chief concerns of economics over the ages have been efficiency and equity. *Shari'a*, in the broader meaning of the word that gives primacy to objectives over rules and regulations, shares these concerns. However, this may not apply to *shari'a* as it relates to *fiqh*, referring to laws codified at a particular time and place. The historical context in which we approach our subject today sends mixed signals. The schools of traditional *shari'a* learning have long been tilted toward teaching codified *fiqh* with few insights into the objectives of *shari'a*, or *maqasid al-shari'a*. But new assignments given to *shari'a* scholars trained in these schools have increasingly called for paying attention to objectives while interpreting the rules. To what degree this challenge has been met is a question this paper explores. The paper begins by describing what has happened in the name of Islamic economics during the last century. It then assesses where Islamic finance stands today. Focusing on the gap between vision and reality, the paper points out the limitations of *shari'a* advising as it is currently practiced, and calls for remedial measures to make it more wholesome and effective.

THE ISLAMIC ECONOMICS PROJECT

Islamic economics was conceived in the early part of the twentieth century as an antidote to socialism and capitalism—an Islamic response to what was perceived as godless Western ideologies. The emphasis was to be on justice. Freedom from colonial rule, exploitation, and oppression was to be accompanied by a return to Islam, which stood for the elimination of

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[1] Independent researcher and consultant, Milpitas, California.

poverty and the reduction of unequal distribution of wealth. Islam would help to secure these goals without the socialist regimentation that deprived people of their freedom and robbed them of their property. Islamic economies would not allow labor to be exploited by capitalists, nor the environment to be spoiled by greedy profit seekers. The appeal in all of this was an appeal to the objectives of Islam, the *maqasid al-shari'a*. There were few references to *fiqh*, or *shari'a* in the sense of laws and regulations as codified in early Islamic history. Those who championed this alternative vision were mostly modern educated people, university teachers, journalists, political activists, and poets. Even among the *'ulama* expounding the Islamic economic system, very few could be characterized as experts in *fiqh* or Islamic law. Although it was asserted that the Islamic economic system would be free from interest and gambling-like speculation, the *mechanics* of interest-free banking did not occupy the center stage. That came much later, in the 1970s. Focusing on the mechanics of banking without interest brought in the *shari'a* experts. Before discussing the role of the *faqih* (the *shari'a* expert) in the successful launch of Islamic finance in the last quarter of twentieth century, there is something further to note regarding the history of the Islamic economics project.

In the early 1970s, I produced a survey of writings on Islamic economics to that time, in English, Arabic, and Urdu.[2] Out of the 700 items included in the bibliography, only eight were dated before 1920. Out of these, only two dealt with the subject of interest, and the remaining dealt with distribution of wealth (2), history (2), trade (1), and *waqf*, or pious endowments (1). Of the 14 entries in the following decade only one dealt with interest, and the remaining were spread over other subjects.

The first writings on interest-free banking appeared in the 1940s. Out of a total of 28 writings on Islamic economics during that decade, only three were on interest-free banking. Among the remaining, *zakat* and the Islamic economic system in general were the most common topics. Though the authors in this period included *'ulama* trained in traditional schools, they did not write about interest-free institutions.[3] We have 156 entries for the 1950s that include several writings on interest and interest-free institutions, but in this period the writings on socialism, capitalism, and other aspects of Islamic economy far outnumber these. All writings on

[2] This work was originally presented at the First International Conference on Islamic Economics held in Mecca in 1976. It is included in Khurshid Ahmad, ed., *Studies in Islamic Economics* (Leicester: The Islamic Foundation, 1980); as well as in Ahmad, *Muslim Economic Thinking: A Survey of Contemporary Literature* (Leicester: The Islamic Foundation, 1981). An Arabic translation was later published by the Islamic Economics Research Center in Jeddah.

[3] See items 393, 419, and 526 in the bibliography of the survey mentioned in note 2.

interest-free banking in English, Arabic, and Urdu until 1967 are listed in the appendix of my book, *Banking without Interest*.[4] Out of the 18 items listed there, nine belong to the 1960s, two to the 1950s, and three to the 1940s. Four items are not dated.

Few, if any, among the authors of these books are *'ulama*. As the above-mentioned survey would show, most of the writings on interest-free Islamic banking came in the 1960s and 1970s.[5] The flood of technical material on the subject started after the period surveyed, that is to say, after 1975. This is the period in which *shari'a* experts came into the picture in a big way.

SHARI'A EXPERTS

The above statistical survey raises three points. First, the project of Islamic economics launched in the twentieth century was much wider in scope than the introduction of Islamic finance, as it was mainly focused on providing a just and humane alternative to the emerging ideologies of those times, namely capitalism and socialism.

Second, the role of *shari'a* experts in launching that project was at best marginal. This is not to belittle the role of *shari'a* scholars but to put it in proper perspective. As we proceed to describe, they do play a very significant role in the contemporary practice of Islamic banking, in contrast to the early days of the Islamic economic project noted above. However, their role is rather technical, whereas the main project from which Islamic finance branched out was civilizational, oriented as it was toward the *maqasid al-shari'a*, which have little to do with technicalities. As will be shown in the following, *shari'a* experts have been doing what their training equips them to do, and they have been doing it well. Unfortunately, their training is no longer well designed to serve the *maqasid al-shari'a* in an environment that differs from that which is represented in the books they study. This places the entire burden of identifying the *maqasid* involved in a matter, as well as finding ways and means of securing them, on the individual *shari'a* expert. Furthermore, the *shari'a* advisory function also involves monitoring the consequences of adopting a certain course, and in light of lessons learned, changing course if necessary. The *shari'a* experts do care for *maqasid al-shari'a.* As argued elsewhere, there are numerous recent examples of *fatawa* (sing. *fatwa*)

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[4] Nejatullah Siddiqi, *Banking without Interest* (Leicester: The Islamic Foundation, 1997). The book was first published in Urdu in 1969.

[5] There were 246 of these writings in the 1960s, followed by 176 writings in the first five years of the 1970s. It should be noted that 72 out of the 700 items in the bibliography are not dated.

given on the basis of *maqasid*.[6] The problem is not of willingness to take *maqasid* into account. The challenge comes from the nature of the task in the new environment. These are tasks calling for not only economic analysis, but also drawing upon the latest developments in other social sciences such as sociology, psychology, political science, and management. In the absence of proper institutional arrangements for training and necessary backup in terms of fundamental research, instances of malfunction have been increasing in recent years. This in turn has caused anxieties in the market and raised the possibility of a backlash in terms of consumer rejection.

Third, it is only natural that the progress of the Islamic financial industry be evaluated in the context of the larger project of Islamic economics of which it is an offshoot. That many find Islamic finance to be failing in serving the larger goals of Islamic economics should not be a shock, particularly in view of the short period of time since the 1970s when its actual practice started, and in view of the complexity of the task at hand.

The first few *fatawa shar'iyya* that deal with Islamic banking and finance, and provide us with a window into the role of *shari'a* experts in the development of Islamic finance, date back to the late 1970s and early 1980s. They originated in the Dubai Islamic Bank, Kuwait Finance House, and Faisal Islamic Bank in the Sudan.[7] Most of the early *fatawa* deal with well-known contracts like *mudaraba* and *musharaka* along with *tijara* (trade). *Murabaha* was not in the picture in this early phase, nor were *salam* and *istina'*. We are not sure about leasing (*ijara*), but it may have been on the agenda of Kuwait Finance House. Issues relating to trade dominated the scene, giving rise to questions and answers relating to guarantees and bills of trade. There was no conscious effort to find Islamic substitutes for conventional financial products (which differed from what was obviously the focus at the time: finding Islamic ways to do what needed to be done). In the 1980s the two big conglomerates, Dar al-Mal al-Islami and al-Barakah, established in the beginning of the decade, became the most important sources of *fatawa*, even though smaller entities like the

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[6] *Fik-o-Nazar* 43, no.2 (Oct–Dec 2005): 3-24. This is an Urdu paper on *maqasid al-shari'a* and contemporary Islamic thinking.

[7] *Fatawa* of the *shari'a* boards of Kuwait Finance House and Faisal Islamic Bank Sudan are available on their respective websites: www.kfh.com and www.fibsudan.com. The website of Dubai Islamic Bank (www.alislami.co.ae) does not give details nor are its *fatawa* available in print, to the best of my knowledge. However, several collections of *fatawa* from different sources are now available in print, on CD-ROM, and online. Among them are the economic fatwas marketed by Harf, available online at www.harf.com. See also www.al-islam.com.

Jordan Islamic Bank had independent *shari'a* boards. Some of these *fatawa* are available in print.

The emergence of Islamic financial institutions (Islamic banks, Islamic insurance companies, Islamic investment companies, etc.) was preceded by a great deal of homework, which involved *shari'a* experts. Some of these works are available in the form of committee reports.[8]

The involvement of *shari'a* experts in the project was also crucial in lending legitimacy to the newly established Islamic financial institutions. For the Muslim masses under colonial rule, western financial institutions were an extension of colonialism, an instrument of exploitation like other colonial institutions. Introducing banks and insurance companies in Muslim societies was therefore always suspect, as the history of the nineteenth century shows. Government officials and businessmen with a vested interest would have never succeeded in selling these institutions to the people.

It is time to mention state-sponsored bodies occupied with the task of the "Islamization" of banking operations in Pakistan, Iran, and Sudan. *Shari'a* experts served on these bodies, either as members, as in the case of the Council of Islamic Ideology in Pakistan, or as advisors to the central bank of the country, a pattern later followed in Malaysia and Indonesia. Both of these countries have in-house committees of *shari'a* experts. Most of the pronouncements of the Council of Islamic Ideology and other official bodies mentioned above are available in print.

Around this time, in the middle of 1980s, big multinational financial corporations started operating in the Islamic financial market. Whereas the two biggest Islamic conglomerates, Dar al-Mal al-Islami and al-Barakah, were managing funds around five billion dollars each at the peak of their success, Citibank, HSBC, and ABN AMRO were managing hundreds of billions of dollars. Each started aggressively, first to prevent their rich Arab clients from deserting them in favor of Islamic banks, and then to mop up the surplus liquidity in the oil-rich Muslim countries. The small but rich Muslim countries of the Persian Gulf also entered the fray at the official level. Even after the introduction of *murabaha*, *ijara, salam,* and *istisna'* during the 1980s, the Islamic financial market needed more sophisticated financial products to handle the estimated three hundred billion dollar funds under management at the dawn of the twenty-first century. The impulse to try to duplicate conventional financial products seemed natural.

Some important departures from early practice in the matter of *shari'a* advising should be noted at this stage, as they may prove to have implications for the study of the role of *shari'a* experts. Most of the

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[8] Siddiqi, *Banking without Interest*, 185-188.

shari'a experts serving the Islamic financial industry in its infancy were not well versed in the English language.[9] Western multinationals marketing Islamic financial products needed *shari'a* experts who could read, write, and speak English. That was a scarce commodity in the late 1980s and continues to be so. Secondly, we find increased secrecy and reduced transparency in this later phase. Being private institutions, the new entrants were under no obligation to make public all that their *shari'a* experts told them. Thirdly, those issuin*g fatawa shar'íyya* in the early 1970s had come from an environment in which a *fatwa* was seen as a public good, but this was not an obvious consideration in the different environment where conventional legal experts charged hefty fees per hour of consultation. The move to follow that same practice of hefty fees in Islamic juristic advising seemed to be a natural next step. Lastly, wide publicity of *fatawa* in the early phase served the additional purpose of assuring the niche markets for Islamic financial products that they were being served the *halal* products they cherished. But with the passage of time, the importance of this function was overshadowed by the advantages of reaping the gains of innovative moves.

SHARI'A ADVISING UNDER STRESS

In anticipation of further empirical research, one can only surmise that the trend of focusing on duplicating conventional financial products through Islamic financial engineering started in the 1990s and came to dominate the scene in the new century. The most important areas seem to be *sukuk* duplicating bonds and *tawarruq* duplicating bank-loans. Leaving detailed empirical research for more competent scholars, we proceed to describe the malfunction in *shari'a* advising that has occurred in the case of *tawarruq,* as one example.[10]

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[9] Names and brief CVs are available on a number of the websites mentioned above.

[10] One who needs cash first buys something on credit, becoming indebted for a certain sum of money to be paid at a future date, and then sells that thing for cash. The cash to be paid in the future is larger than the cash one receives in the present. This method, used earlier for tiding over individual difficulties, has been recently institutionalized by some Islamic financial institutions. Some helpful information is available on the Internet. We have briefly dealt with the issue in "A Survey of the State of the Art in Islamic Banking and Finance in Theory and Practice," which will be published by the Islamic Research and Training Institute, Islamic Development Bank, Jeddah. One recent publication on the subject is Ahmad Muhammad Khalil al-Islambuli, "Al-Murabaha wa al-inah wa al-tawarruq bayn usul al-bunk wa khusumihi," *Journal of King Abdulaziz University: Islamic Economics* 18, no. 1 (2005): 59-68, http://islamiccenter.kaau.edu.sa/english/index.htm.

The view that declaring *tawarruq* to be *shari'a* compliant is a case of malfunction in *shari'a* advising is based on two grounds. Firstly, it was necessary to evaluate the *masalih* (benefits) and *mafasid* (harms) involved, given that adoption of this practice on a large scale by financial institutions was an entirely new initiative without precedent in the history of Islam. In the words of some scholars, *tawarruq masrafi* is qualitatively different from *tawarruq* practiced at the individual level, person to person. Secondly, evaluating *masalih* and *mafasid* in the case of widespread practice of *tawarruq* has been beyond the capacity of *shari'a* experts, generally speaking, as it requires expertise not provided in *shari'a* schools. It is necessary to look at the ultimate macroeconomic consequences of approving this product. It is not possible to detect the full extent of the *mafsada* (harm) involved without doing so. The *maslaha* (benefit) cited by those approving the product mainly relates to the individuals, but it is smaller than the public harm that would occur. In accordance with a well-established *qaida* (dictum), the smaller private gain has to be given up in order to avoid the larger public harm.[11] Unfortunately, the macroeconomic part of the argument never came into focus in the deliberations on the subject. It could not be considered because the kind of training that is required to assess the probable harm in the adoption of *tawarruq* is not available in *shari'a* schools. The ability to conduct economic analysis in order to delineate the consequences of allowing *tawarruq* is not present among *shari'a* experts, generally speaking.

One of the banes of the modern financial system is the proliferation of debt. Debt instruments dominate the financial scene. From money creation and supply of credit to investment and capital formation in the domestic market and at the international level, the proliferation of debt has accelerated everywhere. Islamic economists since the earliest years, and increasingly during the last three decades,[12] have pointed out that almost all of the major ills of the contemporary economic and financial system are rooted in this phenomenon. Predominance of debt leads to instability. It creates opportunities for gambling-like speculation. It increases disparities in the distribution of wealth, as it is based upon interest. Islamic economists have advocated an asset-based system of creating money and extending credit, in which money loans would occupy a marginal role. The problem with *tawarruq* is that it introduces money in the present, which is offered in exchange for a larger amount of money in the future. It thus

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[11] See rule 26 in *The Majelle* (Lahore: Law Publishing Company, 1980).

[12] I have reported some of these works in the fourth chapter of my book, *Riba, Bank Interest and the Rationale of Its Prohibition* (Jeddah: Islamic Development Bank, Islamic Research and Training Institute, 2004). The publication is available online at www.irti.org.

opens the door for debt proliferation. As noted earlier, arguments given in favor of *tawarruq* demonstrate an unawareness of the macroeconomic consequences of debt proliferation.

CONCLUSION

It is not possible in this brief paper to go into further detail discussing the reasons for the malfunction in *shari'a* advising. It has occurred, and can occur again. The issue needs to be discussed seriously, and addressed at the appropriate level of scholarship. It would be most unfortunate if the discussion were to degenerate into a blame game. The matter is far too complex to be dealt with in terms of pronouncements of right and wrong, or sincere or suspect motivation. In emphasizing the complexity of the issue, let us remember that economists were called upon by sponsors of *shari'a* boards and advisories to assist the *shari'a* experts. They participated in several conferences and seminars organized to sort out matters such as inflation and indexation. They continue to be invited to participate in non-voting capacities in such bodies as the OIC-sponsored Fiqh Academy at Jeddah, the Fiqh Council of the Muslim World League at Mecca, and the Islamic Fiqh Academy in India. It remains to be researched how far this association has served its purpose. If the association still leaves much to be desired, why is that the case? In the days of specialized expertise, it may be too much to expect any one person to be an expert on the whole of *shari'a* or in all branches of *fiqh*. How realistic is it to expect one person to be an expert in both *shari'a* and economics? All that can be said with certainty is that the current practice of *shari'a* advising and auditing, buttressed by occasional hearings given to economists, is vulnerable to further malfunction. As to how the problem may be fixed, we have yet to even grapple with that problem. I do not claim to offer any quick fix. It is important, however, to recognize that a problem exists, and that this problem deserves serious attention.

Banking, insurance, and investment were not the only financial institutions taking off from the Islamic economics project launched many decades ago. In several countries with a Muslim majority the project covered other areas of the economy such as trade, commerce, and international economic relations. The establishment of the Islamic Development Bank and its numerous subsidiaries is an eloquent testimony to that. Even in countries where Muslims live as minorities, there have been considerable efforts to reorganize *awqaf* (pious foundations) and harness them once again in service of the goals they served in Islamic history, such as improving education and health care. What have sprung up in many cases are official as well as private institutions for the collection

and disbursement of *zakat*. *Shari'a* scholars have had a strong role in the conception as well as direction of these institutions. Last but not least, the teaching of Islamic economics and finance, as well as research in related subjects, have spread throughout the landscape of Muslim education, with the *'ulama* often taking a leading role.

In conclusion, *shari'a* experts have played an important role in the progress of Islamic economics and finance. However, there has been a degree of malfunctioning that needs further investigation and correction. Furthermore, the issues we face are far too complex to be handled properly without some conceptual as well as structural changes in *shari'a* advising. The future of Islamic economics and finance may well depend on rising to this challenge.

The Tension between Legal Values and Formalism in Contemporary Islamic Finance

Abdurrahman Habil[1]

Contemporary Islamic finance has attempted to adapt to the realities of modern finance by recourse to several methods.[2] This paper focuses on one such topic, that of legal artifice or stratagem (*hila*, pl. *hiyal*).[3]

Let it be admitted at the outset that the claims of this paper about the dominance of *hila* in contemporary Islamic finance cannot be elaborated in length in the following few pages. However, this paper will achieve its goal if it draws attention to the possibility that the role of *hila* in contemporary Islamic finance is underestimated, and that the concept of *hila* may need to be widened to include several hitherto unquestionable modes of Islamic finance. In short, the goal of this paper is to reemphasize the question of whether the classical religious debate about *hiyal* needs to be reopened.[4]

THE DOMINANCE OF *HIYAL* IN CONTEMPORARY ISLAMIC FINANCE

The basic argument of this paper is that a financier should only act as *rabb al-mal* (finance provider). A financier is not a trader, a contractor, or a real estate developer, as Islamic financial institutions attempt to do nowadays in the three main finance modes of *murabaha* (commissioned sale with

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[1] Head of Legal Division, Abu Dhabi Islamic Bank, Abu Dhabi, United Arab Emirates.

[2] See Frank Vogel and Samuel Hayes, *Islamic Law and Finance* (The Hague: Kluwer Law International, 1998), 34-41.

[3] For further discussion of *hiyal*, see Joseph Schacht, introduction to *An Introduction to Islamic Law* (Oxford: Clarendon Press, 1964), 78-84; N. J. Coulson, *A History of Islamic Law* (Edinburgh: Edinburgh University Press, 1994), 100,139-141; Vogel and Hayes, *Islamic Law and Finance*, 39-41,143,183; and Wael Hallaq, *A History of Islamic Legal Theories* (Cambridge: Cambridge University Press, 1997), 173,185-187.

[4] Vogel and Hayes, *Islamic Law and Finance,* 40.

markup), *istisna'* (commissioned manufacture), and *ijara* (lease). A financial institution may only assume the role of trader or manufacturer or real estate developer under the guise of *hila*. This argument is based on three observations: prearrangements with third parties, the intention of the parties, and the complexity of structures and multiplicity of documentation.

Let us first consider the counterargument that an Islamic bank is a *mudarib*, that is, an "active partner" receiving customers' deposits to invest in trade, real properties, or any other lawful investments. But an Islamic bank is only a *mudarib* vis-à-vis the depositors, and is a financier as far as its customers are concerned. This is evidenced by the fact that an Islamic bank cannot trade directly with its customers without the mediation of a third party in the two finance modes of *murabaha* and *istisna'*, be it a third party supplier of goods as in *murabaha* or a third party contractor or manufacturer as in *istisna'*. It is the third party factor that reveals the true function of the Islamic bank as financier. In *ijara* the third party does not play a major role because the leased asset is usually purchased from the customer and leased back to him (with the title to be ultimately transferred back to him). However, the *hila* here is perhaps more transparent, as the transitory ownership of the bank is only superimposed on the financing deal. Any attempt to overshadow the role of financier under the cover of trade, manufacture, or real estate development may be simply *hila*.

In addition to prearrangements with third parties, the intention of the parties may be another indication of *hila*. In ordinary, classical *murabaha* and *istisna'*, the seller does not necessarily acquire or manufacture the goods for the purpose of credit sale. In contemporary "banking *murabaha*" or "banking *istisna*," the seller *necessarily* acquires the goods or has them manufactured (through third parties) for the very purpose of credit sale. The extension of credit is the true intent of the parties, not simply trade or manufacture. Likewise in *ijara*, the intent of the parties is to extend credit to the customer by superimposing the lease on the transaction. We will discuss later the justifications for such superstructures, but two brief notes may be made in passing. First, suffice it to note that the profit in *murabaha* and *istisna'* and the rent in *ijara* is invariably based upon the money market rate, not as a "temporary index," but as an actual and inevitable indicator. Second, the existence of credit sale as a mode of finance in medieval Islam does not necessarily mean that Islamic law has to live with *hila* forever. It must be acknowledged that *hila* did exist in at least some schools of Islamic law since the early stages. This does not, however, ensure that *hila* can cope with the complexities of modern finance.[5]

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[5] See Vogel and Hayes, *Islamic Law and Finance*, 139. Although *hiyal* existed in theory in the Hanafi and Shafi'i schools, their role in the legal practice of the classical

The third indication of *hila* is the existence of complex structures and multiple documentations. *Murabaha* is based on the purchase of the goods by the financial institution from a third party supplier, usually preceded by an order and promise to purchase from the customer, and frequently coupled with agency from the purchaser to the financial institution to sell the goods to another supplier after selling them to the customer. The underlying structure in *istisna'* is the technique of *istisna' muwazin* (back-to-back *istisna'*), which depends on third party contractors or manufacturers. *Ijara*, in its turn, is structured on the basis of purchase of the leased asset from the customer and leasing it back to him, whereby the customer ultimately re-acquires the leased asset upon full payment of liability. Even when the leased asset is purchased from a third party, the underlying transaction is not a lease but pure financing, especially in view of the fact that the rental payments are directly determined on the basis of market lending rates, and that the lease ends in ownership. To address the issues of maintenance and insurance as obligations of the lessor, the concept of "service agency" effectively transfers such liabilities to the lessee.[6] In contrast to a simple lease, an *ijara* transaction would require no less than four separate agreements: one for purchase, one for lease/lease-back, another for service agency, sometimes another for put/call options, and a final one for transfer of ownership to the customer upon the end of a lease. The bank accordingly assumes all the roles of purchaser, lessor, principal, and seller in one single transaction.

Some *hiyal* are so simple that they are now fully integrated into contemporary Islamic finance and are no longer questioned. This is the case with simple *murabaha*, such as the resale of vehicles or consumer goods, when the customer acquires ownership of the goods. However, other applications of *hila* are not so simple and are extremely

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period is far from certain. See Nicholas Dylan Ray, "The Mediaeval Islamic System of Credit and Banking: Legal and Historical Considerations," *Arab Law Quarterly* 12, no. 1 (1997): 43-90. Ray states on page 47: "In fact, despite the acceptance of *hiyal* by the Hanafi and Shafi'i schools, there is little reason to believe, on the basis of documentary evidence, that *hiyal* played a major economic role in medieval Islamdom, at least in relation to interest-bearing loans, most of which seem to have been contracted (in strict opposition to Islamic law) between Muslims and individuals of other religions, or between bankers and desperate governments, and which loans did not depend on *hiyal*." See also page 59: "If it can be demonstrated that interest-bearing loans were of little economic consequence in their own right, it would be apparent that the *hiyal* permitting their use were equally unimportant. This question of the economic role of the *hiyal*, and of interest-bearing loans in general, though difficult to answer, is of utmost importance for the comparative study of economic history in medieval Europe and the Near East."

[6] For detailed discussion of the various mechanisms of contemporary Islamic finance, see Vogel and Hayes, *Islamic Law and Finance*, 139-149, 182-193, 212-214.

controversial. For instance, in *tawarruq* (cash seeking) *hila* finds one of its most controversial applications. Pursuant to an order and promise to purchase from the customer, the bank purchases a commodity from a broker and sells it to the customer by way of *murabaha*. The customer immediately appoints the bank as agent, or "messenger," to sell the commodity to another broker (prearrangement between the former and the latter broker being already in place). No commodities are actually changing hands between the brokers, the bank, and the customer. No payments are made by the bank to the first broker or any supplier when the bank "purchases" the commodities, nor are any payments made by the second broker or any ultimate purchaser to the bank when the bank finally "sells" the commodities. In short, only book entries (and brokerage) are at work, and the process ends in the customer receiving cash. Normally the only two justifications for any purchase transaction are *qunya* (acquisition) and *istirbah* (profit seeking). Neither is intended by the customer in *tawarruq*. Only cash is at issue and the purchased commodity is totally irrelevant.[7] The essential safeguard of *daman* (contractual liability), as shall be explained below, is totally absent from such a transaction. Only a fictional, transitory pre-sale *daman*[8] is created, but the purchaser is left with cash and liability for premium over cash, without any actual seller's liability.

There has recently been some focus on *tawarruq*, perhaps due to its starkly fictional structure. However, such a focus may lead to distraction from the overall fictional picture, and from the issue of whether or not *tawarruq* is simply an extreme application of *hila*. *Hila* may be an alarming sign of predicament in the legal system.[9] It may indicate an inability to reach beyond the form, a failure to grasp the essence of the legal rule, and a lack of thinking in light of general principles.[10]

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[7] See on *tawarruq*, Vogel and Hayes, *Islamic Law and Finance*, 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.

[8] See note 17.

[9] See Lon Fuller, *Legal Fictions* (Stanford: Stanford University Press, 1967), 7: "[T]he 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."

[10] The distinction between the so-called "lawful *hiyal*" and "unlawful *hiyal*" seems to originate in a confusion between legal fiction as a technique for the development of the law (*fiction de droit*; *présomption de droit*), and stratagems devised for the sole purpose of circumventing the law (*simulation*; *suriyya*). See, Satoe Horii, "Reconsideration of Legal Devices (*Hiyal*) in Islamic Jurisprudence," *Islamic Law and Society* 9, no. 3 (2002): 312-357.

SHIFTING THE BURDEN OF PROOF IN *MUDARABA* AS AN ALTERNATIVE TO *HIYAL*

One of the suggested alternatives to *hiyal* is the shifting of the burden of proof to the *mudarib* (the working, or active, partner, that is, the customer as distinguished from the bank), in the sense that the *mudarib* becomes required to prove that the loss was not due to his own misconduct or negligence.

To begin with, the financier in *mudaraba* (capital-labor partnership) is accurately called *rabb al-mal* (the capital provider).[11] The nature of *mudaraba* as a genuine finance mode is shown at first sight by its simple structure. No orders, promises, third parties, or agents are called for. No side letters or convoluted documentation is needed. What is needed is one simple agreement between *rabb al-mal* and the *mudarib*. The former is making available to the latter a certain amount to finance a certain activity to be undertaken by the *mudarib* for a certain period, and the ratio of distribution of profits, if any, is set out.

Mudaraba has long since been recognized as the only acceptable characterization of investment accounts. Here, the depositor is *rabb al-mal* and the bank is the *mudarib*. However, Islamic financial institutions have always avoided *mudaraba* as a finance mode because of its risks, as the *mudarib* is not liable for the profit or even the principal, except in the case of negligence or misconduct.

Several suggestions have been advanced to mitigate the risk of *mudaraba* and adapt it to the modern financial system.[12] The concept of the "public, or mutual, *mudarib*" has been suggested by analogy to the "public, or mutual, manufacturer" who is held liable even without proof of negligence or misconduct for materials entrusted to him by his customers.[13] But such a concept is only useful to approach the bank-depositor relationship issue and cannot be generalized to include every *mudarib*.

Perhaps the best solution thus far suggested to actualize *mudaraba* as the most important channel of Islamic finance has been reached by approaching the problem from the burden of proof angle.

From this standpoint, the age-old principle that the *mudarib* is only liable in the event of negligence or misconduct is still observed in view of its significance as one of the cornerstones of the whole edifice of Islamic

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[11] For more on *mudaraba*, see Vogel and Hayes, *Islamic Law and Finance*, 110, 130-139, 193-195.

[12] On the potential of insurance in this respect, see Ibid., 150-154.

[13] See 'A'isha al-Sharqawi al-Maliqi, *al-Bunuk al-Islamiyya* (Casablanca: Al-Markaz al-Thaqafi al-'Arabi, 2000), 325, 343; and Vogel and Hayes, *Islamic Law and Finance*, 132.

finance. However, it is the onus of proof that has been shifted. It is the *mudarib* who would be required to prove that the loss of profit or principal was not due to his negligence or misconduct. In this way, the risk of *mudaraba* insofar as the Islamic bank is concerned is lessened to a great extent.

Abu Dhabi Islamic Bank has been among the leading Islamic Banks in reintroducing *mudaraba* into Islamic finance. Its *shari'a* board has already approved the shift of the burden of proof in *mudaraba* and several full fledged *mudaraba* agreements built on this concept have been executed and implemented.[14] However, shifting the burden of proof in *mudaraba*, important as it is, still leaves many cases unsolved, especially in consumer-related finance.

THE TECHNIQUE OF *HIYAL* IN LIGHT OF THE *MAQASID* VALUES

If it is agreed that there are some general principles (*maqasid*) underlying the entire Islamic law of financial transactions (*fiqh al-mu'amalat*), then the principle of *daman* (liability or contractual liability) is one of the most fundamental of such principles.[15] This principle seems to require the presence of "justified liability" and the absence of "unjustified liability" in every transaction in order to exclude both *riba* (usury) and *gharar* (uncertainty). Thus, sale (including a premium over cash in credit sale) is lawful due to the justified liability of the seller for defects and "vindication" (*istihqaq; istirdad; darak*; third-party claims) to counterbalance the purchaser's liability to pay the price. Interest on credit is unlawful in view of the unjustified liability of the borrower to pay back principal and interest without a corresponding liability on the part of the

[14] Shifting the burden of proof in *mudaraba* may also be a solution to the problem of security of deposits against losses, especially in countries where Islamic banks are not exempted from such requirement. See, al-Maliqi, *al-Bunuk al-Islamiyya,* 633.

[15] See Peter Stein and John Shand, *Legal Values in Western Society* (Edinburgh: Edinburgh University Press, 1974), 258: "Legal principles are the meeting-point of rules and values." See on *maqasid*: al-Shatibi, *al-Muwafaqat* (Cairo: Al-Maktaba al-Tijariyya al-Kubra); Ibn 'Ashur, *Maqasid al-shari'a al-islamiyya* (Amman: Dar al-Nafa'is, 2001); al-Raysuni, *Nazariyyat al-maqasid 'ind al-imam al-shatibi*, 4th ed. (Riyad: Al-Dar al-'Alamiyya li-l-Kitab al-Islami, 1995); Ibn Zughayba, *Maqasid al-shari'a al-khassa bi-l-tasarrufat al-maliyya* (Dubai: Markaz Jum'a al-Majid, 2001); al-Alim, *Al-Maqasid al-'amma li-l-shari'a al-islamiyya*, 2nd ed. (Riyad: Al-Dar al-'Alamiyya li-l-Kitab al-Islami,1994). On the general principles and "internal structure" of Islamic contracts and commercial law, see Vogel, "Ijtihad in Islamic Finance," *Proceeding of the Fifth Harvard University Forum on Islamic Finance* (Cambridge: Harvard University, 2003), 122.

lender like that of the seller. *Gharar* is likewise unacceptable because of the lack of liability due to uncertainty. The purchaser of the "stray camel" would be liable for the price while the seller would not be liable for delivery, defects, or third-party claims.[16]

Most of the basic issues of *fiqh al-mu'amalat* seem in the final analysis to revolve around the concept of *daman*.[17] Issues such as the unacceptability of the *mudarib*'s liability for the loss of the *mudaraba* capital, the rejection of the partner's liability for his partner's share or the illegality of the lessee's liability for loss of the leased asset (absent negligence or misconduct) are all apparently related to the idea of *daman* in order to guard against the transaction turning into a guaranteed premium over principal. Third party guarantee of the profit of the *mudaraba* or the partnership is not acceptable for the same reason. The whole concept of profit and loss sharing may be ultimately based on the principle of *daman,* as each party is liable for loss (justified *daman*), and neither is liable for the other party's profit (unjustified *daman*). Likewise, the central issue in *gharar* is perhaps *daman*, as *gharar* involves the lack of *daman*, here "justified *daman*," due to the uncertainty of the principal obligation. In other words, *daman* is generally a *shart* (prerequisite) in sale and lease but a *mani'* (impediment) in *mudaraba* and partnership.

As a matter of fact, even a quick survey might show that most *hiyal* in contemporary Islamic finance are intended to introduce some *daman* such as when the Islamic bank acts as a seller in *murabaha,* a contractor in *itisna'* or lessor in *ijara* to create some liability, albeit often transitory, remote, and fictional, on the part of the bank. An illustration from practical personal experience may be in order. A client approached an Islamic bank for automobile finance. The transaction proceeded like any car *murabaha*. The client had already picked the car, identified the seller (technically speaking, the "original seller" or "the supplier"), and negotiated the purchase price with him. The bank signed a purchase contract with the seller, paid him the price, and signed a credit sale contract with the client. But the client later came to know that the car had been stolen and the seller apparently left the country. Had the transaction been a car loan, the client

[16] See Vogel and Hayes, *Islamic Law and Finance*, 100.

[17] 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-l-daman* (profit goes with liability) and *al-ghurm bi-l-ghunm* (loss, that is, liability, goes with gain). See Ibn Nujaym, *al-Ashbah wa-l-naza'ir* (Beirut: Dar al-Kutub al-'Ilmiyya, 1999), 127-128; al-Suyuti, *al-Ashbah wa-l-naza'ir*, vol. 1, (Beirut: Dar al-Kutub al-Ilmiyya, 1999), 295-296; Salim Rustum Baz, *Sharh al-majalla,* (Beirut, 1986), 56-58. On *qawa'id,* see generally Vogel, "Ijtihad in Islamic Finance," 121-122, and Vogel and Hayes, *Islamic Law and Finance,* 35, 72.

would not have even thought of complaining to the bank. But the client knew well her rights as a purchaser (not just a borrower) and demanded that the bank assume its responsibilities as a seller. The issue was submitted to the bank's *shari'a* board, which then ruled that the bank was liable for third-party claims (*daman al-istihqaq*). The outstanding *murabaha* installments were accordingly waived and the paid installments refunded to the client in full. This is perhaps a clear illustration of how Islamic finance is different from conventional finance. It was the client who identified the car and the seller, and negotiated the whole purchase deal with him. The bank was a financier in the true sense of the word and only a seller in a very technical sense, by virtue of the two contracts of purchase and sale it signed. But why should a financier be liable for third-party claims against its customer's cars? As our example shows, the formalities of purchase and sale are only technical implementations of the principle of *daman*.

However, more often than not, the techniques overshadow the value. The case discussed above is exceptionally clear due to its unusual circumstances. In the vast majority of cases, the value of *daman* in the sense of "justified liability" on the part of the financial institution gives way to *daman* in the sense of "unjustified liability" on the part of the customer. The dominance of casuistic reasoning by the maxim that "every loan that attracts a benefit is usurious (*riba*)" necessitated the avoidance of interest-taking by introducing some *daman* into the transaction. Thus, the devices of *murabaha*, *ijara,* and the like came into existence in order to ensure some liability on the part of the financial institution. But such liability is usually mitigated to the greatest extent possible by effect of various waivers, disclaimers, and other arrangements, whereas the customer's liability is invariably confirmed. The devices now function to undermine the very values they are supposed to safeguard.[18]

[18] *Daman* in the sense of contractual liability should be clearly distinguished from the concept of *daman* as risk of loss, risk of ownership, or liability in the sense of pre-sale liability for loss, which may be confusing in this context. The value of *daman* is perhaps undermined by shifting the emphasis from the post-sale seller's liability to the so-called pre-sale liability for loss. The 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*.

CONCLUSION

Hila is defeating the very purpose of Islamic law by uprooting a great legal system from its ethical foundations and unjustifiably transforming an originally equity-based finance system into a debt-based one. It converts transactions whereby the financier should assume a certain minimum share of risk into debt-based financing and guaranteed profit clothed in the dress of a sale or lease. Even aside from its ethical vagueness and irrationality, *hila* is casuistic and its applicability is limited by its very nature. Therefore it cannot cope with the complex issues challenging Islamic finance today. Islamic finance will not be able to bear long under the pressure of so many complex and proliferating issues through a reliance on *hila*. Sooner or later, *hila* leads to a dead end.

Awareness of the deadlock into which *hila* is leading Islamic finance is now growing. The call is steadily rising for the elimination of some of its most extreme applications, such as *tawarruq.* But if *murabaha*, heavily based on *hila* as it is, constitutes in many cases the greatest share of Islamic banking transactions, then those issuing such a call must come to grips with the fact that *tawarruq* is only a variation on *murabaha* and that the existing methodology cannot give more than it already has.

Islamic finance should perhaps focus more on its underlying values and less on cumbersome, convoluted techniques. Reasoning by *maqasid (al-ta'lil al-maqasidi*), that is, by general principles derived by induction from individual texts and *'ilal*[19] instead of directly reasoning by such texts and '*ilal*, has a potential that is yet to be explored. Such reasoning may remain faithful to the ethical foundations of the *shari'a* without losing sight of the complexities of modern life. For instance, more attention should be given to the principle of *daman*, as briefly illustrated above, instead of the focus on "every loan that attracts a benefit is usurious." Perhaps a loan becomes usurious not simply because it attracts a benefit, but because the "unjustified *daman*" on the part of the borrower is not counterbalanced by any *daman* on the part of the lender. However, an elaborate discussion of *maqasid* is beyond the scope of this paper. Suffice it to note in conclusion that recourse to *maqasid* analysis may be the only viable alternative to *hiyal*.

To conclude, it may be apt to quote a proposal made in a similar context:

> I propose that this skeleton in the family of the law be taken from its closet and examined thoroughly. After that examination we may decide what we ought to do with it. At

[19] Plural of '*illa*, or "ratio legis."

> any event I am convinced that keeping it in the closet is both dangerous and unbecoming.[20]

[20] Fuller, *Legal Fictions*, 4-5.

Islamic Retail Finance in Europe: Market Potential and Legal Challenges

Kilian Bälz[1]

This paper investigates the market potential and legal constraints for *shari'a*-compliant retail products in Europe, focusing on the United Kingdom and the German markets. The paper grew out of my involvement in designing *shari'a*-compliant retail products for the German domestic market. Compared to the development of Islamic retail finance in the United Kingdom, developments in Germany are significantly lagging behind. Islamic retail products, particularly Islamic home finance, have been an integral component of the product range of English banks for several years now, and in 2004 the Islamic Bank of Britain commenced operation as the first fully *shari'a*-compliant bank in Europe, followed by the European Islamic Investment Bank that commenced operation in 2006.[2] In contrast, in Germany there are currently no Islamic retail products available, despite a Muslim population that exceeds 3 million.[3] Although there have been some deliberations regarding the establishment of an Islamic bank in Germany, these projects are still far away from implementation. While the English market is booming, the German market is close to non-existent. The (almost) complete lack of Islamic financial products holds true for most other European markets: Islamic retail finance in Europe is by and large confined to the United Kingdom.

This issue sets the framework for the question that will be pursued in this paper: Why is it so difficult to introduce Islamic retail products in

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[1] Partner, Gleiss Lutz: Frankfurt, Germany.

[2] For further information on these two banks, see http://www.islamic-bank.com/islamicbanklive/GuestHome/1/Home/1/Home.jsp; and http://www.eiib.co.uk/html.

[3] This is with the exception of certain investment funds, which are registered for public distribution in Germany. In particular, there are no *shari'a*-compliant home financing schemes, current accounts, or consumer loans available.

European markets outside the United Kingdom? Why do countries such as Germany and France seem to be not susceptible to Islamic finance, despite considerable domestic Muslim populations?

Considering the attention that Islamic finance has attracted over the last few years among the German public, the answer cannot be one of disinterest or lack of information. There has been extensive media coverage on the potential of Islamic finance both in the general and financial press, focusing on how German institutions might take advantage of the global trend. The reasons why the development of Islamic finance has been so slow regardless of public attention, therefore, must lie somewhere else.

In the following, the argument is put forth that development in the field of Islamic finance must be analyzed within a broader framework. First, Islamic financing transactions must be integrated into and adapted to the overall legal and regulatory framework. This task is of particular importance in relation to retail products that are based on the industrialization of the banking business. In Germany, regulation works differently than in the United Kingdom, and the German regulatory framework may be less responsive to the needs of ethnic and religious minorities, making it difficult to introduce Islamic products to the German market. Second, and perhaps more importantly, *shari'a*-compliant retail products must also mirror the needs of the respective Muslim community (or communities). While a global market for "big ticket" Islamic financing transactions may have evolved, this does not hold true for Islamic retail products, which are neither universal nor based on globally uniform standards. The success of Islamic retail products therefore is dependent on a double cultural accommodation: adjusting the product to the requirements of local laws as well as the specificities of local Muslim communities. The latter depends on certain institutional arrangements, which in the past have been more favorable in the United Kingdom than in Germany.

WHY CARE ABOUT IT?

The underlying assumption of the analysis presented here is that it is indeed a good idea to push the development of Islamic retail finance in Europe further. Although this assumption may be widely shared within the Islamic finance community, it is far from being uncontroversial. This is not due just to the general skepticism and criticism that is raised against Islamic finance, both the concept and its implementation. In a German setting, one often encounters the argument that further development of Islamic retail products is neither required nor desirable. The latter

approach is particularly prominent among those who have difficulty conceiving of Germany as a multi-ethnic and multi-religious society, and among those who openly advocate a "hegemonial culture" (*Leitkultur*).[4] From this perspective, there is no need to foster the pluralization of the financial system by offering products that target Muslims. The financial system should be one and the same for all, in order to prevent the development of so-called "parallel societies" (*Paralellgesellschaften*). Thus consumer credit is one means of promoting integration, compelling people to adapt to mainstream society, as far as financial services are concerned. Proponents of integration often refer to several *fatawa* (legal opinions) issued over the last decade, in which Muslim scholars exempted European Muslims from the prohibition of *riba* in consumer finance. The argument normally goes that as long as Muslims are living in a non-Muslim country and no Islamic financial services are available, Muslims may use conventional modes of finance (in order to avoid a situation in which the Muslim population is excluded from financial services altogether). This leads some to conclude that Islamic retail finance is not only undesirable, but also unnecessary.

I advocate the opposite approach and promote the idea that developing Islamic retail finance is recommended. The reasons are several. First, from a business perspective the German Muslim population of more than 3 million has not, until recently, been the focus of any German retail bank. This market, considering the sheer number of Muslims living in Germany, obviously has potential. Second, the development of niche markets conforms to the predominant marketing strategy in the German financial services industry today, where attention has shifted back to the domestic retail market. Here, banks are seeking to diversify their product range in order to better reach customer groups that have been neglected in the past. Third, and perhaps more significantly, there is a strong trend toward socially responsible and ethical finance that has also been endorsed by more recent legislative enactments. Financial services no longer are ethically neutral, but are expected to also conform to certain non-economic criteria, such as environmental friendliness, sustainability, and other green or social criteria. This opens a window for financial transactions conforming to Islamic principles as well, provided one is ready to accept Islamic finance as one form of ethical or faith-based finance (compared to the conventional model based exclusively on economic parameters). Finally, from a policy perspective, it has been acknowledged that the goal of granting as many people access to financial services as possible is an

[4] The concept of "hegemonial culture" is similar to the thesis put forth by Samuel Huntington. See Huntington, *Who Are We? The Challenges to America's National Identity* (New York: Simon & Schuster, 2004).

important one. Access to financial services ("financial inclusion") is increasingly being perceived as a civil rights issue.[5] Based on this perception, one may argue that members of the Muslim community should not be barred from enjoying financial services simply due to their faith. In turn, financial institutions should not escape from regulation because of their Islamic orientation.[6] Financial inclusion, therefore, also helps achieve effective regulation of the German market. Thus, from a policy perspective, systematically developing the Islamic finance market is recommendable.

STRUCTURING ISLAMIC RETAIL PRODUCTS: *SHARI'A*, STATE LAW, AND ECONOMIC COMPETITIVENESS

Islamic retail products must comply with very different and at times contradicting requirements from different social and legal fields. This makes the structuring of Islamic retail products challenging. First, and from the customer perspective most importantly, a product must conform to the principles of the Islamic *shari'a*. This is what makes an Islamic financial product different in the eyes of the target group. Second, the product must comply with the laws and regulations of the jurisdiction it is implemented in. It must conform, for instance, to consumer protection laws as well as to the rules of banking regulation. As will be discussed in more detail in the following pages, European legal systems, with very few exceptions,[7] do not provide for any special treatment of Islamic financial transactions (and it is unlikely that such special rules will be enacted in the near future). Islamic financial products thus must be made to fit into the normal regulatory and legal framework. Third, the product must, from an economic perspective, be competitive. One may be able to argue that people have a certain willingness to also invest in their faith and may be prepared to deal with some disadvantages provided that the financial product conforms to their religious principles. However, the economic

[5] See, e.g. the U.K. Financial Inclusion Taskforce, http://www.financialinclusion-taskforce.org.uk/default.htm.

[6] See, e.g. Bundesministerium der Finanzen, "Der Missbrauch des Finanzsystems duch 'Underground-Banking'–Bestandsaufnahme und Gegenmaßnahmen," http://www.bundesfinanzministerium.de/cln_01/nn_17844/nsc_true/DE/Service/Downloads/Abt__I/27145__0,templateId=raw,property=publicationFile.pdf.

[7] Most noticeably the United Kingdom has implemented special regulatory and tax rules in order to accommodate Islamic financial transactions. More such rules are announced to be implemented in the course of 2007. See the press release in connection with the 2007 Islamic Finance Summit in London, at http://www.hm-treasury.gov.uk/newsroom _and_speeches/press/2007/press_12_07.cfm.

burden of transacting in accordance with the *shari'a*, in particular adverse tax effects triggered by certain Islamic structures, must not be excessive since this deters potential customers.

From this it follows that the development of Islamic retail products poses challenges in different areas. In the following I will look closer into some of them, including the formulation of *shari'a* principles, the adjustment of Islamic finance to consumer protection laws, the avoidance of adverse tax effects, and the issue of dispute resolution. I will not focus on doctrinal details, but will rather place emphasis on the problem-solving procedure. The aim is to discuss, in the light of the experience in the U.K. market, how one may approach these issues in other jurisdictions. I argue that the success of structuring Islamic retail products depends on a certain institutional arrangement, which facilitates a dialogue between financial institutions and representatives of the regulator and the Muslim communities. This also requires taking local specificities seriously, as institutional arrangements vary between one country and the other.

Local Retail Products, Global Islamic Principles? Why there is no "one size fits all" in the Islamic Retail Market

A bank intending to offer a *shari'a*-compliant product has various options for validating its claim to comply with Islamic principles. The most straightforward method for an entrant to the German market may be to simply copy a successful product offered by a competitor in another EU market, and bring it to Germany. This is indeed the origin of many (perhaps most) financial innovations that have evolved over the last few years in Germany. With regard to *shari'a*-compliant products, however, copying a successful product is not actually a feasible alternative. An Islamic financial product gains its competitive advantage not only through its commercial terms, that is, by providing the customer with funds at competitive cost or promising an attractive return on investment; the product is also dependent on an ethical (non-economic) claim, namely compliance with Islamic law and the principles of the Islamic religion. Islamic legitimacy cannot be generated simply by copying a product, but rather depends on the target community. As will be further elaborated below, Muslim communities vary from one European country to another. This requires that they must also be approached in different ways.

With regard to consumer products, another alternative to copying the product of a foreign competitor would be to seek guidance from internationally accepted standards. The most prominent organization developing standards in the field of *shari'a* compliance is the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), a

non-governmental organization based in Bahrain that has been active for some 15 years in formulating *shari'a* rules (and other standards) for the Islamic finance industry.[8] The work of AAOIFI is extremely valuable for anyone concerned with Islamic finance. The focus of AAOIFI, however, has so far been more concerned with the big-ticket market than with retail. In addition, AAOIFI does not develop products, but simply establishes a framework within which they can be developed. Third, even those institutions relying heavily on AAOIFI would, in addition to referring to the AAOIFI standards, normally also consult a *shari'a* board, internal or external, to supervise compliance with those principles. As a result, standardization in the fashion carried out by AAOIFI may help, but will not suffice in solving the problem.

What remains is to develop a product tailored specifically to the particular market. This is how most Islamic financial products have been developed in the past. Normally, the product is developed in cooperation with a team of scholars who also approve a concrete model transaction. Over the last few years a number of institutions and individuals have earned a reputation as *shari'a* advisors. It is a commonplace, however, that over the centuries the *shari'a* has been a discursive legal system with a fair degree of pluralism (which may be perceived, from the perspective of the practicing lawyer, as uncertainty at the level of black-letter rules).[9] This is also reflected in the present day discourse among *shari'a* scholars regarding Islamic financial innovations. Consequently, the authority that a certain scholar enjoys may vary according to affiliation with a particular school of law, a respected Islamic institution, and even ethnic origin. This is not to negate that big-ticket Islamic financing transactions have generated a new kind of Islamic transnational *lex mercatoria* (a kind of transnational law merchant that has evolved through trade practice, to a large extent independently from state law). Neither is it to question that there is a global discourse among Islamic scholars, particularly on the internet, that can also be observed in the area of Islamic banking. On the local level, however—and this is the level that is ultimately relevant when structuring Islamic retail transactions—regional and ethnic differences play a significant role that must be taken seriously.

This means that at least to some extent, *shari'a* certification has a local component. Here, the differences between the United Kingdom and

[8] See the AAOIFI website, at http://www.aaoifi.com.

[9] First, legal doctrines in Islamic law have, as in all legal systems, evolved over time. Second, and maybe more importantly, there are differences of opinion with regard to certain legal questions between (and at times within) the different schools of law (*madhahib*); for a comparative evaluation see, e.g. [Jazîrî].

Germany come into play.[10] In the United Kingdom the following can be observed:

1. The majority of Muslims are of Pakistani origin, a country that officially endorses Islamic economic principles and the prohibition of riba;
2. There are a fair number of Muslim think tanks and Islamic scholars versed in financial matters, as well as an indigenous (British) *shari'a* discourse;
3. There is a tradition of academic research in Islamic law with a practical orientation (such as at the Department of Law at the School of Oriental and African Studies);[11]
4. English is widely understood, making *shari'a* know-how from abroad accessible.

In Germany, by contrast:

1. The majority of Muslims are of Turkish descent, and in the past lived in a secular state with a rigorous separation of state and religion and a non-Islamic economic order;
2. Muslim think tanks did not exist until recently, and Islamic scholars are often not interested in economic matters, producing a very limited indigenous *shari'a* discourse;
3. There is a rich tradition of scholarship in the area of Islamic law, associated with big names such as Ingnaz Goldziher (1850–1921) and Joseph Schacht (1902–1969), but it is mostly academic in nature;
4. Only very few internationally renowned *shari'a* scholars speak German, causing German discussions to be isolated from international developments.

This comparison reveals the difficulties in attempting to reproduce the English experience in Germany, where there is a shortage of local scholars willing to engage in the discourse on the one hand, and difficulty in bringing in foreign *shari'a* expertise on the other. As a result there is a lack of competent *shari'a* advisors who are able to participate in the development of Islamic financial products. This situation can only be resolved in the long run by increasing awareness regarding financial issues

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[10] For a comparative overview of Muslim communities in different European countries, see e.g. Jan Rath et al., *Western Europe and Its Islam* (Leiden/Boston/Cologne: Brill, 2001); and Silvio Ferrari and Anthony Bradney, *Islam and European Legal Systems* (Aldershot: Ashgate Darmouth, 2000).
[11] See http://www.soas.ac.uk/centres/centreinfo.cfm?navid=17.

on the one hand, and improving practical education in *shari'a* on the other.[12]

Mandatory Consumer Protection Laws versus Islamic Legal Principles: Liability of Banks Under *Murabaha* Agreements

If there is one single asset that is closest to the heart of the average English person, it is probably the home. In contrast, in automotive Germany the car may be a more important identity token. For this reason the following practical example is taken from the area of automobile finance.

In countries with developed Islamic retail markets such as the UAE or Malaysia, most car finance schemes are based on *murabaha* contracts. The bank acquires the car selected by the customer, who then purchases it from the bank on a cost-plus basis, paying the purchase price in deferred installments. From a *shari'a* perspective, the transaction is a contract of sale. From an economic angle, it resembles a financing transaction, where the bank facilitates the customer's acquisition. As most banks do not intend to take on any responsibility for the potential defects of the car selected by the client, the structure depends on an exclusion of warranty claims on the side of the bank. The bank in turn assigns the warranty claims to the customer who, if so required, can bring them directly against the car dealer. The structure is somewhat similar to the one under a financial lease.

From the perspective of European consumer protection rules, such a structure, under a sales contract, gives rise to concern. Pursuant to Article 3 of the Directive 1999/44/EC of 25 May 1999 on the Sale of Consumer Goods, a seller acting in connection with his business may not exclude its warranty claims if it sells a new chattel to a consumer. It also may not refer the consumer to a third party to bring these warranty claims in lieu of discharging the warranty claims itself. From this it follows that the bank, under a *murabaha* structure, may have to fully assume the position of a car dealer, also dealing with any defects of the car during the warranty period. This is a risk that banks are normally not willing to take. Banks are not fond of trading in cars, nor are regulators very enthusiastic when financial institutions engage in such activities.

In the United Kingdom, a Muslim seeking *shari'a*-compliant car finance presently has two options: a communal one and a commercial one.

[12] It is worth mentioning that over the last few years several German universities have established positions for "Islamic studies" that are intended to train Islamic religious instructors. One may hope that they will enhance an indigenous *shari'a* discourse that will also contribute to financial affairs. See, e.g., the Chair for Islamic Religion at the University of Münster, http://www.uni-muenster.de/ReligioeseStudien/ Islam/Personen.

Under the communal option, offered by Ansar Finance for example, the person joins an association, makes certain regular contributions, and is then entitled to take out a *qard hasan* (an interest-free loan).[13] This scheme seems to be an effective way of organizing credit within a certain community, and also resembles nineteenth-century credit cooperatives. The disadvantage of this scheme is that it is not suited to serve the community at large. It can only serve a limited number of people. In addition, it relies on personal trust and is not suited for the "industrialized" business of retail banking. A typical commercial scheme, in contrast, would be the one offered by the Islamic Bank of Britain.[14] There, consumer credit is based on a *tawarruq* structure. Under this structure, the bank trades in commodities on behalf of the client, who then receives funds for a purpose of its choice. If acquiring a car, the bank is not to be involved in purchasing the car at all. Instead it carries out a commodity transaction, though with much more foreseeable risks. Although this may seem to be a pragmatic approach for Islamic banks to take toward consumer credit, the Islamic legitimacy of *tawarruq* transactions remains in dispute. The permissibility of *tawarruq* is based on a formalist understanding of *shari'a*, whereas many Islamic scholars favor a more substantive approach that requires financial institutions to take on the business risk and be involved in the concrete transaction.[15]

Approaching the issue from the German angle, there are two possible solutions. The first is to search for a doctrinal exemption for *murabaha* transactions, attempting to use doctrinal concepts of German law in order to find a niche for an Islamic finance product. As understood by the courts, the provision banning the exclusion of warranty claims does not apply to financial leases with a purchase option (although the result of such a transaction is the acquisition of a certain asset, thus effectively working like a sales contract from an economic perspective).[16] In view of this, it would be possible for the bank to use a *murabaha* structure, but lease the car during the warranty period to the customer, who would be under an obligation to purchase it once the period has lapsed. This *murabaha-ijara* structure may help to get around the restrictions of consumer protection law. It is based on the interplay of Islamic and secular legal principles, intending to bring both legal systems into harmony (taking advantage of a certain regulatory arbitrage between the two systems).

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[13] See http://www.ansarfinance.com.

[14] See http://www.islamic-bank.com/islamicbanklive/Personal/1/Home/1/Home.jsp.

[15] See, e.g., the critical discussion in Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics and Practice* (New York: Cambridge Universtiy Press, 2006), 69-70.

[16] See the leading case of the German Federal Court (*Bundesgerichtshof*) of 21 December 2005, *Neue Juristische Wochenschrift* 2006, 1066-1068.

Alternatively, the issue could be addressed on the level of the bank–dealer relationship. Here, the bank could enter into an agreement with certain selected car dealers pursuant to which they (1) will hold the bank harmless from any and all warranty claims raised by the customers, and (2) provide the free repair services required during the warranty period. The latter approach has the downside that the bank will be dependent on an ongoing relationship with selected car dealers. This may be an option for certain banks specializing in car finance, because often such institutions are affiliated to a certain manufacturer. It may be less attractive for commercial banks, which try to get involved in car deals as little as possible.

Legislative Exemptions versus *Shari'a* Innovations: The Issue of Double Transfer Taxes

Perhaps the most prominent instance where Islamic retail transactions are at odds with secular law is the issue of double transfer taxes (or double stamp duty, as the issue is referred to in the United Kingdom). This issue is normally triggered by Islamic home financing schemes.

The underlying issue is straightforward. Under a *murabaha* transaction, there is a double transfer of legal title (as from the *shari'a* perspective, there must be), first from the seller to the bank, and second from the bank to the customer. Although the bank will normally own the property for a logical moment only, this suffices to trigger transfer taxes, both under U.K. tax laws and section 1(1) no. 1 of the German Real Estate Transfer Tax Act (*Grunderwerbssteuergesetz*). The result is that under an Islamic home financing scheme double transfer taxes will be due, which is detrimental to the economic competitiveness of such transactions.

The British approach to this issue is well known. In order to discuss this and other issues, the U.K. regulator, the Financial Services Authority (FSA), called a working group consisting of regulators, *shari'a* scholars, bankers, accountants, lawyers, and representatives of the Muslim communities. The working group discussed how to integrate Islamic financing transactions into the British legal framework. As one of the consequences an amendment to U.K. tax law was enacted, which explicitly exempts Islamic home finance from the double stamp duty. The result is a partial exemption of Islamic financing transactions from British law.[17] This exemption is restricted to a well defined, singular matter. It is not the starting point for a parallel regulatory system for Islamic financial

[17] See sections 72 and 73 of the Finance Act 2003 (the *ijara* and *murabaha* transactions are referred to in the act as "alternative property finance").

institutions, such as exists in Malaysia and Bahrain, for example.[18] It is limited to exempting Islamic financial transactions from specific provisions of British law that have an unintended discriminating effect.

Under German law, this issue remains unresolved, but there are several avenues that may be pursued. First, one can think of an approach similar to the one in the United Kingdom and create an ad hoc exemption. This would be consistent with the approach that German law has taken to Muslim affairs in other instances, such as ritual slaughtering. Although ritual slaughtering is prohibited by law under the German Animal Protection Act (*Tierschutzgesetz*) and is deemed as cruelty toward animals, Section 4a(2) now provides for an exemption if it is "required by the needs of members of certain religious communities . . . whose mandatory principles of their religious community prescribe religious slaughtering." Based upon this, ritual slaughtering is now permissible as required by *shari'a*.[19] A similar exemption could be introduced into the German Real Estate Transfer Tax Act. However, there is presently no equivalent to the FSA working group in Germany, so it may be difficult to get the parliamentary and ministerial support required to enact such a solution. To date, the dialogue in Germany among professional groups regarding Islamic finance is only slightly developed. This makes it difficult to coordinate the efforts toward amending existing tax laws. In view of this, it may be worth considering other ways of approaching the issue. In particular, one could think about whether the Islamic notion of "legal title" is entirely the same as the notion in German civil law. If it is possible to argue that the bank acquires legal title only under Islamic law, and not under German law, it may be an option to argue in favor of an exemption to the transaction from double stamp duty, without amending existing tax laws. The transaction would take advantage of the regulatory arbitrage between the Islamic and the German legal system.

Shari'a Appellate Bodies versus State Courts: Dispute Resolution

Among the unresolved issues in Islamic finance is the issue of dispute resolution. Despite some scattered case law, mostly from English and Malaysian courts, the question of how to deal with disputes arising out of Islamic financing transactions remains to be tackled. The limited case law

[18] However, the U.K. Treasury has more recently announced that it will implement more such rules in order to further facilitate growth of the Islamic finance industry in the United Kingdom and develop London into an Islamic finance hub.
[19] For a discussion of the tensions between protection of animal welfare and freedom of religious practice, see Hans-Georg Klufe, "Das Schächten als Testfall des Staatszieles Tierschutz," *Neue Zeitschrift für Verwaltungsrecht* 2006, 650-655.

of the English courts (there are no German cases yet, to the best of my knowledge) shows how difficult it is for a secular court to come to terms with an Islamic financing agreement.[20]

The reason is twofold. First, Islamic financing transactions are structurally different from conventional transactions. They can be difficult to grasp for a court that is neither versed nor interested in *shari'a* matters. Second, particularly in a retail transaction, the parties may enter into Islamic transactions with a very special expectation: they expect to transact pursuant to *shari'a* rules. Yet it is questionable whether a state court will be prepared to give an opinion on that issue. On the other hand, especially to the extent that consumers are concerned, parties also expect the same level of protection that they would enjoy if the dispute was handled by a state court. From what I can see, there are three options for taking things forward.

The first and most obvious option is to vest the state courts with the competence to decide in such disputes. This would be consistent with the general approach in consumer matters. The problem with this approach is that, at least as far as Germany is concerned, there is little knowledge of *shari'a* among the members of the judiciary. There are certain precedents that suggest that judges, particular concerning family disputes, are willing to take *shari'a* rules seriously and spend considerable effort in determining their content. However, in disputes involving foreign law[21] the outcome is difficult to predict, given the absence of any established case law. In addition, it is expected that courts will attempt to avoid dealing with the details of *shari'a* issues. As a result, the courts may settle the individual dispute on a commercial level, but it cannot be expected that the decision will necessarily enjoy authority in the circles concerned.

The second option would be to refer the dispute to arbitration. Arbitration tribunals, as a general tendency, are freer regarding the rules they apply to the dispute. If the parties so wish, an arbitration tribunal can also decide a dispute according to the principles of the Islamic *shari'a*. A

[20] I have discussed this in Kilian Balz, "Islamic Financing Transactions in European Courts," in S. Nazim Ali, ed., *Islamic Finance: Current Legal and Regulatory Issues* (Cambridge: Harvard Law School Islamic Finance Project, 2005), 61.

[21] One question is whether *shari'a* rules will, from the perspective of English and German law, formally qualify as "foreign law." Under the established doctrines in private international law, the notion of "law" is synonymous with "state law." This means that transnational legal principles, such as the *shari'a* principles applied by Islamic banks, would not qualify as law at all. Nevertheless, in determining the substance of those rules, the courts would rely on experts, both in England and in Germany. The major difference may be that an English court would expect the parties to present expert evidence, while a German court would also appoint a respective expert ex officio.

state court, in contrast, cannot be expected to apply anything but state law. However, in many jurisdictions, there is reluctance submit consumer disputes to arbitration.[22] The vast majority of arbitration institutions are targeting commercial parties and are better equipped to handle large scale disputes among enterprises (as opposed to hearing "petty matters" arising out of consumer credit transactions or mortgages). In jurisdictions such as Germany, where the courts of first instance are easily accessible at reasonable cost, inserting an arbitration clause may have the effect of depriving a consumer of the possibility to enforce his or her rights. Therefore, there are certain restrictions imposed on arbitration clauses entered into with consumers.[23] The legislator normally is concerned that arbitration tribunals are not best suited to protect the interests of the weak, as mandatory laws of prime importance in the area of consumer protection are only hesitatingly applied by arbitration tribunals.

The third option represents the middle-ground position: a permanent appellate body dealing with Islamic financial disputes, which is subject to scrutiny and review of the courts. Such an appellate body has the advantage that, as an arbitration tribunal, it would be freer with regard to the legal principles it applies, and more flexible with regard to the judges it appoints. It would be a permanent body, and therefore would be expected to be better equipped to take care of consumer concerns than an arbitration tribunal proceeding according to rules designed for commercial disputes. It would be expected to publish its decisions, and as in court, its proceedings could be made accessible to the public. Its activity would be supervised by the state courts, to which any party may appeal if it feels aggrieved by the decisions of the appellate body.

THE WAY FORWARD

The analysis and suggestions of this paper can be summarized as follows:

- There is no one-size-fits-all approach in Islamic retail finance. Islamic retail finance transactions always have to be adjusted to the local environment in which they operate. This differentiates retail

[22] See, e.g., W. Luarence Craig,William Park, and Jan Paulsson, *International Chamber of Commerce Arbitration,* 3rd ed. (Dobbs Ferry, NY: Oceana Publications, 2000), 69-70.

[23] See, e.g., section 1030(2) of the German Code of Civil Procedure exempting landlord–tenant disputes from arbitration and section 1031(5) of the Code of Civil Procedure, setting up additional formal requirements for arbitration clauses entered into with consumers.

finance from the international "big ticket" transactions, which, at least to a considerable degree, are based on globally unified standards.

- The local environment comprises the state regulatory framework, such as tax laws and mandatory consumer protection rules. The state regulatory framework differs from one jurisdiction to another. It also extends to *shari'a* issues. An Islamic retail product must be tailored with a view to a specific Muslim community. There are no globally accepted *shari'a* standards for retail products.
- In order to adjust Islamic retail transactions to local markets, it is also advisable to initiate a process of "professionals in dialogue." This applies in particular to jurisdictions such as Germany. Assembling problem-solving capabilities will help to foster innovative solutions, both in the area of *shari'a* law and the legal framework in which Islamic retail transactions work. Only the cooperation of professionals representing different areas of expertise (*shari'a*, accounting, tax, regulation, legal) will allow us to break the present deadlock.
- Innovation will always depend on taking advantage of the specificities of both the *shari'a* and the respective national legal order. Using regulatory arbitrage can be a way to reconcile *shari'a* requirements with mandatory state law. This requires engaging in discourse between local lawyers and *shari'a* scholars who are versed in the respective jurisdiction and close to the Muslim community.
- The discursive development of Islamic retail products must be mirrored on the dispute resolution side. *Shari'a* appellate bodies, established by the industry and supervised by the state judiciary, may be the most efficient way to tackle that issue. Such appellate bodies are best suited to combine an understanding of *shari'a* matters with the required level of protection for consumers.

Islamic Finance and the International System: Integration without Colonialism

Robert R. Bianchi[1]

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

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

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

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

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

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

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

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

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[2] See John C. Bogel, *The Battle for the Soul of Capitalism* (New Haven: Yale University Press, 2005); Willam Brittain-Catlin, *Offshore: The Dark Side of the Global Economy* (New York: Farrar, Straus and Giroux, 2005); Richard J. Newman, "Corporate Kleptocracy: Why Conrad Black Has Hollinger Investors Seeing Red," *USNews.com*, September 13, 2004, http://www.usnews.com/usnews/biztech/articles/040913/13black.htm; and Ibrahim Warde, "Crony Capitalism: The Banking System in Turmoil," *Le Monde Diplomatique* (English edition), November 1998, http://mondediplo.com/1998/11/04warde1.

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

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

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

Will Westerners Take Over Islamic Finance?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[9] El-Gamal, "Interest and the Paradox of Contemporary Islamic Law and Finance."

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

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

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

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

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

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

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

When Is There Too Much Convergence and Harmonization?

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

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

International Regimes and Transnational Civil Societies

The core of the new Islamic financial regime is already up and running. The Organization of the Islamic Conference—the so-called United Nations of the Islamic world—launched the Islamic Financial Services Board in 2002 and the Accounting and Auditing Organization for Islamic Financial Institutions in 1991.[13] These standard-setting bodies inherit both the authority and the political problems of the entire OIC framework. Like all successful regimes, this one will need to juggle multiple functions simultaneously—mediator and arbitrator, monitor and enforcer,

[13] Islamic Financial Services Board, "Information on the Islamic Financial Services Board (IFSB)," http://www.ifsb.org/index.php?ch=2&pg=1&ac=1; and Accounting and Auditing Organization for Islamic Financial Institutions, "The Shari'a Board," http://www.aaoifi.com.

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

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

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

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

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

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

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

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

Part III

The Sukuk Phenomenon

Sukuk (Islamic Bonds and Securitizations): Toward A Viable Capital (Including Secondary) Market

Michael J. T. McMillen[1]

One of the most active areas of Islamic finance involves the issuance of *sukuk* (Islamic bonds and securitizations). These issuances not only form the base for the development of a *shari'a*-compliant capital market, but also, potentially, the base for the development of secondary markets for *shari'a*-compliant instruments. Most *sukuk* issuances to date constitute Islamic bonds, rather than true asset securitizations. The credit base for these issuances is not an asset pool, as would be the case in a true securitization. Rather, it is the credit of an operating entity (most frequently a sovereign). In order to achieve success in the development of capital markets and secondary markets, and benefits of asset securitizations, *sukuk* issuances will need to be structured as true asset securitizations that are broadly distributed across both Islamic finance and the conventional finance markets. While governmental and government-sponsored entities perform critical functions in the establishment and growth of capital markets and secondary markets, they are far from sufficient. Achieving the desired results is dependent upon broad and sustained private sector involvement that in turn is dependent upon the ability to obtain ratings for the *sukuk* issuances from the most prominent rating agencies.

This essay first surveys some of the generic *sukuk* structures now in use or being contemplated for use in the near future. The essay then considers a case study implementing features from these generic structures, the Bahrain Financial Harbour *Sukuk*. The essay then turns to a consideration of some of the factors that impede or inhibit the growth of

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[1] Partner, Dechert LLP; New York, New York. All opinions expressed in this essay are solely those of Mr. McMillen and do not necessarily reflect the opinions of Dechert LLP or the University of Pennsylvania. All copyright and other intellectual property rights are expressly retained by Michael J. T. McMillen. Portions of this essay have appeared or will appear in other publications.

Islamic capital markets (including secondary markets). Various market-related factors are noted. Thereafter, legal factors are considered, including systemic, structural, and operational function factors and factors pertaining to the enforcement of the *shari'a* in both purely secular jurisdictions that do not incorporate the *shari'a* to any extent in the secular law of the nation, and jurisdictions that do incorporate the *shari'a* to some extent in the secular law. With respect to the former jurisdictions, the essay considers the implications of the English appellate case, *Shamil Bank v. Beximco*. With respect to the latter jurisdictions, the essay focuses on structural, systemic, and legal opinion issues, including those of particular relevance to asset securitization *sukuk* such as (1) true sale, (2) non-consolidation, (3) bankruptcy remoteness, (4) the necessary collateral security structure, (5) enforceability of agreements, (6) choice of law, and (7) enforcement of judgments and awards.

SUKUK (ISLAMIC BONDS AND SECURITIZATIONS)

Introduction to *Sukuk* Structures

Sukuk issuance currently is one of the fastest growing areas of Islamic finance.[2] *Sukuk* are frequently referred to as "Islamic bonds." A more

[2] As an indication, during 2006 Dow Jones and Citigroup recently launched the "Dow Jones Citigroup Sukuk Index." *Sakk* (plural: *sukuk*) means, in ancient Arabic, "to strike" or "to hit," as in to strike or imprint one's mark on a document or tablet. As a derived term it means "minting coins." While the *sukuk* concept has deep roots in the history of Islamic finance, the current structural formulations are a product of the "jurisprudence of transformation and adaptation" of modern Islamic finance that has emerged since the 1980s wherein the classical system of nominate contracts (*'uqud masammat*) is viewed as a set of building blocks rather than as complete and immutably static transactional formulations and structures in and of themselves (with evolutionary effects on the classical system of transactions (*mu'amalat*)). See Yusuf Talal DeLorenzo and Michael J. T. McMillen, "Law and Islamic Finance: An Interactive Analysis," in *Islamic Finance: The Regulatory Challenge*, ed. Rifaat Abdel Karim and Simon Archer (John Wiley & Sons, 2007) (hereafter cited as DeLorenzo and McMillen, "Law and Islamic Finance"). Other examples of the reconfiguration of the nominate contracts in recent times can be found in Abdulkader Thomas, et al., *Structuring Islamic Finance Transactions* (Berlin: de Gruyter Recht, 2005). For more detailed discussions of issues relating to the implementation of *sukuk* as capital markets instruments, see Michael J. T. McMillen, "Contractual Enforceability Issues: *Sukuk* and Capital Markets Developments," *Chicago Journal of International Law* 7 (2007): 1-41 (hereafter cited as McMillen, "Contractual Enforceability"); McMillen, "Islamic Capital Markets: Developments and Issues," *Capital Markets Law Journal* 1 (2006): 136-172 (hereafter cited as McMillen, "Islamic Capital Markets"); and DeLorenzo and McMillen, *Law and Islamic Finance*, 154-187.

accurate descriptive analogy, from conventional securitization finance and taking cognizance of ownership attributes, would be "pass-through certificates"[3] or "investment certificates."[4] Thus, a *sakk* represents a proportional or fractional undivided ownership interest in an asset or pool of assets or an investment venture or operating venture.

Sukuk are of two general types: Islamic bonds and Islamic asset securitizations. Islamic bonds are based upon the credit of an entity that is

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[3] Descriptions of various conventional securitization structures are contained in Frank J. Fabozzi, ed., *The Handbook of Mortgage-Backed Securities* (New York: McGraw-Hill, 2001). For an interesting comparison of the earliest securitizations with more recent securitization trends, compare the 2001 revised edition with the 1985 version of the same title.

For literature analyzing the benefits of asset securitization, see Joseph C. Shenker and Anthony J. Colletta, "Asset Securitization: Evolution, Current Issues and New Frontiers," *Texas Law Review* 69 (1990-1991): 1383-1405 (hereafter cited as Shenker & Colletta, "Asset Securitization"); James A. Rosenthal and Juan M. Ocampo, "Analyzing the Economic Benefits of Securitized Credit," *Journal of Applied Corporate Finance* 1 (1992): 32 (hereafter cited as Rosenthal & Ocampo, "Securitization Benefits"); Steven L. Schwarcz, "The Alchemy of Asset Securitization," *Stanford Journal of Law, Business & Finance* 1 (1994-1995): 133 (hereafter cited as Schwarcz, "Alchemy of Securitization"); and Robert Dean Ellis, "Securitization Vehicles, Fiduciary Duties, and Bondholder's Rights," *Journal of Corporate Law* 24 (1998-1999): 295. The foregoing, and Schwarcz, "The Universal Language of International Asset Securitizations," *Duke Journal of International & Comparative Law* 12 (2002): 285 (hereafter cited as Schwarcz, "International Securitization"), provide readable introductions to securitization concepts, structures, and issues. See also Schwarcz, "Securitization Post-Enron," *Cardozo Law Review* 25 (2003-2004): 1539. Although limited to commercial mortgage-backed securitizations, the U.S. CMBS Legal and Structured Finance Criteria of Standard & Poor's (2003, with updates) (hereafter cited as *S&P Rating Criteria*) provides a comprehensive and detailed presentation of the many issues that must be considered and resolved if asset securitization *sukuk* are to be posited as a backbone of an Islamic capital market. For a good overview of a wide range of conventional securitization issues and current European practice in the commercial mortgage-backed securities markets, see Andre V. Petersen, ed., *Commercial Mortgage-Backed Securitization: Developments in the European Market* (Sweet & Maxwell, 2006) (hereafter cited as Petersen, *CMBS*).

Examples of the literature pertaining to specific types of securitizations include Patrick D. Dolan, "Lender's Guide to Securitization of Commercial Mortgage Loans," *Banking Law Journal* 115 (1998): 597; Dolan, "Securitization of Equipment Leases," *New York Law Journal* (August 11, 1999): 1; Dolan, "Lender's Guide to the Securitization of State Lottery Winnings and Litigation Settlement Payments," *Banking Law Journal* 115 (1998): 710; and Charles E. Harrell, et al., "Securitization of Oil, Gas, and Other Natural Resource Assets: Emerging Financing Techniques," *Business Lawyer* 52 (1996-1997): 885.

[4] See Rodney Wilson, "Overview of the *sukuk* market," in *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk,* eds. Nathif J. Adam and Abdulkader Thomas (Euromoney Books, 2004), 3.

participating in the transaction (the issuer, guarantor, or other credit support provider) rather than on specific assets and cash flows derived from those assets. Asset securitizations involve asset transfers from an originator into a trust or similar special purpose vehicle with *sukuk* issuance by that trust or vehicle and payments on the *sukuk* derived from the payments received with respect to those transferred assets. Most *sukuk* offerings to date have been of the bond type, and the ultimate credit in most of those bond offerings has been a sovereign entity. There have been very few true securitizations, largely because of the inability to obtain ratings from major international ratings firms for securitization *sukuk* issuances (ratings have been obtained for the sovereign bond issuances based upon the rating of the sovereign credit).

In 2003, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) issued the Standard for Investment *Sukuk* ("AAOIFI *Sukuk* Standard").[5] It defines *sukuk* as certificates of equal value put to use as common shares and rights in tangible assets, usufructs, and services, or as equity in a project or investment activity. The AAOIFI *Sukuk* Standard carefully distinguishes *sukuk* from equity, notes, and bonds. It emphasizes that *sukuk* are not debts of the issuer; they are fractional or proportional interests in underlying assets, usufructs, services, projects, or investment activities. *Sukuk* may not be issued on a pool of receivables. Further, the underlying business or activity, and the underlying transactional structures (such as the underlying leases), must be *shari'a*-compliant (the business or activity cannot engage in prohibited business activities, for example).

The AAOIFI *Sukuk* Standard provides for 14 eligible assets classes. In summary, there are securitizations: (1) of an existing or to-be-acquired tangible asset (*ijara* – lease); (2) of an existing or to-be-acquired leasehold estate (*ijara*); (3) of presales of services (*ijara*); (4) of presales of production of goods or commodities at a future date (*salam* – forward sale); (5) to fund construction (*istisna'a* – construction contract); (6) to fund the acquisition of goods for future sale (*murabaha* – sale at a mark-up); (7) to fund capital participation in a business or investment activity (*mudaraba* and *musharaka* – types of joint ventures); and (8) to fund various asset acquisition and agency management (*wakala* – agency), agricultural land cultivation, land management, and orchard management activities.

Some of the foregoing types of *sukuk* bear predetermined returns; others allow for the sharing of profit and, in some instances, loss. To date,

[5] *Shari'a* Standard No. 17 in *Shari'a Standards: The Full Text of Shari'a Standards as at Rabi' 1425H – May 2004* (Accounting and Auditing Organization for Islamic Financial Institutions, 2004).

most issued *sukuk* have been *sukuk al-ijara* bearing predetermined rates of return. The *sukuk al-musharaka* and the *sukuk al-mudaraba* are examples of profit- and loss-sharing *sukuk*.

Market participants desire to issue asset securitization *sukuk* in the near future.[6] A major challenge in implementing that desire is the ability to obtain ratings from major international ratings agencies on transactions that are dependent, at any level, upon laws in jurisdictions within the Organization of the Islamic Conference (OIC) and other jurisdictions and economies that desire to use *shari'a*-compliant financing techniques as their primary economic form (the *Islamic Economic Sphere*—jurisdictions and economies that use primarily interest-based financing techniques as their primary economic form are referred to as the *Western Economic Sphere*). The main impediments are discussed later in this essay and relate to characteristics of the relevant legal systems and the inability to obtain satisfactory legal opinions with respect to a range of enforceability issues, including true sales of assets and various bankruptcy law matters. Considerable legal reform is necessary in many jurisdictions to ensure sufficient certainty, predictability, consistency, and transparency in order to allow market and transactional participants to make risk assessments with comfort and confidence and to allow lawyers to render the necessary legal opinions. Absent the ability to make such assessments and obtain such opinions, the asset securitization *sukuk* market, and Islamic capital markets generally, will remain severely constrained.

Implementation of legal reform is a slow process (and, as a result, the movement toward securitization *sukuk* is likely to be a gradual process). However, there are organized efforts to define the necessary legal reforms. For example, the Islamic Financial Services Board (IFSB) is undertaking a broad survey of trust laws, securities laws, capital markets laws, and bankruptcy laws in an effort to identify and suggest necessary legal reforms so as to facilitate the development and growth of capital markets, including *sukuk* issuances and secondary trading. Efforts of this type hold the potential to ease constraints on the issuance of securitization *sukuk* in the Islamic Economic Sphere.

It seems probable that the initial asset securitization *sukuk* issuances will emanate from United States and European jurisdictions. These are likely to be securitizations of assets in those jurisdictions, rather than assets located in jurisdictions within the Islamic Economic Sphere.[7] The reasons

[6] For a discussion of the benefits of asset securitizations, see Rosenthal & Ocampo, "Securitization Benefits," and Schwarcz, "Alchemy of Securitization." See also Michael S. Gambro, "Selected Legal Issues Affecting Securitization," *North Carolina Banking Institute* 1 (1997): 131, and McMillen, "Contractual Enforceability,": 3-4.

[7] Prohibitions on *riba* (roughly translated as "interest") and on the sale of instruments that do not represent fractional undivided ownership interests in tangible assets present

for this are: (1) increased involvement in Islamic finance by international banks and investment banks; (2) those institutions have substantial *shari'a*-compliant assets (such as leased equipment and real estate) that are desirable investments for *shari'a*-compliant investors; (3) those institutions have significant securitization experience; and (4) importantly, those institutions can obtain the necessary ratings because the transactions can be structured entirely within jurisdictions where necessary legal opinions are readily obtainable. Unrated securitization *sukuk* may involve assets in jurisdictions within the Islamic Economic Sphere, but the issuers of those *sukuk* are likely to be located outside such jurisdictions in order to minimize true sale, bankruptcy and other enforceability issues. However, the market for unrated *sukuk* is likely to be dwarfed by the market for rated *sukuk* in the medium to long term.

In anticipation of the development of securitization *sukuk* (including whole business securitizations), this essay undertakes a general survey of the generic structures that will be used, or adapted for use.

Generic *Sukuk al-Ijara* Structures

The most widely used *shari'a*-compliant structure in real estate, equipment, and private equity finance is the *ijara* structure depicted in Figure 1 below.[8] In an asset acquisition, the Funding Company will

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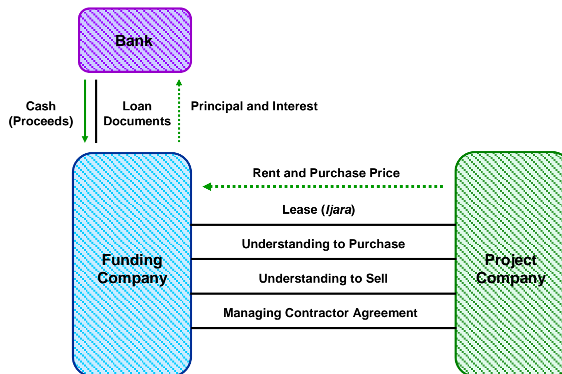
a seemingly insurmountable problem for securitization of many categories of conventional receivables, such as conventional mortgages and credit card receivables. Many of these receivables will never be made *shari'a*-compliant in and of themselves, but it seems likely that bifurcated structures will be developed to securitize these assets (just as conventional interest-based financing is now used in most international *shari'a*-compliant real estate and private equity financings).

[8] See McMillen, "Islamic Shari'ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies," *Fordham International Law Journal* 24 (2000-2001): 1184 at 1237-63 (hereafter cited as McMillen, "Fordham Project Finance Structures"); McMillen, "Islamic Shari'ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies," *The Proceedings of the Third Harvard University Forum on Islamic Finance: Local Challenges, Global Opportunities* (Cambridge: Harvard Islamic Finance Information Program, 2000), 111-31 (hereafter cited as McMillen, "Harvard Project Finance Structures"); and McMillen and Abradat Kamalpour, "An Innovation in Islamic Financing—Islamic CMBS" in Petersen, *CMBS,* 382-412 (hereafter cited as McMillen and Kamalpour, "Islamic CMBS"). McMillen, "Fordham Project Finance Structures" and McMillen, "Harvard Project Finance Structures," discuss the standard *ijara* structure in its earliest incarnations. McMillen and Kamalpour, "Islamic CMBS," focuses on basic *sukuk* structures using *ijara*, *murabaha* (sale at a mark-up), *mudaraba,* and *musharaka* structures. Many variations on this structure have been used, with particular adaptations as a result of tax and real estate regimes in different countries.

acquire the asset (usually from a third party) with conventional loan funds and equity from the Project Company (in which the *shari'a*-compliant investors make an investment). In a private equity transaction, the loan proceeds will allow the Funding Company to purchase some assets (usually much less than all of the operating assets) from the Project Company. In any case, the Funding Company will then lease the assets it holds to the Project Company pursuant to the Lease (*Ijara*). Pursuant to the Understanding to Purchase, the Funding Company (at the direction of the Bank) will be entitled to cause the Project Company to purchase the assets in certain circumstances (such as defaults). Pursuant to the Understanding to Sell, the Project Company will be entitled to purchase the assets in certain circumstances (voluntary retirements of the *sukuk* or sale of the asset to third parties). The purchase price under the Understanding to Purchase and the Understanding to Sell will be equal to the outstanding principal amount of the loan from time to time.

Figure 1: Generic *Ijara*

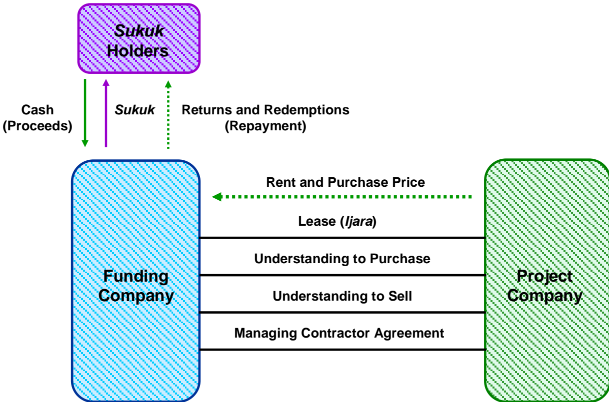


This structure can easily be converted to a number of different securitization structures. Figure 2 depicts a generic *ijara sukuk* in which the conventional interest-bearing loan by the Bank to the Funding Company is replaced by having the Funding Company engage in a *sukuk* issuance.[9] Rent from the Lease (*Ijara*) will provide periodic payments on the *Sukuk* and the payment of the purchase price under the Understanding

[9] Bankruptcy and other considerations may necessitate the insertion of a special-purpose issuance vehicle between the Funding Company and the *Sukuk* Holders; this modification is not illustrated. Throughout this essay, capitalized terms used in discussing specific structures and not otherwise defined are defined by reference to the Figure.

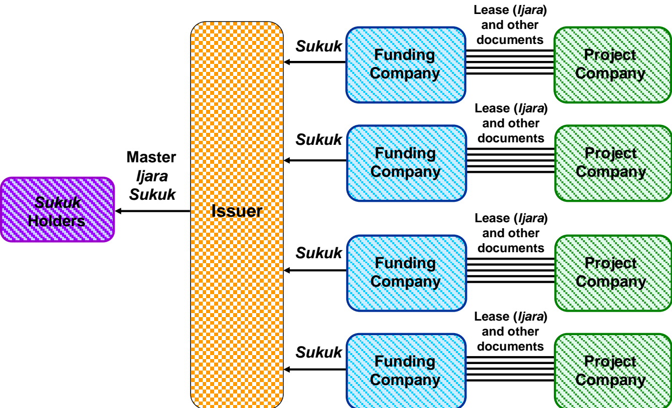
to Purchase or Understanding to Sell will be used to make payment of the outstanding principal amount of the *Sukuk* in mandatory or elective retirements of the *Sukuk* or a sale of the asset to a third party.

Figure 2: Generic *Ijara Sukuk*



Pooling opportunities are also afforded by this structure, as illustrated in Figure 3. For example, each Funding Company could issue a *Sukuk* to the Issuer, who would then issue a different Master *Ijara Sukuk* to the *Sukuk* Holders.

Figure 3: Generic Pooled *Ijara Sukuk*



In each of these structures, the rental stream from the various Leases (*Ijara*) can be structured to produce a precise cash flow on the *Sukuk* (and Master *Ijara Sukuk*), fixed or variable, based upon an amortization schedule or a bullet repayment. Another common adaptation allows creation of *sukuk* that have economic qualities similar to standard bonds, and these structures are currently common in the market. The structures are amenable to modification to achieve different accounting and tax results (such as ownership by either the Funding Company or the Project Company, as desired). As a general statement, trading in debt above or below par is an impermissible violation of *riba* precepts (being interest). On the other hand, the ability to trade freely in capital market instruments is critical for the creation of liquidity. The resolution of the apparent *riba* issue lies in the fact that an *ijara sukuk* represents a fractional undivided ownership interest in the underlying tangible assets rather than pure debt. Therefore, those *sukuk* can be traded above or below par as tangible asset trades.

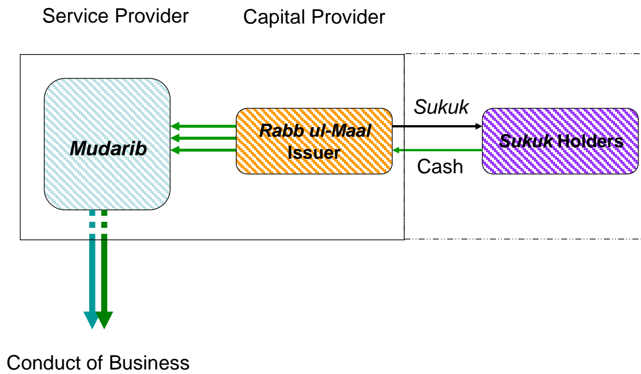
There are some limitations to the use of the *ijara sukuk*. For example, many originators do not own appropriate underlying assets that are subject to *shari'a*-compliant leases or can be made available for such leases during the *sukuk* term, and in many jurisdictions, there are significant adverse tax consequences (such as transfer taxes) associated with the introduction of the assets into a *sukuk* structure.

Ijara sukuk transactions to date have not been true pooled securitizations. They have used a limited number of discrete assets and are rated, not on the basis of pooled asset performance, but on the basis of the ultimate credit, the lessee, and the ultimate purchaser of the asset at maturity or default. Thus, most transactions to date are akin to bond financings.

Generic *Sukuk al-Mudaraba* Structures

The *mudaraba* structure may also be incorporated into a *sukuk* offering in a number of different variants of the *sukuk al-mudaraba*. A generalized generic form of a *sukuk al-mudaraba* is set forth in Figure 4.

Figure 4: Generic *Sukuk al-Mudaraba*



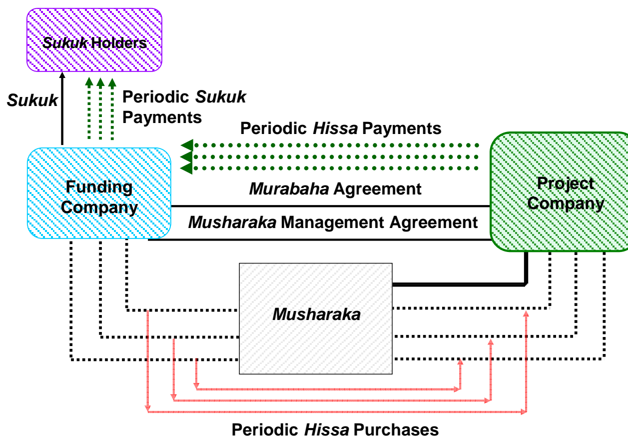
In the standard *mudaraba* structure, the *Mudarib* provides services and the *Rabb al-Mal* provides capital. In the *sukuk al-mudaraba*, the capital-contributing *Rabb al-Mal* Issuer obtains the capital by issuing a *Sukuk* to the *Sukuk* Holders. This is similar to a limited partnership or limited liability company. However, the *shari'a* principles applicable to allocations and distributions of profits and losses and the permissibility of capital contributions by the *Mudarib* will be quite different from secular limited partnerships or limited liability companies. Despite such differences, with careful tax structuring there are opportunities to allow the *Sukuk* Holders to achieve partnership tax treatment in this type of structure in some jurisdictions.

In investment funds, this *mudaraba* may constitute the entirety of the fund. In operating businesses, this may also be the only entity necessary for the conduct of the relevant business. In more complex project financings, this *mudaraba* will likely enter into joint venture and/or other contractual arrangements with other parties, such as project sponsors and other project participants. In current practice, however, the *sukuk al-mudaraba* is infrequently encountered. Some of the reasons relate to the fact that this is a partnership arrangement and institutional financiers tend to retain the view that their financing should be preferentially paid rather than being subject to the vagaries of successful operation of the enterprise, particularly where the venture is controlled by the client (*mudarib*) rather than by the financing institution. And this perception has not been limited to Western interest-based financing institutions. The successful use of the *sukuk al-musharaka* may change this perception on a broader basis.

Generic *Sukuk al-Musharaka* Structures

The Funding Company and the Project Company may form a *musharaka* joint venture to undertake a business venture. The *musharaka* may attain the advantages of *sukuk* financing by including the issuance of a *sukuk al-musharaka* in this structure. Each party may contribute capital to the *musharaka.* Each of the partners receives "units" or "*hissas*" in the *musharaka* in accordance with their respective capital contributions. The Funding Company's capital contribution is in cash and equals the proceeds of the *sukuk* issuance. The contribution of the Project Company may be in kind and in cash. A generic *musharaka* structure is depicted in Figure 5.

Figure 5: Generic *Sukuk al-Musharaka*



The *Musharaka* will be managed by the Project Company pursuant to the *Musharaka* Management Agreement. The parties will also enter into a *Murabaha* Agreement (or other purchase agreement) pursuant to which the Project Company will purchase *hissas* owned and held by the Funding Company from time to time on specified dates during the term of the *sukuk*. The Funding Company will receive profit distributions from the *musharaka* and the proceeds from sales of the *hissas* to the Project Company, which are distributed to the *Sukuk* Holders in accordance with agreed formulas.

One of the earliest transactions of this type was a 1997 Saudi transaction with respect to electric generation and transmission assets.[10] Three banks contributed both fixed and variable rate financing for the

[10] See McMillen, "Fordham Project Finance Structures," 1184-1236.

construction of the assets by purchasing *hissas* in an undisclosed *sharikat mahassa* (the *musharaka*) as construction milestones were completed. One bank acted as the administrative and finance manager of the *sharika*, and the electric utility acted as the technical manager of the *musharaka*. At defined times, in accordance with a financing amortization schedule, *hissas* were sold by the banks to the utility pursuant to a *murabaha* agreement in order to effect repayment of the financing.

The *musharaka* structure has not been unanimously accepted by *shari'a* scholars. One area of discussion among the scholars relates to the pricing of the *hissas* being sold to the Project Company. Some scholars take the position that the price of the *hissas* must be established at the time of the sale to the Project Company and cannot be established at the inception of the *Murabaha* Agreement for a serial purchase arrangement. The reasoning is that a sale price that is in excess of the market price would represent a disproportionate share of the *musharaka* profit. Another line of discussion focuses on the compulsory nature of the *hissa* purchase and sale. A selling partner would be obligated to sell if the buying partner (the Project Company) elects to purchase, but the buying partner cannot be compelled to purchase. Some *shari'a* scholars have required that a series of *murabaha* agreements be executed, one at the time of each *hissa* sale and purchase. A further point of discussion relates to the provisions of the Musharaka Management Agreement that restrict profit entitlements and limit loss allocations to the bank partners (or the *sukuk* holders).

Careful structuring with respect to the matters addressed in the preceding paragraph, and the acceptance of existing *musharaka sukuk* structures by some of the more influential *shari'a* scholars, will ensure that the *musharaka sukuk* will remain a securitization vehicle in Islamic finance.

Generic *Sukuk al-Murabaha* Structures

There have been a number of *sukuk* issuances based upon *murabaha* transactions. As a general matter, these are of three types: (1) an Operating Company purchases an asset using the proceeds of a *sukuk* issuance and retains ownership of that asset; (2) the *Sukuk* Holders are participating in a *murabaha* transaction itself (akin to a bond); and (3) a number of deferred *murabaha* payment obligations constitute the pool upon which the *sukuk* is issued (akin to a true securitization). Figure 6 illustrates a bond-type *sukuk*.

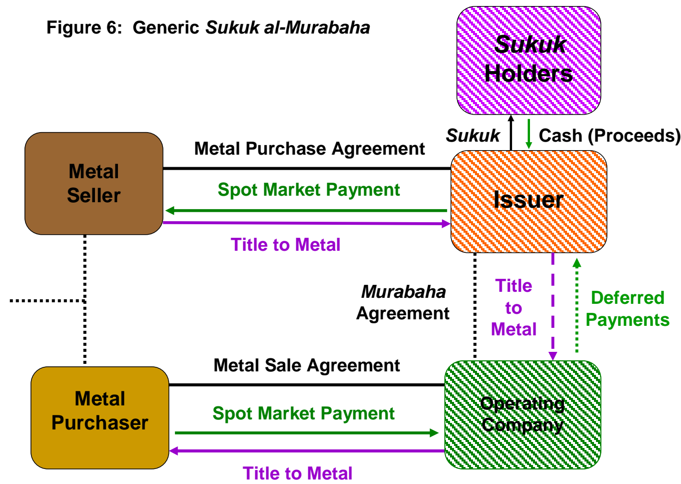
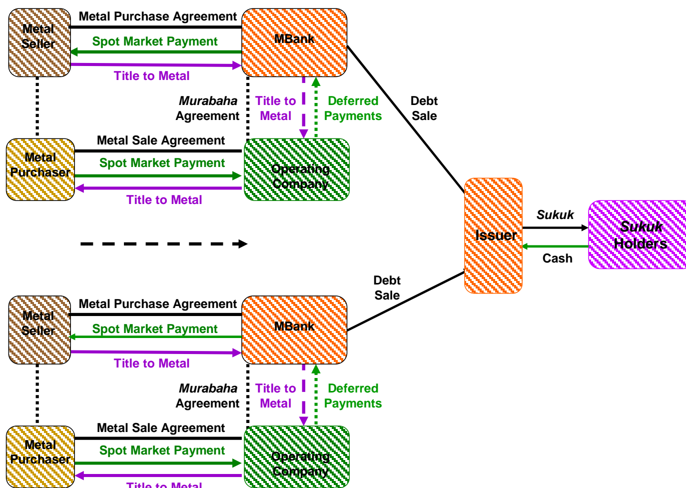


Figure 6: Generic *Sukuk al-Murabaha*

The *sukuk al-murabaha* is issued to the *Sukuk* Holders by the Issuer. The *Sukuk* represents a "participation interest" in the underlying *murabaha* transaction. The issuance proceeds are used to purchase metal on the spot market. The metal is then sold to Operating Company on a deferred-payment basis, and Operating Company sells the metal to the Metal Purchaser on the spot market. The net result is that the Operating Company holds cash equal to the spot market price of the metal which it can use in its operations, and the Operating Company has a deferred-payment obligation on the *Murabaha* Agreement that is used to service the *Sukuk*. Periodic issuances are possible.

Figure 7 illustrates a *murabaha sukuk* in which the deferred *murabaha* payment obligations under a pool of *murabaha* transactions are pooled, and the Issuer sells a *sukuk* off of that pool.

Figure 7: Generic Pooled *Sukuk al-Murabaha*



It is clear from a review of the two *murabaha sukuk* structures that the party needing financing (Operating Company) obtains cash only by selling the tangible asset (the metal or other asset). Thus, on an on-going basis, this *sukuk* does not represent an ownership interest in a tangible asset—the asset has been sold. Only the deferred debt obligation remains after sale of the asset. *Ijara sukuk* are tradable above and below par because they are structured to represent fractional undivided ownership interests in tangible assets. The issue is significantly more difficult for a securitization or pooled *murabaha sukuk*.

Some scholars have taken the position that *murabaha* debt is not tradable unless it continues to be backed by assets. Other scholars have taken the position that a *murabaha sukuk* that is not backed by assets is tradable at par, but not at a premium or discount to par. Other scholars, mostly in Southeast Asia, have taken the position that the deferred debt obligation arose in and through a *shari'a*-compliant transaction, and may thereafter be the basis for a tradable *sukuk*, including at a premium or discount. The purchase of the *murabaha* debt (the "Debt Sale" element in Figure 7) can therefore be problematic from a *shari'a* point of view. This issue is particularly acute if the debt needs to be sold at a discount (as is the case in many conventional securitizations) in order to achieve credit enhancement of the underlying pool of *murabaha* debt that will ultimately back the *sukuk* for ratings purposes.

The 2003 Solidarity Trust Services Limited trust certificates issuance of the Islamic Development Bank (IDB), a seminal *sukuk* issuance, addressed some of these issues. The pool of assets underlying the *sukuk*

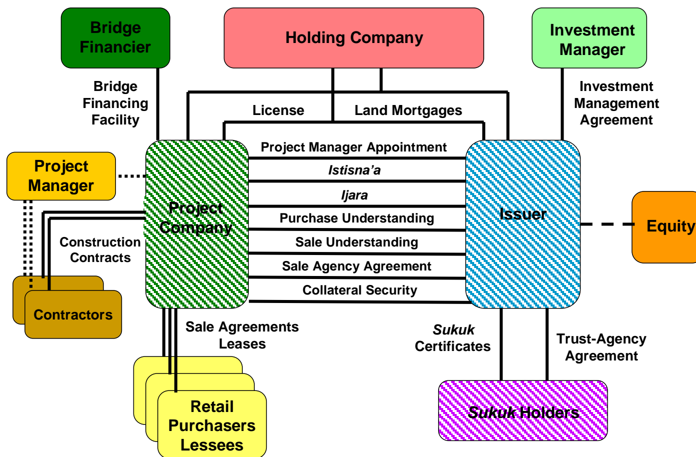
were *ijara*, *murabaha,* and *istisna‘* (construction contract) payment obligations. In order for the *sukuk* to be tradable, including at a premium over or discount to par, the *Shari‘a* Board required that not less than one-third of the obligations in the pool must be *ijara* obligations on tangible assets owned and leased in a *shari‘a*-compliant manner. Although this structure involved the pooling of various *shari‘a*-compliant obligations, it was not a true rated asset securitization. The IDB guaranteed pool performance to the Issuer, and this guarantee was the basis for the rating. The issue thus resembled an IDB bond issue. An important feature of the structure was the ability to replace *shari‘a*-compliant obligations constituting part of the pool with other compliant obligations. This feature provides the basis for developing *shari‘a*-compliant structures akin to conventional collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs).

Bahrain Financial Harbour *Sukuk*

The July 2005 Bahrain Financial Harbour *Sukuk* provides an example of a *shari‘a*-compliant financing that combines a number of the structural elements described in this essay, most notably the *istisna‘* and the *ijara*. The structure also includes a *shari‘a*-compliant interim investment mechanism and a *shari‘a*-compliant bridge financing facility. Figure 8 provides a graphic summary of the overall documentary structure of the financing transaction.

The Project is comprised of the development and construction of the “Financial Centre Development Phase” of the Bahrain Financial Harbour Project (i.e., the Dual Towers (East and West), the Financial Mall, and the Harbour House Facilities) located in Manama, Kingdom of Bahrain. The financing of the development and construction of the Project is provided by the issuance of the *Sukuk* Certificates and limited equity investments in the Project. As construction payments are periodic throughout the construction period, the proceeds of the *sukuk* issuance are invested in certain *shari‘a*-compliant investments pursuant to the Investment Management Agreement until drawn with respect to those construction payments.

Figure 8: Overall Transaction: Documentation



The *Sukuk* Certificates were registered, certificated, and transferable. [11] Each certificate represents an undivided beneficial ownership interest in the Trust Assets (as hereinafter defined), and the sole recourse of *Sukuk* Holders is to the Trust Assets. The certificates provide for periodic distributions on a quarterly basis in an amount equal to LIBOR plus 2.5 percent per annum. The redemption price is equal to 100 percent of the face value of the *Sukuk* Certificates (each in an amount of US $10,000). Early redemptions are payable from excess funds. Dissolution events include events of default, total loss events, and certain other events. There will be total redemption of the certificates upon a total loss of the project.

The "Trust Assets" include (1) completed "Project Segments" and all interests in the "Project Land," (2) the rights of Al Marfa'a Al Mali Sukuk Company B.S.C. (the "Issuer") under the "Transaction Documents," including the "Security Documents," (3) the rights of the Issuer to amounts

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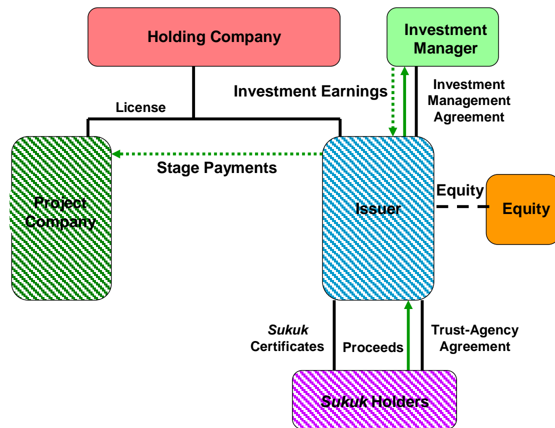
[11] A number of issues arise during the early stages of construction with respect to rent payments on the *ijara* where physical assets have not yet been constructed to the point of "economic sufficiency" so as to enable the payment of rent. In the context of a *sukuk*, there is a similar set of issues pertaining to the ability to trade the *sukuk* above or below par value prior to construction of the physical assets to the state of required economic sufficiency. Many *shari'a* scholars, if not most, take the position that trading of *sukuk* certificates is not permissible prior to that time. This issue was addressed in the Bahrain Financial Harbour *Sukuk* offering by noting the issue and leaving the *shari'a* determination to the individual certificate holder.

(including earnings) in its bank accounts, (4) any proceeds of the sale or lease of Project Segments, (5) certain "Eligible Investments," including those pursuant to the Investment Management Agreement, (6) all insurance proceeds received by the Issuer, and (7) all insurance proceeds relating to the Project Land.

Figure 9 provides a graphic illustration of the initial entity formation, the equity and *sukuk* proceeds infusion, and the general nature of the Stage Payments with respect to the completion of construction milestones.

Figure 9: Entity Formation, *Sukuk* Sale, General Payment Mechanism



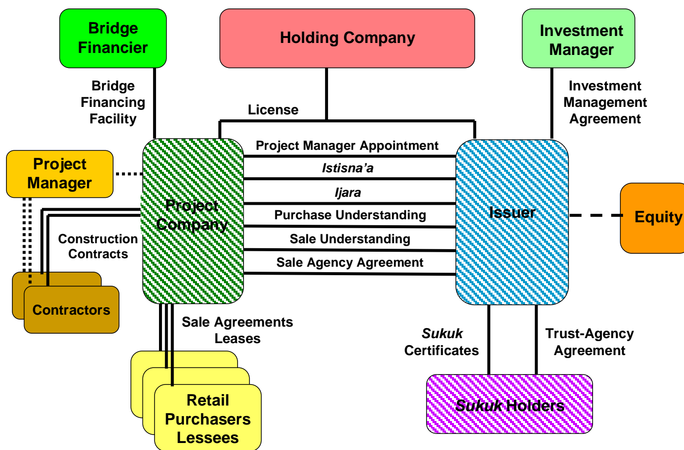
Before summarizing the cash infusion, it is essential to note that the Holding Company holds all legal and beneficial title to the "Land," which includes the Project Land and a broader parcel of land. The Holding Company grants a License to the Issuer and the Project Company giving the Issuer the rights and permissions to develop and carry out all necessary work to construct the Project on the Project Land. The Holding Company will subdivide the Land, and in connection therewith, transfer the legal and beneficial title to the Project Land to the Project Company. The Project Company is deemed to have made the same grant to the Issuer after acquisition of title to the Project Land as the Holding Company made at the inception of the transaction.

To allow issuance of the *Sukuk* Certificates, the Trust and Agency Agreement is entered into, and the Issuer acts as both trustee and agent on behalf of the *Sukuk* Holders. The equity investment and the proceeds from issuance of the *Sukuk* Certificates are deposited with the Issuer. The Issuer then transfers those proceeds to the Investment Manager for investment pursuant to the Investment Management Agreement. As and when Stage

Payments are required from time to time with respect to the construction of the Project, funds are drawn from the Investment Manager and paid over to the Project Company. The Project Company will ultimately pay these Stage Payments to the various construction subcontractors.

The elements of the transaction that are necessary to effect construction and repayment of the *Sukuk* Certificates are summarized in Figure 10.

Figure 10: Structural Elements for Construction and *Sukuk* Repayment



To effect construction of the Project, the Issuer and the Project Company appoint a Project Manager to oversee construction. The Issuer and the Project Company also enter into the *Istisna'* pursuant to which the Project Company will cause the construction of the Project pursuant to Construction Contracts overseen by the Project Manager.

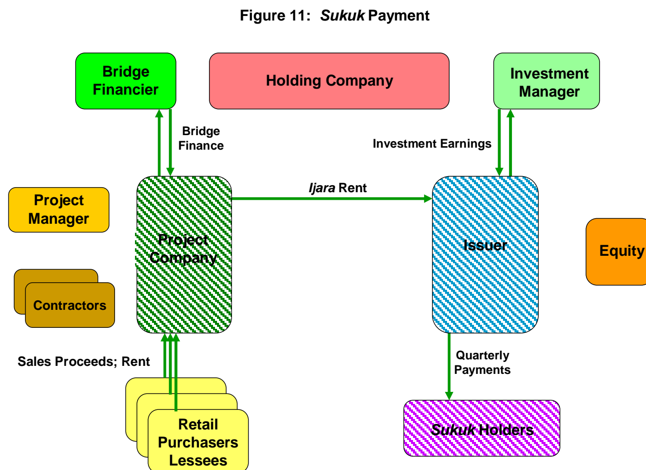
The Issuer leases the Project Land to the Project Company pursuant to a forward *Ijara*. Advance rentals are paid with respect to each uncompleted Project Segment and rentals are paid with respect to each completed Project Segment. Ancillary Lease Letter Agreements (not shown in Figure 10) relate to the specific lease terms applicable to each Project Segment. The Purchase Undertaking and the Sale Undertaking are executed between the Issuer and the Project Company. Under the Purchase Undertaking, the Project Company will purchase the Project upon the election of the Issuer in certain circumstances (such as defaults). Similarly, under the Sale Undertaking, the Issuer will sell the Project Segments upon the election of the Project Company in certain circumstances (such as the sale of Project Segments, or portions thereof, to third parties). The

Purchase Undertaking and the Sale Undertaking are essentially the same as the Understanding to Purchase and the Understanding to Sell in the standard *ijara* structure used for acquisition financings and construction and development financings.[12] The Issuer and the Project Company also enter into the Sale Agency Agreement. Like the Managing Contractor Agreement in such a standard *ijara* structure, the Project Company agrees to perform certain maintenance and insurance obligations for the Issuer and agrees to sell or rent various aspects of the Project to Retail Purchasers and Lessees. The funds from such sales and rentals are an important element of the cash flows that will be available for repayment of the *Sukuk* Certificates.

Finally, the Project Company obtains a *shari'a*-compliant revolving Bridge Financing Facility from the Bridge Financier. This facility is primarily for the payment of rent shortfalls under the *Ijara*. The Issuer is not a party to this Bridge Financing Facility and cannot initiate remedies under the Bridge Financing Facility. However, the Issuer does benefit from certain representations and warranties provided under the Bridge Financing Facility. The Issuer can also initiate certain drawings under the Bridge Financing Facility, and is entitled to default notices under the Bridge Financing Facility.

The structural elements for repayment of the *Sukuk* Certificates being in place, the cash flows for their repayment are summarized in Figure 11.

Figure 11: *Sukuk* Payment

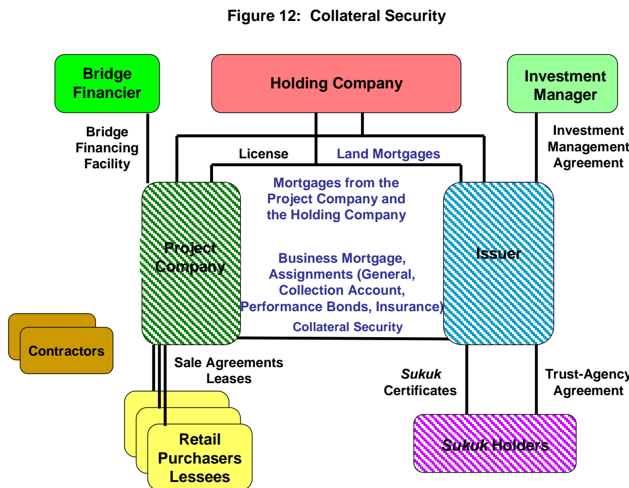


[12] See McMillen, "Fordham Project Finance Structures," 1237-1263, and McMillen, "Harvard Project Finance Structures," 111-131. The Understanding to Purchase, Understanding to Sell, and Managing Contractor agreements are discussed in these articles.

The primary sources of funds for repayment are the proceeds from sales by the Project Company of Project Segments, or portions thereof, and rentals obtained by the Project Company for the rental of Project Segments. Shortfalls in any given period may be covered by drawings on the Bridge Finance Facility. These are paid by the Project Company to the Issuer as *Ijara* Rent and then to the *Sukuk* Holders with respect to quarterly payments. It is also possible to draw upon the investment earnings and amounts invested with the Investment Manager to cover other shortfalls in the quarterly payments.

The final aspect of the structure that should be considered is the collateral security package that is made available for the benefit of the *Sukuk* Holders. This collateral security package is graphically summarized in Figure 12.

Figure 12: Collateral Security



The first element of the collateral security package consists of the Land Mortgages. These consist of a present Land Mortgage over the Land (including the Project Land) from the Holding Company to the Issuer. There is also a Land Mortgage Side Letter pursuant to which the Holding Company agrees to subdivide the Land and transfer legal and beneficial ownership in the Project Land to the Project Company. Upon such transfer, the Project Company will also grant a Land Mortgage to the Issuer.

The second element of the collateral security package is comprised of a group of security documents from the Project Company to the Issuer. The primary security documents are (1) a Business Mortgage pursuant to which the Project Company grants a security interest in all of its assets, including uncompleted Project Segments, (2) a General Assignment

pursuant to which the Project Company grants a security interest in all of its contractual rights, licenses, benefits, and receipts in relation to the Project, (3) a Collection Account Assignment pursuant to which the Project Company grants a security interest in all proceeds from time to time in the Collection Account (being all amounts received from sales and rentals of Project Segments), (4) a Performance Bond Assignment pursuant to which the Project Company grants a security interest in all of its rights and benefits under performance bonds and advance payment guarantees, and (5) an Insurance Assignment pursuant to which the Project Company grants a security interest in certain insurance proceeds.

SUKUK: CAPITAL MARKETS AND SECONDARY MARKETS

Bond and securitization issuances and secondary market trading in these issuances are primary structural elements of capital markets—particularly secondary markets—in global finance. Bond issuances focus on the economic viability of the issuing entity as an operational entirety, whether it is a governmental or private sector entity. The primary economic focus in an asset securitization is a discrete pool of assets. The entity focus in such a securitization is of relevance as a secondary structural matter; the focus on the entity is designed to ensure that the entity does not interfere with the realization of benefits on the underlying assets.

While both bonds and pooled securitization vehicles are essential elements for the functioning of vibrant capital markets, securitizations have particular benefits for the market participants. They both allow and require broad asset diversification, and thus broad risk diversification. They allow asset originators to manage their balance sheets by transferring assets off those balance sheets to a larger, more diversified investor base. The originator receives immediate cash payments for the transferred assets, which can be used to generate more assets, without disrupting the deferred payment mechanism afforded to the asset user or the financing investor in those assets. The securitization process also allows greater risk management and liquidity management for all market participants. The securitization vehicle results in reduced financing costs for the originator of the assets.[13]

As noted above, the two different types of *sukuk* are equivalent to bond and securitization issuances, and their effective structuring and use should allow Islamic finance to integrate seamlessly into the global capital markets at both the primary and secondary levels. Most *sukuk* issuances to date have been of tradable certificates in the nature of bonds (rather than

[13] For literature on the benefits of securitization, see note 3 above.

asset securitizations). Yet there has been very little actual trading of these certificates. In part this is due to the quality of most of those issuances. However, it is also due to the lack of capital market access and the absence of secondary markets in the field of Islamic finance.

The questions that come to the fore relate to the factors that have inhibited or impeded the growth of Islamic capital markets. These factors can be summarized into two general categories: (1) institutional market factors and (2) legal enforceability factors. The latter category can be subdivided into (a) general systemic factors and (b) factors specific to asset securitizations and similar transactions.

Market Factors

The primary market-related inhibitors and impediments affecting Islamic capital markets and secondary markets may be summarized as:

(1) the lack of market volume and the absence of program issuers at all levels, particularly the absence of government sponsored entities that have been critical to the development of capital markets in other jurisdictions;[14]
(2) the degree of market fragmentation, including with respect to: (a) countries, (b) currencies, (c) the state of legal and regulatory development, (d) the degree of elucidation of, and agreement on,

[14] Historically, governmental institutions and government sponsored entities have been critical to the development of securitization markets and related secondary markets. In the United States, institutions such as the Federal National Mortgage Association (FNMA or Fannie Mae), the Federal Home Loan Mortgage Association (Freddie Mac), the Government National Mortgage Association (GNMA or Ginnie Mae), and the Student Loan Marketing Association (SLMA or Sallie Mae), among others, have been particularly effective in helping to establish broad secondary markets and in otherwise realizing the benefits of securitization. For example, participation of these entities in the securitization markets has helped develop the relevant legal and regulatory framework, fostered and overseen the development of standards and standardized documentation, and helped generate volume and depth of the markets. Governments and quasi-governmental agencies have acted as regulators, enablers, issuers, and purchasers of securitized instruments and related securities, with profound effects on the capital and secondary markets and the effectuation of monetary policy. See Richard D. Jones, *Commercial Mortgage Backed Securities—The Emergence of CMBS*, in Petersen, *CMBS*, 1-17; Shenker & Colletta, "Asset Securitization," 1373-1420; and "Comment: An Overview of Commercial Mortgage Backed Securitizations: The Devil Is in the Details," *North Carolina Banking Institute* 1, 288 at 291-296, for concise histories of the development of mortgage-backed securities, including the involvement of government-sponsored entities.

applicable *shari'a* standards, (e) the degree of incorporation of the *shari'a* into applicable secular laws, and (f) disjuncture resulting from the operation of both Islamic and conventional interest-based markets in the same realms;
(3) underdevelopment of markets;
(4) market illiquidity;
(5) excessive concentration of risks;
(6) the absence of agreed-upon market standards for risk allocation among market participants, and the correlative absence of implementing standards and standardization with respect to transactional documentation, participant roles, and market procedures, practices, and guidelines;
(7) the lack of *shari'a*-compliant currency swaps, rate swaps, and other hedging mechanisms;[15]
(8) inconsistencies and uncertainties with respect to enforcement of agreed-upon risk allocations;
(9) the absence or underdevelopment of necessary and appropriate legal infrastructure;
(10) lack of specialization; and
(11) human resource scarcities, including with respect to qualified *shari'a* scholars and experienced financial, legal, accounting, and other professionals of all types.

Enforceability Factors

Certainty, predictability, consistency, and transparency are critical elements of any effective legal and financial system. They are critical to achieving risk minimization, systemically and transactionally, and are thus a focus of governments, regulators, market participants, and transaction participants. However, of equal (if not greater) importance is the degree of certainty that an agreed-upon set of risk allocations (whether or not minimized) will be given effect by the legal and financial system. This is equally true whether the commercial and financial activity is predicated on interest-based principles or *shari'a* principles.

Consideration must be given to both the general structure and the operation of the legal and financial system, and to its operation with respect to specific capital markets transactions, in this case *shari'a*-

[15] There are initiatives to develop standardized *shari'a*-compliant hedging mechanisms, including an initiative of the International Swaps and Derivatives Association (ISDA). However, given the *shari'a* requirements that tradable instruments represent an ownership interest in tangible assets, and the prohibitions on the sale and purchase of debt and similar instruments, this is a particularly challenging area in Islamic finance.

compliant asset securitizations utilizing *sukuk* structures.[16] For the purposes of this essay, these considerations are distilled to a focus on whether the risk allocations that are agreed upon among the market participants will be enforced. Those risk allocations are embodied in (1) the structure and operation of the relevant legal system, (2) the substantive and procedural laws of the relevant jurisdictions, (3) contracts and specific transactional requirements,[17] and (4) relevant market and institutional practices and procedures, including the obtaining of ratings from prominent rating agencies.[18] The opinions of qualified lawyers will be provided as to each of these matters, sometimes as a general market matter, and at other times in the course of product structuring and as a

[16] More detailed discussions of the issues addressed in this section are found in DeLorenzo and McMillen, "Law and Islamic Finance," 154-186; McMillen, "Contractual Enforceability," 8-40; and McMillen "Islamic Capital Markets," 153-166.

[17] For some provocative thoughts on the origins and similarities of Islamic law and Anglo-American common law, see John A. Makdisi, "The Islamic Origins of the Common Law," *North Carolina Law Review* 77 (1998-1999): 1635. For thoughts on the similarities between Islamic law and Anglo-American law with respect to the concept of contracts and obligations, see Frank E. Vogel and Samuel L. Hayes III, "Law and Islamic Finance: Risk, Religion and Return," *Kluwer Law International* (1998): 66-68; E. Allan Farnsworth, "Parables and Promises: Religious Ethics and Contract Enforceability," *Fordham Law Review* 71 (2002-2003): 695; and Abdul Jalil Al-Rawi, "Principles of the Islamic Law of Contracts," *George Washington Law Review* 22 (1953-1954): 32. Vogel, Hayes, and Farnsworth each discuss specific Qura'nic covenants and injunctions with respect to the enforceability of promises and obligations, as well as commentary on those covenants and injunctions.

With respect to contracts and liquidity as important elements of risk reduction, see Peter L. Bernstein, *Against the Gods: The Remarkable Story of Risk* (New York: John Wiley & Sons, 1996). In summarizing the explanation developed by Kenneth Arrow and Frank Hahn on the relationship between money, contracts, and uncertainty, he states: "In business, we seal a deal by signing a contract or by shaking hands. These formalities prescribe our future behavior even if conditions change in such a way that we wish we had made different arrangements. At the same time, they protect us from being harmed by the people on the other side of the deal. . . . [T]he past and the future are to the economy what woof and warp are to a fabric. We make no decision without reference to a past that we understand with some degree of certainty and to a future about which we have no certain knowledge. Contracts and liquidity protect us from unwelcome consequences, even when we are coping with Arrow's clouds of vagueness" (205). The essence of these explanations and arguments as to the importance of contracts is predicated on a series of presumptions as to the stability and predictability of the enforcement of those contracts.

[18] On ratings criteria in respect of European commercial mortgage-backed securities, see Judith O'Driscoll, "Standard & Poor's Rating of European CMBS: Legal and Structural Considerations," in Petersen, *CMBS*, 60-72. With respect to United States commercial mortgage-backed securities, see *S&P Rating Criteria*, particularly, "Section Four: Special-Purpose Bankruptcy-Remote Entities," 89-98 and "Section Five: Legal Opinions," 99-114 for a thorough discussion of the major requirements.

precondition to closing of individual transactions. Examples include the necessity of obtaining legal opinions of qualified lawyers (x) as a critical element of the ratings process where the absence of satisfactory legal opinions will preclude the issuance of a rating for a particular *sukuk* issuance, and (y) as a precondition to the financial closing of any individual transaction. The remainder of this essay considers various existing legal inhibitors and impediments to the development and growth of Islamic capital markets (including secondary markets), with a particular focus at the transactional level on *sukuk* issuances.

STRUCTURE AND OPERATION OF THE LEGAL SYSTEM

At the most general level, the structure and operation of the relevant legal system must be considered.[19] Considerations at this level include: (1) whether the relevant legal system is based upon a system of binding precedents; (2) whether legal and arbitral decisions, and the rationale for those decisions, are published and widely available; (3) whether the judicial structure is responsive to continuity, consistency, and transparency in the application of judicial precedents; and (4) the timeframe for enforcement of remedies within the system.

As a general matter, there are significant systemic impediments with respect to many (if not all) of the foregoing matters in most of the jurisdictions within the Islamic Economic Sphere. The concept of binding precedent is often totally absent. Decisions are rarely published. In many jurisdictions, each case is considered *de novo* and without regard to other decisions rendered in similar cases. Judges and other adjudicators are afforded wide and unfettered discretion in determining cases. The time-frame for enforcement is frequently so long that it precludes effective remedies, particularly in fast-moving markets such as the capital markets. The old saw that "justice delayed is justice denied" is too frequently a comment on reality in many jurisdictions.

Each of these factors is frequently cited by international securitization and capital markets institutions as a reason for their reluctance to engage in capital markets initiatives in the Islamic Economic Sphere. Each of these factors is also cited as an exception to legal opinions that must be rendered in capital markets transactions (or a factor precluding the issuance of any legal opinion). And each of these factors is cited by major international ratings agencies as problematic and among the primary reasons that asset

[19] On matters addressed in this subsection, see DeLorenzo and McMillen, "Law and Islamic Finance," 154-186; McMillen, "Contractual Enforceability," 8-40; and McMillen, "Islamic Capital Markets," 153-166.

securitization *sukuk* involving these jurisdictions have not yet been rated. These are substantial impediments to growth of the securitization markets (and thus the capital markets, including secondary markets) in these jurisdictions, and there should be immediate focus on the removal, or a satisfactory alleviation, of these impediments.

SUBSTANTIVE AND PROCEDURAL LAWS

Capital markets transactions, including *sukuk* transactions, involve a wide range of both Islamic and conventional multinational banks and financial institutions as participants, and participation by both *shari'a*-compliant and conventional participants. They also conform to both the *shari'a* and at least one body of secular law.[20] A critical inquiry focuses on the issue of whether the principles and precepts of the *shari'a* will be legally enforced in any given circumstance, with respect to any given structure, product, or transaction, and to any given jurisdiction, which in turn gives rise to consideration of a wide range of related questions.[21]

By way of context, consider first the degree to which the *shari'a* is or is not incorporated into the law of any given jurisdiction. At one end of the spectrum are jurisdictions, such as the United States, the United Kingdom,

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[20] With respect to the matters addressed in this subsection, see DeLorenzo and McMillen, "Law and Islamic Finance, 164-165. The Bahrain Financial Harbour *Sukuk* transaction discussed in this essay is illustrative of the range of participants. Examples of other *shari'a*-compliant transactions involving a range of participants and jurisdictions are discussed in McMillen, "Fordham Project Finance Structures," 1237-1263; McMillen, "Harvard Project Finance Structures," 111-131 (see note 8 above); McMillen, "*Shari'a*-Compliant Finance Structures and the Development of an Islamic Economy," in *The Proceedings of the Fifth Harvard University Forum on Islamic Finance: Islamic Finance: Dynamics and Development* (2003), 89-102; McMillen, "Islamic Finance Review 2005/2006: A Year of Globalization and Integration" and McMillen, "Raising the Game of Compliance: People and Organizations," both in *Euromoney Islamic Finance Year in Review 2005/2006* (2006): 1-12 and 70-75; McMillen, "Shari'a-compliant real estate finance in Europe," in *Euromoney 2006 Guide to Opportunities and Trends in Islamic Finance* (2006): 10-13; McMillen, "Structuring Shari'ah-Compliant Transactions Involving Non-Compliant Elements: Use of the Nominate Contracts" (a paper presented at the Islamic Financial Services Board conference, Islamic Financial Services Industry and the Global Regulatory Environment Summit 2004, May 18-19, 2004, in London); and McMillen, "Special Report U.S. Briefing: Islamic Finance: Breaking the Mould," *Middle East Economic Digest (MEED)* 38 (September 22, 2000): 28-29, describing some of the earliest *shari'a*-compliant transactions in the United States involving Middle Eastern investors.

[21] Consider, in this regard, DeLorenzo and McMillen, "Law and Islamic Finance" 161-162.

Japan, South Korea, and most Western jurisdictions, in which the secular law does not incorporate any element of the *shari'a* (*Purely Secular Jurisdictions*). At the other end of the spectrum are jurisdictions in which the *shari'a* comprises the entirety of the secular law. Most jurisdictions within the Islamic Economic Sphere incorporate the *shari'a* into the secular law to some greater or lesser extent (and are referred to as *Shari'a-Incorporated Jurisdictions*).

While the *shari'a* is not incorporated into the secular law in Purely Secular Jurisdictions, enforcement of the *shari'a* is still obtainable in these jurisdictions. In current practice, this is accomplished by structuring the relevant contracts in such a manner that they are compliant with the *shari'a* in the opinion of the *shari'a* scholars that pass on the specific transaction, albeit without mention of *shari'a* in those contracts. Western lawyers will then render legal opinions that those contracts are "valid and binding agreements, enforceable in accordance with their terms," which is the standard opinion language of remedies or enforceability opinions.

The more difficult and uncertain situation in Purely Secular Jurisdictions is whether the relevant contracts will be enforceable if and to the extent that those contracts are made subject to the *shari'a* as a governing law concept applicable to those contracts, or incorporate *shari'a* principles and precepts as contractual terms. The most recent relevant appellate court decision is the English case, *Shamil Bank of Bahrain E.C. (Islamic Bankers) v. Beximco Pharmaceuticals Ltd. and Others* ("*Shamil Bank v. Beximco*").[22] This case focused on the governing law provisions of the relevant legal contracts in a *shari'a*-compliant financing (and refinancing) arrangement. The contracts contained the following language: "Subject to the principle of the Glorious *Shari'a,* this Agreement shall be governed by and construed in accordance with the laws of England." In summary, the appellate court, like the lower court, determined that the governing law clause did not require consideration of the *shari'a*.

The court determined that only one law can govern enforceability of the contractual provisions, in this case the law of England, not both English law and the *shari'a*. This is in accord with principles of national

[22] *Shamil Bank of Bahrain E.C. (Islamic Bankers) v. Beximco Pharmaceuticals Ltd. and Others*, [2004] EWCA Civ 19, [2004] All ER (D) 280 (Jan), 28 January 2004. This case is analyzed in further detail, with respect to the matters addressed in this subsection, in DeLorenzo and McMillen, "Law and Islamic Finance," 166-172; McMillen, "Contractual Enforceability," 15-21; Andreas Junius, "Islamic Finance—Issues Surrounding Islamic Law as a Choice of Law under German Conflict of Laws Principles," *Chicago Journal of International Law* 7 (2007): 537; and Kilian Bälz, "Islamic Financing Transactions in European Courts," in *Islamic Finance: Current Legal and Regulatory Issues*, ed. S. Nazim Ali (Cambridge, MA: Islamic Finance Project, Harvard Law School, 2005).

sovereignty. The parties are entitled to choose the applicable law of the contract,[23] but the law so chosen must be the law of a country,[24] which precludes the choice of the *shari'a* which is a set of "Islamic religious principles"[25] and "religious and moral codes,"[26] rather than the law of a nation. The court next noted that, acknowledging English law as the governing law, the contract may incorporate provisions of another foreign law or a set of rules as terms of the contract whose enforceability is to be determined by such national law.[27] The court determined that, in the instant case, the references to the *shari'a* were insufficiently specific and precise to be effective under these doctrines.[28]

While the decision leaves many questions unaddressed and unanswered, it does provide a basis for the argument that the *shari'a* may be enforced by virtue of its incorporation into a contract that is enforceable under the laws of England or New York or another Purely Secular Jurisdiction—if the relevant *shari'a* principles and precepts being incorporated are sufficiently specific and other aspects of relevant choice of law or conflicts of laws principles are satisfied. There is an implication from the opinion that incorporation in those circumstances might be considered to be analogous to incorporation of provisions of the French Civil Code, the Hague Rules, or the Harter Act. In any such incorporation, of course, the relevant *shari'a* principles and precepts being incorporated would have to be sufficiently specific and the incorporation would have to be in compliance with other applicable legal doctrines. Customary limitations would apply. These include, by way of example, (1) limitations pertaining to illegal acts or acts contrary to public policy, which cannot be the subject of a valid and enforceable contract, (2) limitations relating to contractual contravention of a paramount law, such as a constitution or, in certain *Shari'a*-Incorporated Jurisdictions, the *shari'a* itself, and (3) limitations pertaining to unwaivable and mandatory legal provisions (which most frequently apply to matters where the sophistication and

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[23] *Shamil Bank v. Beximco*, at paragraph 48, citing Article 3.1 of the Rome Convention ("a contract shall be governed by the law chosen by the parties"). Paragraph 40 summarizes the similar finding of the lower court.

[24] *Shamil Bank v. Beximco*, at paragraph 48, citing Article 1.1 of the Rome Convention ("the rules of this Convention shall apply to contractual obligations in any situation involving a choice between the laws of different countries"). Paragraphs 40, 42, and 43 summarize the lower court's similar finding on this issue of interpretation.

[25] *Shamil Bank v. Beximco*, at paragraph 54. See also paragraph 40 with respect to the characterization of this matter by the lower court.

[26] *Shamil Bank v. Beximco*, at paragraph 55. See also paragraph 40 with respect to the characterization of this matter by the lower court.

[27] *Shamil Bank v. Beximco*, at paragraphs 50–52, citing Dicey & Morris, *The Conflict of Laws*, 13th ed. Vol 2, 32-086 and 32-087.

[28] *Shamil Bank v. Beximco*, at paragraph 52.

bargaining power of the parties are disparate). The (preclusive) difficulty at present is that an adequate degree of specificity may be difficult to achieve given the absence of compilations of *shari'a* principles and precepts. Development of "model laws" for each of the main nominate contracts and transactional structures would address the incorporation issue in terms of specificity.[29]

Turning to *Shari'a*-Incorporated Jurisdictions, the degree to which the *shari'a* is incorporated in the secular law of the land varies considerably from jurisdiction to jurisdiction.[30] In some jurisdictions, the *shari'a* is described as "a" source of law, to be considered at some level of the hierarchy of judicial analysis. In other jurisdictions, the *shari'a* is described as "the" paramount law or source of law. In most jurisdictions, portions of the *shari'a* are incorporated, either legislatively or judicially, into codes that are otherwise purely secular and not necessarily *shari'a* compliant. Whatever the degree of incorporation of the *shari'a,* different schools of Islamic jurisprudence will be applied in different jurisdictions. Enforcement bodies and procedures, which vary markedly from jurisdiction to jurisdiction, may have a significant impact on whether and to what extent incorporated *shari'a* principles and precepts are given effect.[31] Given that the *shari'a* is itself not incorporated in a comprehensive writing, and given the factors noted in this essay under the heading, "Enforceability Factors: Structure and Operation of the Legal

[29] For a more detailed discussion of the structure and implementation of such model laws, see McMillen, "'Enforceable In Accordance With Its Terms': A Proposal Pertaining to Islamic *Shari'a*," Fourth Meeting of the Council and Second Meeting of the General Assembly of the Islamic Financial Services Board, Bali, Indonesia, 2 Raby' al-awal 1425 H.E., April 2, 2004 (hereafter cited as McMillen, "Enforceability Proposal").

[30] For a review of the extent to which the laws of various Middle Eastern nations have been and are comprised of the *shari'a*, and the extent to which other legal principles are incorporated in the laws of such nations, see Ann Elizabeth Mayer, "Islam and the State," *Cardozo Law Review* 12 (1990-1991): 1015; Nayla Comair-Obeid, *The Law of Business Contracts in the Arab Middle East* (Boston: Kluwer Law International, 1996), particularly chapter 3; and David Bonderman, "Modernization and Changing Perceptions of Islamic Law," *Harvard Law Review* 81 (1967-1968): 1169. The discussion in this section, to the extent that it addresses the integration of the *shari'a* into the law of various nations, is based in part upon these sources. See also Majid Khadduri, "Islam and the Modern Law of Nations," *American Journal of International Law* 50 (1956): 358, and Noel J. Coulson, *Commercial Law in the Gulf States* (London: Graham and Trotman, 1984). See also Noel J. Coulson, *A History of Islamic Law* (Edinburgh, 1964) and Joseph Schacht, *An Introduction to Islamic Law* (Oxford, 1964), as general histories of Islamic law.

[31] Consider, for example, the discussion in McMillen, "Fordham Project Finance Structures," 1193-1203, with respect to enforcement entities in the Kingdom of Saudi Arabia.

System," it is difficult to determine with certainty, predictability, and consistency, whether and to what extent a given contractual set of risk allocations will be enforced in many jurisdictions within the Islamic Economic Sphere, an obvious impediment to the growth of capital markets.

LEGAL OPINIONS IN FINANCING (INCLUDING *SUKUK*) TRANSACTIONS GENERALLY

In virtually all transactions, including *shari'a*-compliant transactions, and in both Purely Secular Jurisdictions and *Shari'a*-Incorporated Jurisdictions, the parties will require that their counsel or opposing counsel provide a series of legal opinions. Two sets of opinions are usually required. One set (the "entity authority" opinions) will address the due formation and valid existence of the participating entities under relevant applicable law. The second (the "enforceability" or "remedies" opinions) will address the validity and binding effect, and enforceability, of the relevant documents.[32]

"A remedies opinion deals with the question of whether the provisions of an agreement will be given effect by the courts."[33] The essence of the enforceability or remedies opinion is that each of the "undertakings"[34] in the contracts to which the client is a party are enforceable under the designated law governing the contracts, and the

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[32] See, with respect to the matters addressed in this subsection, DeLorenzo and McMillen, "Law and Islamic Finance," 174-195, and McMillen, "IFSB *Shari'a* Enforceability Proposal."

[33] "Third Party 'Closing' Opinions: A Report of the TriBar Opinion Committee," *Business Lawyer* 53 (1998): 592 (hereafter referred to as "TriBar Report"), at page 619. See also "Special Report by the TriBar Opinion Committee: Use of the ABA Legal Opinion Accord in Specialized Financing Transactions," *Business Lawyer* 47 (1992): 1720 (the "TriBar Specialized Financing Report"). See also "Third-Party Legal Opinion Report, including the Legal Opinion Accord, of the Section of Business Law, American Bar Association," *Business Lawyer* 47 (1991): 167 at Section 10, "The Remedies Opinion," and the definition of "Remedies Opinion" in the Glossary thereof.

[34] The TriBar Report notes that *all* undertakings in the agreements with respect to which the enforceability opinion relates are covered by the opinion. See "TriBar Report," 621. The TriBar Report, at footnote 69, notes that coverage of all undertakings is based upon New York custom and practice, and that not all jurisdictions so interpret opinions. The variance noted in footnote 69 is that of the "1989 Report of the Committee on Corporations of the Business Law Section of the State of California Regarding Legal Opinions in Business Transactions," *Business Lawyer* 45 (1990): 2169. That report endorses a narrower definition of the scope of the enforceability opinion, limiting the coverage of the opinion to only "material" provisions of the agreements that are the subject of the enforceability opinion. It is important to be familiar with the scope of the enforceability opinion in the governing law jurisdiction.

standard formulation is that "the agreements are valid and binding obligations of the Company, enforceable against the Company in accordance with their terms."[35] This opinion is customarily delivered at the closing of the transaction, and its delivery is usually a precondition to the closing of that transaction. Under customary practice,[36] the remedies opinion covers three distinct, but related, matters: (1) it confirms that an agreement has been formed; (2) it confirms that the remedies provided in the agreement will be given effect by the courts; and (3) it describes the extent to which the courts will enforce the provisions of the agreement that are unrelated to the concept of breach.

One of the more significant impediments to the growth of Islamic capital markets relates to the exceptions and exclusions that have been taken with respect to the enforceability opinion summarized above. Exceptions and exclusions to the opinion are set forth in the opinion itself. Customary exceptions and exclusions that are acceptable to transactional parties (and rating agencies) include certain defined circumstances where, under applicable law, the opinion recipient will not have a remedy for a breach of any "undertaking" by the other party to the agreement, or a remedy specified in the agreement (such as specific enforcement) will not be given effect by the courts under the circumstances contemplated.[37] For example, virtually every matter noted under the heading "Enforceability Factors: Structure and Operation of the Legal System" in this essay has been taken as an exception or exclusion to legal opinions rendered in connection with *sukuk* or other *shari'a*-compliant transactions. Thus, for example, exceptions and exclusions have been taken for (1) the absence of binding precedent concepts, exacerbating uncertainties noted below with respect to the *shari'a*, (2) the fact that laws are not always published or widely available, (3) the absence of published decisions and determinations, (4) the effect of lengthy judicial procedures on the practical realization of transactional benefits, (5) the fact that the *shari'a* is comprised of general principles, rather than specific legal requirements, making application in a specific transaction difficult to determine,[38] (6) the fact that different schools of Islamic jurisprudence interpret relevant *shari'a* principles and precepts differently and inconsistently, resulting in similar uncertainties as to application in any given transaction, (7) the lack

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[35] See the relevant opinion language in DeLorenzo & McMillen, "Law and Islamic Finance," 187-195 (see Appendix 1).

[36] "TriBar Report," 620.

[37] Exceptions and exclusions are discussed in greater detail in DeLorenzo & McMillen, "Law and Islamic Finance," 174-195.

[38] Consider, for example, the section entitled "Substantive and Procedural Laws" above and the *Shamil Bank v. Beximco* case discussed in that section with respect to exceptions.

of uniform statements of relevant *shari'a* principles and precepts,[39] (8) the great degree of discretion in a court in these jurisdictions, (9) the uncertainty of remedies within these jurisdictions, and (10) the fact that many of these jurisdictions will not enforce foreign judgments and, even where they will enforce foreign arbitral awards, may infuse the *shari'a* into a review of that award pursuant to public policy doctrines.[40]

Other exceptions and exclusions have been taken with respect to specific organizational, procedural, or substantive matters that are particular to a specific country or judicial or other dispute resolution authority. For example, one set of exceptions and exclusions in a Middle Eastern jurisdiction relates to an exclusion from the jurisdictional authority of a dispute resolution authority that prohibits an award of interest or lost earnings after the day of filing of the action, no matter what the duration of the action before that authority.

Focusing on *sukuk* transactions, there are a number of critical opinion issues. To date, law firms have had difficulty rendering opinions on each of these critical matters. As a result, rating agencies have declined to rate *sukuk* issues (other than bond-type *sukuk* that are based upon a sovereign credit and *sukuk* focused on assets located in the United States).[41]

As a generic matter, and in its simplest form, a securitization involves (1) an originator of assets, (2) an issuer of the *sukuk* or other instrument, which is a trust or SPV, (3) a parent of the issuer, (4) a payer or payers with respect to the assets being securitized, and (5) a purchaser-holder of the *sukuk* or other security. By sale, the originator of the assets transfers the assets to be securitized into the issuer. The issuer sells a *sukuk* to the purchaser and uses the proceeds of that sale to pay the originator for the transferred assets. Over time, the payer or payers make payments to the issuer who then transfers those payments to the *sukuk* purchaser as the holder of the *sukuk*. The issuer provides collateral security over the assets to the *sukuk* holders to secure the payment of the *sukuk*.[42]

The critical inquiries, for opinion purposes,[43] relate to, among other things, transfer and bankruptcy issues.[44] For example, the securitized

[39] See McMillen, "IFSB Enforceability Proposal."
[40] See the discussion of enforcement of foreign judgments and awards in McMillen, "Fordham Project Finance Structures," 1199-1203.
[41] Other areas of the legal infrastructure are not considered in this essay, largely because of the tremendous diversity over different jurisdictions. These include tax law, real estate law, competition law, and corporate law, among many other areas of applicable law.
[42] For further summaries of standard transactional securitizations, see sources in notes 3 and 44 above.
[43] Rating agencies consider a range of other factors pertaining to credit matters. See, for example, *S&P Rating Criteria* (see note 2 above).

assets must be isolated for the benefit of the *sukuk* holders. In the simplest case, the critical elements are that: (1) all right, title, interest, and estate in and to the securitized assets are transferred by the originator to a bankruptcy remote special purpose issuer vehicle, and (2) that issuer must grant a first priority perfected (or perfectible) security interest over those assets to secure payments on the *sukuk* and other claims of the *sukuk* holders. This, in turn, focuses inquiry on (a) the transfer of the assets from the originator to the issuer and (b) the priority, perfection, and enforceability of the security interests granted in the securitized assets provided as collateral for the benefit of the *sukuk* holders. The concomitant examination is made through review of the documentation and through the obtaining of a legal opinion that addresses all of the transactional issues. Looking to the primary substantive legal opinions,[45] the following are the primary areas addressed by the legal opinions:[46]

(1) True sale of the securitized assets to the issuer by the originator such that the transfer will not be re-characterized as a secured loan or otherwise avoided in the bankruptcy of the originator;
(2) The nature of title in the issuer such that the transfer is either perfected or perfectible at the election of the issuer;[47]

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[44] See *S&P Rating Criteria*, 99-114 and 89-98. The literature on bankruptcy-related issues in securitizations is extensive. Examples include Schwarcz, “Alchemy of Securitization”; Schwarcz, “International Securitization”; “Note: Asset Securitization: How Remote Is Bankruptcy Remote?,” *Hofstra Law Review* 26 (1997-1998): 929; Christopher W. Frost, “Asset Securitization and Corporate Risk Allocation,” *Tulane Law Review* 72 (1997-1998): 101; Thomas J. Gordon, “Securitization and Executory Future Flows as Bankruptcy-Remote True Sales,” *University of Chicago Law Review* 67 (2000): 1317; Lois R. Lupica, “Asset Securitization: The Unsecured Creditor’s Perspective,” *Texas Law Review* 76 (1998): 595; and Lupica, “Comment: Transplanting Asset Securitization: Is the Grass Green Enough on the Other Side?,” *Houston Law Review* 38 (2001-2002): 541. With respect to… {ed: something missing here; ask author?} and the Convention on the Assignment of Receivables in International Trade, Appendix to the Report of the United Nations Commission on International Trade Law (“UNCITRAL”) on its 34th Session (2002) GAOR supp. no. 17 (A/56/17), and www.uncitral.org, see Harry C. Sigman and Edwin E. Smith, “Toward Facilitating Cross-Border Secured Financing and Securitization: An Analysis of the United Nations Convention on the Assignment of Receivables for International Trade,” *Business Lawyer* 57 (2001-2002): 727.

[45] Entity organization opinions are critical, and are obtained, but are not discussed in this essay. These opinions address formation of relevant entities, due authorization of the transaction by all entities, and due execution of all documentation.

[46] Other categories that must be covered by legal opinions in asset securitization transactions include tax matters, corporate matters, and transaction-specific matters.

[47] Historically, *shari‘a* scholars have had differing views on the permissibility of separation of legal and equitable title to assets (which occurs in a perfectible asset

(3) Whether the assets are transferred to the issuer free of liens;
(4) Non-consolidation of the assets of the issuer in a bankruptcy of the originator or the parent of the originator;
(5) Bankruptcy remoteness of the issuer itself to ensure that (a) the issuer conducts only a specified business and (b) the issuer's assets are distributed in accordance with the agreed-upon financing structure rather than according to a different legally imposed paradigm;
(6) The collateral security structure for the benefit of the *sukuk* holders, and whether the same are first prior perfected or perfectible interests, including in bankruptcy scenarios;
(7) Enforceability of the transactional documents, as discussed above;
(8) Whether the documentary choice of law will be given effect in each of the respective jurisdictions involved in the transaction; and
(9) Whether judgments and awards in the various jurisdictions involved in the transaction will be enforced in the other jurisdictions of relevance.

Suffice it to say that exceptions and exclusions have been taken in *sukuk* transaction legal opinions with respect to each and every one of the foregoing matters, and those exceptions and exclusions have been of sufficient gravity as to significantly impede the growth of Islamic capital markets. For example, as applied to *sukuk* and other financing structures, the laws applicable to title transfers, liens, consolidation and other bankruptcy matters, collateral security (especially perfection), and choice of governing law are quite unclear and uncertain, and the application of those laws is neither transparent nor predictable. As another example, the enforcement of foreign judgments and awards—although the subject of more experience—is problematic.[48] Some countries will not enforce foreign judgments and arbitral awards. Some will enforce foreign arbitral awards, but not foreign judgments. In some jurisdictions, the extent and degree of enforcement of foreign judgments and awards is not entirely clear, particularly in *shari'a*-compliant transactions where it is arguable that the *shari'a* is a matter of public policy in certain of the enforcing jurisdictions (and thus raises public policy exception issues in virtually every such jurisdiction).[49]

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transfer). If separation of legal and equitable title is not permissible, legal title would have to be transferred in a manner that satisfies all of the applicable perfection requirements (including notification of the payer).

[48] See McMillen, "Fordham Project Finance Structures," 1195-1203.

[49] See McMillen, "Fordham Project Finance Structures," 1195-1203, for a discussion of enforcement mechanisms in the Kingdom of Saudi Arabia.

CONCLUSION

One of the most exciting developments in Islamic finance is the emergence of the *sukuk* as a viable *shari'a*-compliant "debt side" alternative. AAOIFI has laid the groundwork for expansive use of the *sukuk* vehicle and a range of *sukuk* structures have been developed. Some of those structures are summarized in this essay. The lead has been taken by various sovereigns that have issued bond-type *sukuk* that are, at some level, dependent upon the sovereign credit. Realization of the benefits of asset securitization is widely anticipated and broadly sought, through implementation of asset securitization *sukuk* issuances. Whether those instruments will serve as the backbone of a debt-side Islamic capital market and become the nidus for growth of secondary trading in the Islamic economy depends in large part upon the will of governments as well as industry participants and industry organizations to address a range of market and legal inhibitors and impediments. This essay has surveyed some of those impediments and inhibitors, and focused on two general categories: those that are market-related, and those that relate to the legal system. Many of the market factors are being resolved as a function of the growth and increasing sophistication of the Islamic finance markets themselves. Many of these impediments and inhibitors will be removed and resolved just by virtue of the continued growth of the markets in these capital market areas.

The more daunting impediments and inhibitors are those arising from the structure and operation of the relevant legal systems, and the substantive and procedural elements of those legal systems. Short-term adaptive solutions are available (many are now being used; others will undoubtedly be devised). Long-term resolution of these matters, however, will entail not only effort within the Islamic finance industry by industry participants, but also the involvement of governments in a process of fundamental legal reform and clarification, with an eye to coordinated international integration of Islamic finance and markets with conventional interest-based markets. Failure to remove and resolve the legal impediments and inhibitors will constrain capital market growth, thereby limiting the growth of the entire Islamic finance industry, while also limiting the ability of the markets to resolve existing market inhibitors.

Thus, what is needed is a movement to coordinated action, broad-based industry and government involvement in the process, encouragement for the involvement of a broader range of professionals from both the Islamic finance and the conventional finance sectors (private and governmental), and support for reform and clarification undertakings, including those now in process. This essay attempts to join those calling for further consideration of the necessary legal reforms and clarifications, and in identifying impediments and inhibitors, this essay attempts to refine

the focus of reform and clarification efforts in certain legal areas. The spirit of this essay is one of optimism based upon all that has been addressed and achieved in the field of Islamic finance in the last decades, and with a view toward a future in which there is a true Islamic capital market.

Regulating *Sukuk* in Indonesia: Challenges for Implementation

Reza Djojosugito[1]

Due to the differences between the *shari'a* and the conventional legal systems, regulations pertaining to the issuance of *sukuk* need special consideration. This is especially true in the Indonesian case, where the number of legal structures that can be chosen for the issuance of *sukuk* is very limited due to the basic building blocks of the law. While compliance to the principles of *shari'a* is paramount in any issuance of *sukuk*, lack of proper regulation may lead to a situation where some aspects of the *sukuk* transaction are not determined according to *shari'a*.

Indonesia has embarked on a path to regulate *sukuk*. However, since it is a relatively new concept, the regulation regimes for *sukuk* have tended to be reactive rather than proactive, particularly regarding the structure of the *sukuk* transaction. In light of this situation, it is imperative that proper regulation concerning the issuance of *sukuk* be implemented in Indonesia.

At the moment, the mobilization of resources in Indonesia is done through *shari'a* bonds (the terminology is used for lack of a better term). The *shari'a* bond is meant to be a *sui generis* bond that has characteristics that differ from conventional bonds.[2] The *shari'a* bond has been sanctioned and is not regarded as a debt instrument by the National *Shari'a* Board. However, Indonesian laws have a different view of them.

This issue has the potential to attract unnecessary debate, and therefore it is prudent to approach the issue of resource mobilization through other methods. In this juncture, asset securitization seems to be an optimal choice. Looking back at the successful issuance of conventional asset-backed securities between 1996 and 1997 in Indonesia, it is worth

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[1] Legal Office, OPEC Fund for International Development, Vienna, Austria.

[2] Among the different characteristics are that the *shari'a* bond is not a debt instrument, and that the related coupons payments do not represent interest.

exploring the possibility of applying the techniques, with some modifications, to Islamic institutions.[3]

This paper argues for the introduction of legal reforms that would create a legal environment that would lay a foundation for effective regulations for Islamic asset securitization. The paper begins by explaining why asset securitization is the most appropriate financing for resource mobilization for Islamic institutions, and why the existing legal regime in Indonesia is not fully equipped to deal with it, thus requiring the introduction of certain reforms.

THE IMPORTANCE OF ASSET SECURITIZATION

While asset securitization is just one among many vehicles that can be employed for resource mobilization, it can be demonstrated that this vehicle is the most suitable one in the case of developing Islamic financial instruments in conventional environments. The subsection below explains the importance of asset securitization in this context.

Asset Securitization and the Ideal Islamic Banking System

Islamic banking is part of a broader system of Islamic economics that aims to introduce a system of Islamic values and ethics into the economic sphere. The concept of Islamic banking involves more than simply determining how to do banking according to Islam. It is the embodiment of submission to Allah, through adherence to Islamic precepts in all banking activities. Based on this tenet, Islamic banking can be defined as a system of banking that provides just financing, is free from factors unlawful to Islam, and offers benefits not only to the shareholder of the bank but also to the other stakeholders.

Some basic characteristics of Islamic banking can be identified. First, the prohibition of charging exorbitant profit is rooted in an element of justice. The distribution of profit depends upon the magnitude of risk assumed, while the distribution of loss is based on the ability of one to bear such losses. Moreover, Islamic banking is participatory in nature. An

[3] See Neil Campbell, *Securitization in Asia: A Legal Overview* (Hong Kong: Asia Law & Practice Publishing and Euromoney Publications, 1998), 4. Even though there are some doubts about the deals as to whether the sale of the receivables can be regarded as "a legal true sale," the outcome of some domestic transactions (such as the auto-loan securitization for Astra in 1996) suggests that it is possible under Indonesian law to securitize Indonesian receivables and achieve true sales. However, it is true that most of the transactions are cross-border and were completed out of Indonesia.

Islamic bank is supposed to assume all normal risks of business that a businessperson would assume. Profit or loss, irrespective of its quantum, should be shared between the bank and the customer. Return on the bank's investment is normally not the function of time, and when the return is predetermined, it is predetermined in absolute terms and not affected by any delay or prepayment.

Consequently, it is sufficient to say that Islamic banking should avoid the potentially huge divergence between real assets and real liabilities, which may translate into a profit-and-loss sharing (PLS) banking with some elements of morality and justice.[4]

However, in practice, Islamic banking mostly employs a non-PLS mode of financing on the assets side. The heavy reliance on the non-PLS mode often attracts sharp criticism. Critics comment that most Islamic finance techniques used today are no different in substance from those of conventional finance, and that the superficial distinction between Islamic and conventional finance lies mainly in the use of Arabic terms, or in the employment of disguised trade transactions that in substance are similar to those of conventional transactions. Even though this notion can be refuted by myriad *shari'a* justifications for the restricted application of certain conventional techniques, it is sufficient to say that efforts should be directed toward the revival of the early concept of double-tier *mudaraba* in Islamic banking in order to minimize the negative effects of such criticisms.[5]

In this context, assets securitization can play a significant role in conjunction with project finance. Such a connection will enable and encourage the creation of true double-tier *mudaraba*, which has been

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[4] Equality and justice are the core principles of an Islamic economic system. These principles are manifested mainly in the form of prohibition of interest. However, the Islamic ban on interest does not mean that the capital is "free of charge" in an Islamic system. Islam recognizes capital as a factor of production but it does not allow this factor to make a prior or predetermined claim on the productive surplus in the form of interest. The permissible alternative is the profit-sharing system. The reason behind rendering profit-sharing admissible in Islam as opposed to interest is that in the case of the former it is only the profit-sharing ratio, not the rate of return itself, that is predetermined. Another rationale for Islamic finance is that wealth should be put into productive use in order that others may share in its benefits. It is therefore unjustified to charge interest for the mere use of money. The owner of wealth should invest it in a productive and real transaction. Profit-sharing is only one side of the coin. The other side is that losses should also be shared between the parties that can bear such losses. However, the inability to bear a loss will exonerate such obligation.

[5] It should be stressed here that it may be unrealistic to completely eliminate the element of debt and non-PLS instruments in the Islamic banking system. However, the point that the author makes here is that the double-tier *mudaraba* should form the dominant facet of Islamic banking.

difficult to implement so far. This mechanism can create an internal system that allows the matching of different maturities of the first-tier *mudaraba* (on the deposit side) with the second-tier *mudaraba* (on the asset side),[6] and allows for clarity regarding the source of the stream of income.[7]

In the structure based on the two-tier *mudaraba* model, depositors place their funds as a *mudaraba* deposit in the bank, which in turn invests the funds through *mudaraba* in several projects. Such *mudaraba* is structured as a non-recourse project finance transaction using leasing as a main vehicle where the repayment of the financing was convened only to actual revenues generated by the project. Then, each individual project is securitized and sold back to the bank. Because all projects are converted into marketable quasi-equity security, the risk of maturity mismatch between the first-tier *mudaraba* and the second-tier *mudaraba* can be avoided.

Alternative Method for Resource Mobilization

In the absence of a *shari'a* money and capital market, the only available option for resource mobilization is utilization of the existing conventional infrastructure, as long as such an infrastructure does not oppose the principles of *shari'a*. For that purpose, the capital market presents the most appropriate solution to this problem. As long as the means of mobilizing the capital is *shari'a* compatible, the structure is acceptable. The recent Indonesian experience with the issuance of *shari'a* bonds (in the form of *mudaraba* or *ijara* bonds) proved this point. However, this success is not without legal problems. While the trading of debt is not permitted by *shari'a*, the legal status of *shari'a* bonds is still that of a debt.

The conventional instrument that is most compatible with *shari'a* is the equity instrument. However, for any institution considering issuing a

[6] One factor that creates difficulty in matching the first-tier *mudaraba* and the second-tier *mudaraba* is the illiquid nature of the *mudaraba*. By using asset securitization, the second-tier *mudaraba* becomes liquid, making the redemption of the first-tier *mudaraba* much easier, even in the case of the maturity mismatch between the first and second-tier *mudaraba*.

[7] The certainty of the source of income can be achieved through other Islamic methods of financing, such as simple and straightforward *mudaraba*. However, in the case of multiple investors and multiple investments, it is difficult to trace the source of income. While it is theoretically possible to do so through production of several account books, namely one book for each category of investor, tracing the source of income for each investor can create an administrative nightmare. The other example is *murabaha*. While the source of income in this type of financing is also certain, the use of *murabaha* itself has always attracted criticism because the mode of financing is very similar in substance to a conventional loan.

debt-like instrument, changing its issuance into equity or giving up its equity position is not always desirable, as it can dilute their interest or simply prove to be too expensive. Therefore, the desired alternative is to find a quasi-equity instrument that behaves like a debt, yet has all the necessary characteristics to qualify it as equity. In this juncture, the viable alternative is an instrument created through securitizing the assets of such an institution or any subsidiary thereof.

INDONESIAN PRESENT ENVIRONMENT AND PRACTICES

For quite some time, Indonesia has had laws related to *shari'a* banking. Indonesian laws have adopted a dual banking system through the promulgation of Law No. 10 year 1998 concerning amendments to the banking law,[8] forming a legal basis for the development of Islamic banking in Indonesia, and through Law No. 23 year 1999[9] concerning Bank Indonesia,[10] which paved the way for the creation of the *shari'a* based regulatory and supervisory frameworks. The attempt to create a *shari'a* environment was quite promising, and Bank Indonesia has been very active in this regard. Soon after the promulgation of Law No. 10 year 1998, which gave Bank Indonesia the power to supervise and regulate the banking sector in Indonesia,[11] it promulgated several Bank Indonesia Regulations (*Peraturan Bank Indonesia*) that were intended to regulate Islamic banking. The regulatory regimes are quite comprehensive, covering almost every facet of Islamic banking.

However, this is not the case for other financial institutions. Other *shari'a* financial institutions or instruments such as asset securitization do not enjoy the same privileges that Islamic banks do. Other *shari'a* financial institutions or instruments have to rely on the laws of the conventional system. Unfortunately, those laws are not always very compatible with *shari'a*.

[8] *State Gazette* No. 182 (1998).
[9] *State Gazette* No. 66 (1999).
[10] The Indonesian Central Bank.
[11] See Article 24-35 of Law No. 23 year 1999. It is to be noted that under the previous banking regime in Indonesia, despite the fact that BI set and administered the operative rules and regulations related to banking operations, it was the Ministry of Finance that had the ability to enforce the rules, through its authority to issue and revoke banking licenses. See A. Nasution, "An Evaluation of the Banking Sector Reforms in Indonesia, 1983-1993," *Asia Pacific Development Journal* 1 (June 1994): 78.

Laws and Practices Related to Asset Securitization

Although asset securitization is one of the most important mechanisms for finance, Indonesia has not passed any comprehensive laws for asset securitization. There has been, however, an attempt by the government of Indonesia to create such a law.[12] Unfortunately, the draft law, if not modified, will face some issues of compatibility with Islamic legal principles. The problematic provision of the draft law is one that clearly states that securitization can only be conducted over debts.[13]

However, despite the absence of laws at the level of statutes, the law was implemented at the level of regulations in the capital market field.[14] In regard to assets securitization, the Indonesian Capital Market Supervisory Agency (BAPEPAM) has since 1997 issued regulations on asset-backed securitization. In particular, BAPEPAM issued regulation No. IX.K.1 on Asset Backed Securities. It governs the elements of a typical asset securitization. However, it still has some characteristics that are not favorable to the issuance of Islamic asset securitization. It is particularly doubtful whether the vehicle may be used as a vehicle for Islamic *sukuk*. Asset securitization according to such a regulation is done through a vehicle named *Kontrak Investasi Kolektif*, or Collective Investment Contract (CIC), between the portfolio manager and the custodian bank on behalf of the investors. This arrangement seems to attempt to mimic a trust special-purpose vehicle (SPV) for achieving bankruptcy remoteness. In this arrangement, the investment manager has the task of managing the portfolio while a custodian bank becomes a collective depository of the securities. Originators sell their receivables together with the attached security to the CIC. The CIC investment manager responsible for the portfolio, in turn, issues asset-backed securities for investors. The funds raised are transferred to the originators as contracted, and the servicing of the receivables is normally contracted back to the originators.

[12] At present, the Draft Law on Asset Securitization is being considered in the relevant ministries of the Republic of Indonesia.
[13] See Article 3 of the Draft Law on Assets Securitization. This will create difficulties for Islamic financial institutions, as s*hari'a* prohibits selling debts at discount.
[14] The Indonesian capital markets are regulated by the Ministry of Finance through the Indonesian Capital Market Supervisory Agency (BAPEPAM). Under the Capital Market Law of 1995, BAPEPAM sets policy guidelines and regulations and is responsible for the day-to-day supervision of the capital markets. In essence, it has the power to interpret laws and legislation on matters within its jurisdiction, and to establish rules and issue independent decrees to that effect.

The Legal Issue of Sale of Debts

The most important aspect of asset securitization is that the sale of debt should be done as a "true sale" transaction to achieve the bankruptcy remoteness of the transferred assets.[15] The requirement of the Indonesian law is quite simple, namely that the transfer should be made through *cessie*, and the only requirement is notification to the debtors.[16] While it seems simple, some non-legal issues arise. The originator most of the time is hesitant to inform the debtor for various reasons. However, while the requirement of notice may create difficulties, there is a more pressing issue in relation to the rights attached to assets transferred. While Indonesian law has pronounced that all rights associated with the debts are transferred along with the transfer of debts,[17] it is not clear if the assets transferred are not in the form of debts. The same difficulties also arise in regard to debts that are the result of leasing or *mudaraba* transactions, in the absence of any collateral being placed in the leasing or *mudaraba* objects.

Laws Related to Leasing

Even though leasing is the closest mode of financing to *ijara*, the leasing law in Indonesia is still underdeveloped. Leasing is still governed through the Presidential Decree No. 61 year 1988 that was originally only intended to stipulate permitted activities to be carried out by a financial institution.[18] At the outset, this decree does not pose any legal hurdle for application of leasing according to *shari'a*. However, the implementing regulation on leasing activities contains one requirement that seems to contradict the *shari'a*. The Decree of the Minister of Finance No. Kep.Men.Keu.RI.No1169/KMK.01/1991 requires the parties to a leasing agreement to include a clause that determines the liability[19] of a lessee in the event of the non-functionality of the object of the lease agreement.[20] The point of the above example is that while the decree neither permits nor forbids that those activities be carried out through Islamic means, this

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[15] It is possible to have asset securitization without sale of assets. This is known as synthetic securitization. However, it is beyond the scope of this paper.

[16] Article 613 of Indonesian Civil Code.

[17] Article 1533 of Indonesian Civil Code.

[18] Article 2 stipulates the activities, which are leasing, venture capital, trading in commercial papers, factoring, credit cards, and consumer finance.

[19] It is true that the contract can determine that the liability is zero. However, it is clear that this regulation is not intended to be the basis of Islamic leasing.

[20] According to *shari'a*, the leasee to an *ijara* contract cannot be held responsible for the damage or any loss due to the non-functionality of the object of the lease.

decree cannot be considered as the legal basis for Islamic leasing. Moreover, the fact that this decree was based on the laws that do not recognize the principles of *shari'a* [21] can further support the above argument.

Laws Related to *Mudaraba*

Mudaraba is also an instrument whose regulation is still uncharted. The tendency to equate *mudaraba* transactions with share-cropping transactions only makes the matter worse. The *mudaraba* transaction entails more than simply sharing revenue. The heart of *mudaraba* is the transfer of the asset in trust, namely, the transfer of assets into the ownership realm of the *mudarib* for the benefit of the investor. The *mudarib* owns the assets and is not merely the custodian of the assets. Indonesian laws unfortunately cannot adequately protect the parties to the *mudaraba* transaction, as the nature of the transaction is not within the ambit of its legal foundation. As the transfer of ownership in the *mudaraba* transaction resembles the common law trust,[22] Indonesia as a country that follows a civil law system, does not recognize dual ownership[23] in equity and in law. Unfortunately, such a split in ownership is the essential facet of the *mudaraba* transaction, which has not yet been covered by Indonesian law and cannot be governed by conventional civil law principles.[24] However, it is possible to cover the profit-sharing aspects of the *mudaraba* transaction through the freedom of contract principle.

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[21] This decree was based on the Constitution, the Commercial Code, Civil Code, Law No. 12 year 1967 concerning cooperatives and Law No. 14 year 1967 concerning banking. See the Recital of the Presidential Decree No. 61 year 1988. It is to be noted that the Commercial Code and the Civil Code were initially intended for the European sector. They were the codification of living values of the Netherlands and western society. Prior to Indonesian independence, the Islamic-majority native Indonesians were subject to *adat* laws, which consisted of Islamic laws, among others.

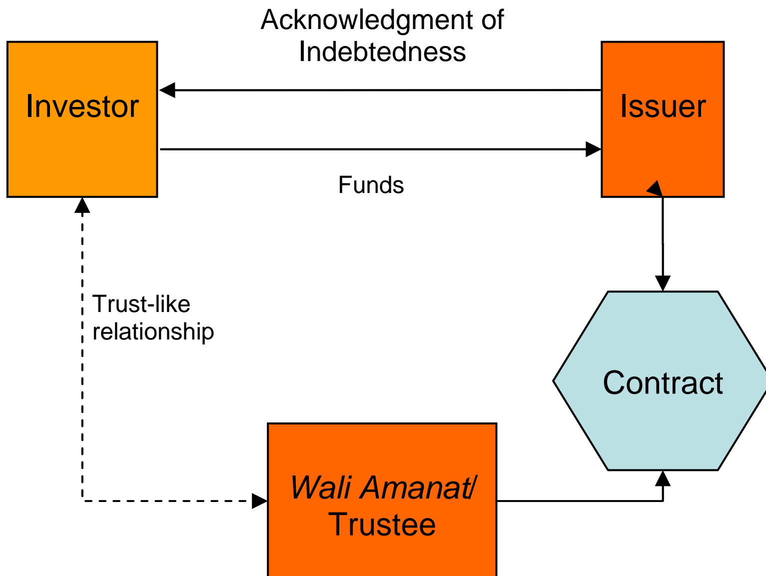
[22] Some Islamic financial institutions even used the terminology "trust financing" to denote the mechanism contemplated in classical *mudaraba.*

[23] It is true that the notion of ownership in *mudaraba* transaction is not exactly the same as the notion of ownership in common law trust. However, it is safe to say that they are similar. Therefore it is appropriate to take the example of dual ownership of the common law system to highlight the problem associated with the implementation of *mudaraba* under a legal regime following a civil law system.

[24] The consequences that may arise are related to the status of the *mudaraba* object in case of insolvency of the *mudarib*, the liability of the *mudarib*, and the rights of the investor. As a full explanation wouldl make this paper unnecessarily long, it is not undertaken here.

Indonesian Existing Practice (*Shari'a* Bonds)

Current *sukuk* in Indonesia are always manifested in the form of a bond, which is legally a debt instrument.[25] The structure of the *shari'a* bond is exactly the same as that of conventional bonds. Below are the structures of the only two types of *shari'a* bonds used, namely the *mudaraba* and *ijara* bonds.



The difference between the structures of conventional bonds and *shari'a* bonds lies in the contract between the *wali amanat*[26] and the issuer. The contract in *shari'a* bonds is not a loan contract. The contracts in

[25] In order to avoid unnecessary controversy, this paper will not name any specific case of *shari'a* bonds for the following reasons: (1) It is not the aim of this paper to criticize the practice, (2) the author does not have all documents pertaining to every single *shari'a* bonds issuance in Indonesia, and (3) the author does not wish to make generalizations about the issuance of *shari'a* bonds.
[26] *Wali amanat* is a legal creature that exists pursuant to articles 50–54 of Law No. 8 year 1995 concerning the capital market. It was fashioned in order to create a legal person similar to a trustee in bond issuance in common law jurisdictions. However, a *wali amanat* is not exactly the same as a trustee. It is a combination of a trustee, an administrator, and an agent.

mudaraba and *ijara* are respectively *mudaraba*[27] and *ijara*[28] contracts. Based on these underlying contracts, the National *Shari'a* Board[29] has pronounced the bonds to be *shari'a* compliant. The *fatawa* on the issuance of *shari'a* bonds stated that the *shari'a* bond is not a debt instrument, and that the coupon payments do not represent interest.[30]

While the *shari'a* pronouncement on the *shari'a* bond is very clear, the law views the *shari'a* bond as a debt instrument. Due to the absence of trust arrangements in Indonesian law, the contract between the *wali amanat* and the issuer cannot change the legal fact that there is a debt relationship between the issuer and the investor. It is to be noted that the legal opinion related to the issuance of *shari'a* bonds always stated that the *shari'a* bond is a debt instrument.[31] This creates a legal dilemma. On the one hand, *shari'a* prohibits the sale of a debt instrument not at face value. On the other hand, the nature of the bond and market necessity requires that the bond be freely traded, namely at discount or at premium. It is true even in the case of the *ijara* bond, where the bond represents not the ownership of the asset but the rental claims associated with the lease of the underlying assets.

Even if the *ijara* bond can be manifested in the ownership of the underlying assets and not merely in the rights to receive rental payment, the issue of liability of the owner of the assets may arise due to the principle of unity of ownership under Indonesian law. As an owner of an asset, the investor will be exposed to numerous risks that may result in the *shari'a* bond being less attractive than its conventional counterpart for rational investors.

CHALLENGES FOR IMPLEMENTATION

As explained above, the issuance of *sukuk* creates some legal complications in Indonesia. Therefore, some steps should be taken to overcome the obstacles. This represents the overall challenge in the implementation of *sukuk*, namely laying the foundation for effective

[27] The *mudaraba* contract employed in the *mudaraba* contract is different than the classical *mudaraba.* The repayment of principal in this contract is guaranteed and is based on the principle of revenue sharing (not profit-loss sharing).

[28] There is no transfer of ownership in this particular *ijara* contract. The subject of *ijara* is only usufruct and does not entail any legal and/or beneficial ownership. (The *sukuk al-manafi'*.)

[29] The National *Shari'a* Board has endorsed eight types of *sukuk*. However, there are only two types of *sukuk* currently used in Indonesia.

[30] The National *Shari'a* Board issued only individual *fatwa* for individual issuances.

[31] See the legal opinions issued in conjunction with the issuance of the *shari'a* bonds.

regulation. Below is an elaboration of some steps recommended for regulating such an issuance in Indonesia.

International Practices Related to Islamic *Sukuk*

It is important to look at international practices related to *sukuk*. While the issuance of *sukuk* takes different forms and methods, there is one similarity among all the issuances of *sukuks*,[32] namely the use of a trust structure, in the sense that there is always involvement of the splitting of ownership of the underlying assets into legal and equitable ownerships. This is the answer to the prohibition of the sale of debts under *shari'a*, and it results in the certificate issued or traded representing the ownership over a real asset. In the case of the famous first Malaysian *sukuk*, the traded certificates represented equitable ownership of the real estate parcel, while in the case of the Islamic Development Bank (IDB) *sukuk*, the traded certificates represent the equitable ownership of the pool of assets that consist of mainly real ownership.

In order to satisfy the *shari'a* requirement, the underlying transactions are almost always in the form of leasing. This is because leasing is the closest mode of financing acceptable to *shari'a* that involves real ownership over real assets. Such requirements resulted in all transactions being structured to involve the leasing of real assets, regardless of whether or not the intention of the would-be investor is in ownership of the associated real estate. Another development appears in the first IDB *sukuk*. It is no longer necessary to have the pool of assets consist of only leasing assets. The issuance of *sukuk* will be still acceptable to *shari'a* if the initial composition of the portfolio consists of at least 51 percent leasing, and at any one time does not drop below 25 percent of the portfolio.

While the *sukuk* structure is always done through a complex structured finance transaction, one simple fact can be identified in it: the foundation of the structure lies in the ability to split the ownership of the underlying assets into legal and equitable ownership.

As a civil law system, Indonesian law has the principle of unity of ownership. Therefore, it is difficult to assign and transfer only the part of the interest, namely equitable interest on the ownership of the income generating assets. While many problems can be sufficiently averted by simply splitting and securitizing the equitable ownership of the asset, the nature of Indonesian law does not permit such separation. This represents the first challenge: formulation of the means for Indonesian law to allow

[32] Except for straightforward *mudaraba* or *muqadara* bonds.

such separation, and the splitting of ownership like the common law counterpart.

Indonesian *Shari'a* Bonds

The second challenge is to create a uniform system that can cater to the conventional as well as the *shari'a* compatible bonds issuance. As previously explained, the only justification for the *shari'a* bonds in Indonesia being issued in the way they are issued is that the Indonesian Capital Market Agency still requires a uniform format in issuing bonds. Therefore the chosen approach adhered to all requirements regarding forms, while maintaining the substance of the matter in conformity with *shari'a*. This approach is not without problems. It creates inconsistencies, especially related to the treatment of bonds under Indonesian law. Indonesian law still views bonds as debt instruments. Although some quarters argue that allowing *shari'a* bonds has resulted in the broadening of the definition of bonds, Indonesian law still regards *shari'a* bonds as debt instruments. The paradox is that while trading in debt instruments that are not at par value is unlawful according to *shari'a*, the issuance of *shari'a* bonds is done precisely in order to allow such trading in debt.

Assets Securitization and *Shari'a* Compliance

The third challenge is related to the nature of asset securitization and its compliance to *shari'a*. In this regard, there are several issues that need to be overcome. While the majority of *shari'a* scholars prohibit the trading of debts, the rulings on the trading of debt-like instruments or non-debt instruments that behave like debt do not enjoy the same consensus.[33] Moreover, trading on proof of participation (whether in the form of shares of a company or unit trust) in a portfolio that consists mainly of debts might be considered as the trading in debts. This fact may potentially create difficulties in using asset securitization as a basis for Islamic *sukuk* in Indonesia. The Indonesian draft law on asset securitization requires that the asset to be securitized is in the form of debt.[34] Fortunately, in the existing regulations of BAPEPAM, there is no express requirement that the portfolio of the Collective Investment Contract (CIC) consist of only debts.

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[33] The ruling regarding IDB's *sukuk* permits the trading of a certificate that represents ownership over a portfolio of assets consisting of both real assets and debts. The caveat is that the initial composition of the portfolio should be at least 51 percent of real assets and in any case should never drop below 25 percent of real assets.

[34] Article 3 of the Draft Law on Assets Securitization.

According to paragraph b of the Regulation IX.K.1, it is possible to have non-debt financial assets in the portfolio. However, while a lease rental payment can be categorized as a financial asset, it is not clear whether an asset subject to lease can be categorized as a financial asset.

The second issue is whether the transfer of the assets will attract a moral hazard problem. While in conventional asset securitization the only moral hazard problem is the possibility that the originator may apply different treatments between the sold assets under the servicing agreement and the unsold assets, the problem will add to the requirements for operation and maintenance of the lease assets if the whole asset (and not only the lease payment) is transferred to the portfolio.

The third issue is related to the CIC model required under the existing BAPEPAM regulation. Even though it has been used several times, the effectiveness of the CIC model remains questionable. The major issue is whether the CIC, which does not have a separate legal personality, can legally enter into contracts with other parties, such as investors and servicers, in the same way that a trustee can. The bankruptcy remoteness of the CIC scheme is also another issue, as its efficacy is still untested. The CIC is basically an SPV that insulates the securitized assets from the insolvency of the originator. While in the conventional asset securitization the SPV exists solely to sell and hold the securitized assets, and may not have obligations other than to those to be paid with the securitized assets, in the *shari'a* asset securitization the SPV may have additional obligations, as the SPV will hold real assets and not merely claims.

Problems with Non-Straightforward Debt

The fourth challenge is related to the problems associated with non-straightforward debts. While Indonesian law has a provision related to the rights attached to a debt, the lack of laws related to leasing poses another problem. The provisions of Article 1533 of the Indonesian Civil Code extend only to the security attached to a debt. In the case of transferring lease payments, the relationship between the lease payments and the lease assets is not very clear. The lease payment is not automatically secured by the lease assets, as the obligor of the lease payment and the owner of the lease asset are always different.

Another issue is related to the lease asset itself. A *shari'a*-compatible lease is limited to an operating lease and not extended to a financial lease. There is a problem in the ability to assign future debts. Under *ijara*, the payment of the rental is given for the enjoyment of the lease assets. Therefore, each payment of rental is considered a separate payment for the enjoyment of the lease asset and not an instalment of an existing debt. This

will create the problem of notification and transfer, as the notification has to be done for each and every rental payment.[35]

Conversion of Conventional Bonds

The last challenge is to convert conventional bonds into *shari'a*-compatible *sukuk*. The biggest issuer of bonds in Indonesia is the government of Indonesia. Therefore the epitome of the development of Indonesian *sukuk* is issuance of *sukuk* by the government of Indonesia. However, the issuance of *sukuk* by the government necessitates infrastructure that is presently not available. The most viable alternative is to convert existing government bonds into *sukuk*.

CONCLUSION

It is clear that *sukuk* can serve as the main vehicle for the development of Islamic banking. However, implementing it in Indonesia, a country following a civil law tradition, is no simple matter. There are several challenges that must be overcome in order to achieve successful implementation of *sukuk*. First, there must be a workable solution introduced to permit the splitting of ownership as in the common law counterpart. Second, there needs to be created a uniform system that can cater to both conventional and *shari'a*-compatible bonds issuance. Third, a legal system must be created that allows trading on quasi-debt instruments without breaching the rules of *shari'a* or attracting a moral hazard problem, while also achieving bankruptcy remoteness. Fourth, existing laws and regulations related to non-straightforward or future debts need to be revamped. Fifth and finally, there needs to be a mechanism allowing the conversion of government conventional bonds into *shari'a*-compatible *sukuk*.

The establishment of a comprehensive legal and regulatory framework that addresses such challenges will not only promote the development of Islamic finance and its regulatory regimes, but will also galvanize the establishment of an Islamic economic system in Indonesia. Although this paper does not offer solutions to those challenges, by identifying them it may lead to necessary reform in the Indonesian legal system. Hopefully, this paper will serve as a first step toward the alignment of the current Indonesian system with *shari'a* requirements.

[35] Article 613 of the Indonesian Civil Code.

Part IV

The Way Forward: Perspectives and Controversies

The Road Ahead for Islamic Finance

Jay Collins[1]

Now is an extraordinary and fascinating time in the development of Islamic finance. The market continues to mature, albeit not as fast as many of us might hope. Nonetheless, progress is enormous, and innovation, far surpassing the days when one could count the Islamic products set on one hand, should be applauded. The numbers speak for themselves: $13 billion in *sukuk* issuance, perhaps as much as $350 billion in Islamic funds under management, and a market that is growing in excess of 15 percent per year.

Our research has pulled together the key lessons regarding the challenges facing Islamic finance, and has highlighted the steps taken to ensure standardization and transparency. Unfortunately, regulation and corporate governance have generally struggled to keep pace with the unprecedented growth in this industry, and with an ever higher bar in the global environment, there is a need for redoubled efforts. In the spirit of developing a forward-looking road map, this article lays out the ten most critical components of future success. Businesses and governments around the world are increasingly benchmarking success with best practices, performance metrics, and long range plans; the more that today's leaders in the field can agree on the components of future success in Islamic finance, the more likely the market is to prosper.

KEY DRIVERS BEHIND THE MAINSTREAM INTEGRATION OF ISLAMIC FINANCE

We begin with what should be an uncontroversial judgment: the growth of Islamic finance has thrust the sector into the mainstream of global finance. Five years ago senior management of large money center global banks could get away without understanding its fundamentals—it was a niche

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market without global scale. That is simply no longer the case today. The move to mainstream will continue given that Islamic instruments are expanding beyond their dedicated base and have strong potential to become a core element of portfolios of non-Islamic institutions and investors. It is useful to put the Islamic finance market's move to mainstream in the context of a number of external factors:

- Petrodollar inflows are creating extraordinary regional liquidity conditions. The improvement in the balance of payments in oil exporters due to the run-up in oil prices is conservatively estimated at $500 billion per year. This liquidity is pushing local equity and bond markets to record highs, boosting central bank reserves and filling stabilization and future funds. Internationally, the shift in wealth to regional investors is contributing to a further spread of compression and diversification from the U.S. dollar. And of great importance, the petrodollar liquidity is driving Middle East regional conventional banks into the Islamic arena.
- Ongoing political trends appear to have dampened the interest of regional investors in direct investment in the United States, while the surge in oil wealth has spurred a desire to find more investment opportunities closer to home. We should be open about the misperceptions and concerns that emerged after September 11, which caused many mainstream investors to hesitate rather than embrace Islamic finance. This bias has now been reversed, and while there is more work to do in telling the story, we are on the right track.
- Further, there is a global surge in investment in infrastructure, both as a result of a renewed government focus and a tremendous growing appetite for infrastructure investments. The potential to target capital from Islamic countries that have a traditional understanding and deep experience in the field of infrastructure toward correcting the historic global problem of underinvestment in infrastructure is enormous. In addition, the infrastructure needs of the Middle East and North Africa region are also huge, giving us the opportunity to marry need with supply of capital.
- Finally, the world has flattened. Financial markets are integrating in an extraordinary way and global markets are converging with local markets. The exponential advances in the pace of information and capital movements, the increasing sophistication of global markets and the tremendous effort of global regulators to keep up with these changes have only fed the integration process. This means that one can no longer look at areas like Islamic finance as discrete and isolated market segments.

Governments will be critical to the success of this effort. Governments play multiple roles in facilitating the development of the Islamic finance market. First and foremost is the role of the central banks and financial service authorities as regulators and supervisors, providing a sound financial framework that supports the market's development. A second important role is that of the issuer, both because sovereigns continue to represent an important share of the market, and because markets look to sovereign issuance as a benchmark and signal of official support for the market's development. A third role, no less important, is that of the asset manager. Considering the vast amount of petrodollars noted above, the decision to invest even a small percentage—say 10 percent—into Islamic assets by central banks, government pension funds, and reserve funds would be absolutely revolutionary in its market impact. At the same time, government intervention should not be so heavy-handed that it dampens market dynamism. In many countries in the Middle East and North Africa, governments continue to dominate the ownership of the banking sector and therefore are also at the table as banks, and consequently, must be part of the solution.

10 STRATEGIC COMPONENTS OF FUTURE SUCCESS

1. The Need for Greater Standardization and Regulatory Alignment; the Road to a Harmonized Financial Code

The need for greater legal, regulatory, and accounting standardization has been much discussed among Islamic finance professionals. While we must respect the important and legitimate differences in views among Islamic scholars, there is little doubt that convergence on a common regulatory framework would support the development of the market. Such a framework must be broad enough to achieve the benefits of standardization and maturity, but flexible enough to accommodate the continued innovation and creative process now underway.

Internationally, the Accounting & Auditing Organization for Islamic Financial Institutions (AAOFI), based in Bahrain, has set the international market practice standard for documentation and regulation. AAOFI's accounting and audit standards are constantly under review and continue to develop in parallel with the development of innovative structures. Additionally, there is the Islamic Financial Services Board (IFSB), based in Kuala Lumpur, which will soon have international regulatory standards for the Islamic banking industry. On a regional level, Bahrain, Dubai, and Malaysia are the main centers of Islamic finance. Qatar and Singapore also have recently enacted laws and regulations to cater to Islamic finance, with

a view to becoming important Islamic financial centers. The U.K. Treasury has leaped ahead of many Muslim countries in its laws dealing with the taxation of Islamic retail banking products, which supports London's role as the center of Islamic finance in the West. English law is the choice of law for Islamic banking documentation, and U.K. GAP principles apply. Altogether, the top ten Islamic financial institutions are subject to no less than five separate regulatory standards.

Each jurisdiction is to be complimented on its efforts to regulate Islamic finance. For everyone involved, there are many lessons that may be learned, including the following:

- Bahrain and Malaysia have the oldest sets of Islamic banking regulations, and the Malaysian courts appear well prepared to deal with disputes relating to Islamic finance.
- Bahrain Monetary Agency (BMA) has led the way in developing a modern regulatory framework with rules and regulations governing Islamic finance.
- The Dubai Financial Services Authority (DFSA), the regulator of the Dubai International Financial Centre (DIFC), also has a set of Islamic banking regulations separate to those imposed by the UAE Central Bank. The DIFC's rules have been drafted by international law firms and cover a range of products.
- The innovations by the U.K. government and the Monetary Authority Singapore for introducing regulation for Islamic finance have also played a constructive role.

There may be no one-size-fits-all answer, and there are strengths to each system, but convergence must be an objective. Convergence will take time, and a degree of "messiness" is inherent in a dynamic and innovative market. These principles are not inconsistent. Consider the common law system in the United Kingdom, which has fostered convergence over time in legal standards within a framework that accommodates change and precedent. However, regulatory and supervisory competition among competing financial centers comes at a cost. Markets will benefit to the extent that governmental policy—in major Western countries as well as in Islamic markets—supports the eventual development of a uniform international regulatory framework for Islamic institutions. And just as convergence is slow in coming in the Islamic world, the Western world, with the exception of the United Kingdom, also has a long road ahead to achieve appropriate supervisory and regulatory standards.

2. Transparency is Critical to Market Development

In this market, as in others, transparency is an essential complementary to standardization in order to achieve greater depth, liquidity, and efficiency. Governments in the Middle East, which are admittedly not always comfortable with the kind of transparency expected in efficient markets, need to achieve a delicate balance. Greater transparency should aim to put the maximum feasible information into the public domain. Governments should maintain an ongoing dialogue with market participants, providing advance guidance as to how the market is going to be regulated and supported (such dialogue will also help the regulator by enhancing market understanding). Non-public information can be disclosed to ratings agencies to assist in their evaluations. Governments should also encourage secondary market development to allow greater price discovery and dissemination of that information to the markets. In sum, if Islamic financial institutions are to play a leading role in the evolution of the market, transparency through standardization in reporting, as emphasized by the ratings agencies, will be an important element of the effort aimed at "defeating the culture of excessive financial secrecy."[2]

3. Simplify the Diverse *Shari'a* Board Process

An additional aspect of the need for convergence concerns the *shari'a* board process. This is an area where significant progress has been made. Structures have become more harmonized in the past few years, and it is quicker to complete transactions compared to before. Differences in documentation and *fatwas* haven't stopped us from doing deals. *Shari'a* scholars are to be thanked for this, for their input in earlier transactions that have assisted in precedents for legal documents. This process continues. But the kinds of innovations that I discuss below are likely to strain the current process, making further simplification all the more important.

Here again, AAOFI has had a critical impact on the development of *shari'a* standards. These standards should be adopted by countries around the world. Were this to happen, the *shari'a* boards could share the critical mass of agreement and turn their focus to areas or transactions that diverge from the standards.

This would also help the capacity constraint on *shari'a* scholars. There are really only a handful of top *shari'a* scholars dealing with Islamic finance in the world today. These scholars share a number of positions on each Islamic bank's *shari'a* board. However, we are not seeing a growth of

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[2] "Enhancing Financial Reporting and Transparency: Keys to the Future of Islamic Finance," *Standard and Poor's Ratings Direct*, December 14, 2005.

young talent entering this field. The answer to this is to train more *shari'a* scholars with training in conventional as well as Islamic banking, markets, and economics. This initiative has been encouraged and supported by the DIFC. However, training is still woefully inadequate to keep pace with market growth. This is another area where public-private partnerships can make a difference.

It is also useful, albeit controversial in some countries, to have a *shari'a* board within the appropriate regulatory authority that oversees the appropriateness of the *shari'a* process. This does not require a convergence of the *shari'a* transaction approval process with the secular regulatory process. Instead, what is needed is consistent oversight of the standards and process for *shari'a* boards.

4. Time is Money: Speeding up the Issuance Process

Many more corporations and governments would issue Islamic paper if the deal issue process were not so daunting. Yet improvements have been made. Today, if the regulatory framework exists, a full ratings advisory service is not required, and assets are easily accessible, it is possible to do a *sukuk* issue within 6–8 weeks. Marketing and road shows are also now easier and faster to arrange. In contrast, the Islamic Development Bank issue took 15 months to execute, and the debut Government of Malaysia issue was under planning and discussions for about a year. The additional legal costs of a *sukuk* issue as compared to a conventional bond are $40–50,000. This is much lower than earlier levels, but still an impediment to some issuers. Both the improved time and cost efficiencies are due in part to increased familiarity of bankers, lawyers, and rating agencies with *shari'a* considerations, as well as increased competition for Islamic transactions among banks. *Shari'a* scholars are increasingly familiar with conventional capital market considerations as well.

Despite these improvements, there is still a long way to go before an issuer can tap the market on a *sukuk* format as opportunistically as can be done in a conventional bond. Turkey is a good example of an Islamic country that can execute a long dated, conventional benchmark issue within 24 to 48 hours through its shelf program. From a structural perspective, the same can be achieved through an Islamic EMTN program and a pool of assets being available "on tap." Although no one has yet taken the initiative to develop and implement such a template, it will likely happen in the future. Such an initiative would go a long way to address the chicken-and-egg issue of lack of issuance and lack of liquidity.

5. Broadening the Market Requires Continued Outreach to Non-Islamic Players

There is little doubt about the explosion of Islamic-dominated institutions, from the first one in 1975 to the over 300 in existence today.[3] In addition to the private participants, the asset class includes—as both issuer and investor—governments, social security systems, central banks, pensions, and investment authorities. Less noticed but essential for the growth of the sector is the issuance and purchase of Islamic assets by non-dedicated players. Indeed, with its maturity, Islamic finance now needs to be seen as an asset class that includes a wide range of investors and issuers, including anchor-dedicated investors, (non-dedicated) banks with Islamic accounts, and high-net-worth investors. The participation of each depends on the others. For example, the presence of anchor-dedicated Islamic institutions is often critical to generating interest in distribution to retail systems. Policy should encourage the continued broadening of the asset class, and set policies with an eye to avoiding fragmentation or compartmentalization of investors or instruments. To reach the next stage of development the following steps are critical:

- Non-dedicated investors need to be drawn to the market by their interest in exposure to regional governments, energy, or infrastructure projects, all of which are inherently Islamic finance friendly.
- Somewhat paradoxically, an important part of the future success of the Islamic market will depend on its ability to grow issuance and interest from non-Islamic issuers. Be they Western governments or energy companies, the Islamic market must convince non-Islamic issuers to embrace the Islamic market as an incremental pool of capital. It should describe itself as it does the Japanese Yen market.[4]
- The broadening of the market should stimulate greater competition on both sides of the market, with the consequence that there should no longer be high premiums for Islamic structures. This will also support the development of an active secondary market for trading, as discussed further below.
- The product range should be increasingly broadened, and there should be innovation particularly with high-net-worth individuals and retail clients in mind.

[3] Mohammed El Qorchi, "Islamic Finance Gears Up," *Finance and Development: A Quarterly Magazine of the IMF* 42 (December 2005).

[4] In 2004, Citigroup underwrote the first non-Muslim government issuer to tap the global Islamic debt market with the 100 million euro *sukuk* issue by the German State of Saxony-Anhalt, an issue designed to broaden the government's range of issuers.

- We need the non-dedicated "street" to follow firms like Citigroup and HSBC in establishing dedicated teams of experts with the ability to operate effectively in both Islamic and conventional markets.

While less government involvement in markets is generally better than more, there is a compelling case for governments to play a limited, focused role in promoting the widening of the market. This brings us to the sixth building block.

6. Governments have a Role to Play in Signaling a Commitment to Islamic investments

The governments of Bahrain, Qatar, Malaysia, and Pakistan have encouraged Islamic financing with the issuance of sovereign *sukuk* and are leading a variety of initiatives. This is leading to other governments realizing the potential and also following suit. Recently, Turkey, Indonesia, and Brunei have indicated their intentions to issue Sovereign *Sukuk* and get involved in a variety of Islamic banking efforts. Brunei is finalizing its first sale of Islamic debt in a bid to develop a local Islamic bond market. Governments will likely be the core of the issuance market in coming years.

7. Liquidity, Liquidity, and Liquidity

We should not underestimate the importance of liquidity in bringing Islamic finance into the mainstream. Most of the early international issues of Islamic instruments have been purchased by buy-and-hold investors, which will not generate an active liquid market in which investors are confident they can sell if and when they see fit. For example, *sukuk*, which are structured to be listed and traded in the secondary market, actually have quite limited trading activity. The imbalance in the supply of Islamic paper versus huge demand creates a buy-and-hold gridlock.[5]

How do we get key institutions to trade the instruments? Increased supply is critical, but is only part of the answer. Governments and central banks that hold a significant portion of the outstanding Islamic paper can do more to attack the problem than they presently are, and work to create an environment in which efficient trading can take place. Central banks

[5] *Murabaha* (a purchase and resale contract in which a real asset is purchased by a bank at the request of its customer by the supplier) is more actively traded, providing greater liquidity at the short end. Yet in this case as well, banks tend to hold the bulk of the assets acquired.

can help by initiating secondary market trades. It would then be up to the street to sustain and nurture the market.

A good example of illiquidity in the secondary market would be a comparison of the Kingdom of Bahrain's $250 MM *sukuk* in 2009 with their $500 MM conventional issue in 2008. Both issues are FRNs. The conventional bond trades to the tune of $250 MM in annual turnover and so one might expect the *sukuk* to have an annual trading volume close to $125 MM. Yet it barely reaches $50 MM. As far as examples go, this is among the best in terms of liquidity. Furthermore, we often find banks quoting bid and offer prices based on an estimate of where the bond would trade, rather than an actual observation of levels at which trades have been executed.

There are already concrete examples of liquidity being bolstered by government initiatives. Bahrain's Liquidity Management Centre (LMC) has been set up to allow Islamic institutions to manage their liquidity through short and medium term liquid investments structured along Islamic lines. The LMC has recently launched an open-ended Short Term *Sukuk* Program (STS) of US $100 MM as of September 2005.

8. Overcoming the First-Mover Disadvantage can Justify a Government Role

A signal of support from governments can play a valuable role in overcoming "first-mover disadvantages." Conversely, any sense that governments are not supportive can have a chilling effect. From energy to infrastructure, governments can help overcome impediments to innovation. For example, for many years it was thought that any country introducing collective action clauses into debt contracts would be punished in the markets. However, once international support mobilized behind the innovation aimed at making debt rescheduling easier following financial distress, markets readily accepted them and there was no measurable premium paid.

9. The Future of the Market Depends on Continued Innovation

Innovation is key in any market, and even more so for Islamic finance. Meeting the demand for innovative and efficient solutions from both issuers and investors requires that we continue to strive to make Islamic products more acceptable and cost efficient. At the same time, it is necessary to create new products by listening to our customers, and arbitrage the best innovations from mainstream markets. Below are a few promising areas for innovation:

- Project finance and infrastructure represent significant opportunities, reflecting the desire of investors for long-dated assets as well as the desire of governments to leverage private markets in the provision of critical public goods. Several recent energy-related project finance deals containing Islamic tranches have been closed, and have proven popular with non-Islamic banks. Further innovation should help extend the acceptance of these products among dedicated Islamic investors.
- Structured products, including real estate and mortgage securitization, is another area of rapid innovation, reflecting the judgment that the monetization of these assets could become an important source of liquidity in the coming years. It is expected to increasingly see real estate used not just to "Islamatize" a transaction, but also used as a "real" security.
- Derivatives are likely to be a key feature of future product development, with an early focus on investors with significant exposure to commodity price or interest rate risk (the latter through a profit rate swap). For governments that have been appropriately conservative in the early years of this market, there is an understandable hesitation to embrace derivatives. They do require that the investor and supervisor have strong risk management and credit systems in place, and give careful consideration to the risks. At the same time, derivatives can play essential risk shifting, mitigation, and diversification functions. While arbitrage and short selling are not acceptable under *shari'a*, other products have been allowed in some cases; notably, transactions involving the purchase and sale of debt contracts in secondary markets (Malaysia). Well designed, each of these functions is consistent with the spirit of Islamic finance principles.
- Domestic money market innovations are critical to increase the effectiveness of monetary policy. These innovations include Islamic profit rate swap products, Islamic CDOs, and FX hedging instruments. One concrete example of innovation in this area is Islamic repos: one regional central bank will soon launch the Gulf Arab region's first Islamic repo transaction as a way to manage liquidity in the Islamic debt markets.
- It is likely that as we progress on many of the issues discussed here, the number of multi-tranche transactions will explode. The compression of the documentation period to more closely approximate that of conventional transactions will eliminate a major break on issuers adding an Islamic tranche to other conventional tranches.

- Finally, there is growing talk about hedge fund products, including a fund of funds, and while it is in the early stages, there is reason to be optimistic that these products will develop further. A balanced fund of equity and debt would likely be well received, but a number of technical challenges remain, including that of identifying enough *sukuk* to put into the fund. So we are back to liquidity.
- Local markets and local currency issuance is currently a hot topic in global markets, and talk of reducing "original sin" through liability management trades into local currency debt abounds. In this regard, governments can take advantage of their home market local currency Islamic demand. Consider the example of Malaysia, where over 90 percent of the capital market issuance is in local currency, and half of that issuance is Islamic. This trend should spread across other markets.
- Many observers might be surprised if innovation in the consumer product space surpasses that of the institutional side. Yet it is possible. International bank operations for the Islamic consumer are already quite profitable, and some banks are very focused on this opportunity. Local conventional banks in Muslim countries are focusing their efforts on Islamic consumer products, such as Islamicaly structured mortgages, personal loans, savings products, credit cards, and insurance.
- With the introduction of new Basel capital rules globally in the next few years, and against the backdrop of a rapidly expanding market, corporates will demand instruments that address their growing capital needs, including Tier II issuance and Tier I hybrid instruments. These equity-driven investments should be inherently *shari'a* friendly but will also depend on how regulators treat Islamic bank capital.

Many of these innovations will be aimed at pension funds. There are a number of opportunities for Islamic finance in the pension fund arena, given the desire of such funds to diversify and raise performance, and the scope for massive growth. Insurance also remains an area of potential innovation.

10. International Banks Can and Should Play a Major Role in the Innovation Charge, but They Will Not be Alone

Citigroup remains strongly committed to the growth and development of Islamic finance. Recently, Citigroup and Dow Jones launched the first Global Islamic Bond Index. The launch of the index is in line with Citigroup's global strategy to offer Islamic issuers and investors world-

class and innovative products that contribute to expanding the frontiers of Islamic capital markets. The long-term strategy of the index is to unlock the global potential for Islamic bonds. The index is seen as the first step toward standardizing the criteria to measure the performance of global bonds complying with Islamic investment guidelines.

Global banks, with their broad product platforms and diverse international experience, are well positioned to lead the innovation charge. For these large banks, the cost of innovation should be lower than a dedicated Islamic bank, as they begin with and can leverage existing conventional product know-how. For example, Citibank's innovative issuance of an Islamic CDO was based on the strength of its global platform for CDO products.

In addition to conventional and Islamic banks—local or global—and central banks, we expect pension funds and social security systems to emerge as important demand and an innovative force. We will likely see international banks introducing innovation in derivatives, real estate, and securitization in the coming months and years with distribution targeted to the growing fund community, and this will create waves of new products.

CONCLUSION

It is an undisputable fact that Islamic finance has experienced immense growth in the past few years. Factors such as increased regional liquidity as a result of petrodollar influxes, a reversal of the negative biases that formed after 9/11, and a global rise in infrastructure investment are moving Islamic finance out from the position it once occupied of a discrete and isolated segment of the market and into the mainstream. It is now necessary for the various players involved to take steps that will encourage the field to continue on its path to success.

There is a need for greater standardization and regulatory alignment that should be achieved through the development of an agreed-upon framework. This framework must be flexible enough to accommodate the creativity and ongoing innovation that is characteristic of the field. In the same vein, it is necessary to have consistent oversight of the standards and processes for the *shari'a* boards that watch over this sector. There must be increased transparency in order to increase the depth, liquidity, and efficiency of the market.

A number of players can do more to carry Islamic finance into the future. Governments, while their role should be limited, can do more to signal their commitment to the field. Simultaneously, it is important that the market be broadened by appealing to non-Islamic players. Islamic finance needs to be viewed as encompassing a wide range of investors and

issuers, including anchor-dedicated investors, banks with Islamic accounts, and high-net-worth investors. Undoubtedly, international banks have a role to play as well. With their wide international experience, global banks are well positioned to lead the innovation charge.

The challenges that will arise in carrying out these developments are enormous. It is a process that will take time and will require much innovation and creativity. Citigroup is committed to continuing as a leader in the development of the market for Islamic finance. We accept these challenges and approach them with great optimism. We look forward to working with public and private sector participants in the years ahead as we drive Islamic finance into the mainstream.

A Simple *Fiqh*-and-Economics Rationale for Mutualization in Islamic Financial Intermediation

Mahmoud A. El-Gamal[1]

Islamic finance is a prohibition-driven industry, aiming to avoid the prohibitions of *riba* and *gharar*. It is well accepted in Islamic jurisprudence that *riba* and *gharar* do not affect the legal validity of non-commutative financial contracts (for example, gifts). Jurists have long viewed this as a potential solution to the problem of *gharar* in commercial insurance, proposing mutual insurance as a non-commutative alternative. Likewise, al-Qarafi had shown that loans are exempted from the rules of *riba* and *gharar* because of their non-commutative (in this case charitable) nature.[2] It is thus argued that a substantial portion of Islamic financial intermediation can and should be conducted through mutual financial institutions. Needless to say, since mutual financial institutions are quite common in Europe and the United States, regulatory frameworks for those institutions are already in existence, thus reducing the need for inventing new regulations for Islamic financial institutions.

INTRODUCTION

The rhetoric of Islamic finance often suggests that the industry employs mutual structures. For instance, a recent article reported the following:

> Sheikh Kamel does not fancy the word customer or depositor and prefers to use the term 'partner.' "Those people who place their money in Al-Baraka Bank or any other Islamic bank are considered

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[2] A. al-Qarafi, *Anwa' ul-buruqi fi anwa' il-furuq* (Beirut: Dar al-Kutub al-'Ilmiya, 1998).

shareholders of these banks. This means if these banks prosper so will they."[3]

The mutuality structure (wherein depositors are in fact shareholders of the bank) implied in this quotation, and belied by investment-account practices in Islamic banking, would solve one of the most difficult regulatory and governance issues raised by these institutions. In these institutions, investment-account holders have neither the protection of being creditors of the Islamic financial institution, nor do they have the protection of being equity holders with representation on those institutions' boards of directors. This introduces a host of other well-documented risk factors for the institution, since it has to account for the probability that account holders will withdraw their funds for fear of excessive risk taking by shareholder-appointed managers. [4] Economic advantages of the mutuality solution are discussed in El-Gamal (2006), which provides an additional religious rationale for mutualization based on traditional juristic analysis of *riba* and *gharar*.[5]

In the area of insurance, while some scholars have accepted all forms of insurance as permissible,[6] the official majority opinion adopted by the Fiqh Academy of the Organization of Islamic Conference rejected that opinion in ruling 9/2. In that ruling, the Academy distinguished between two main types of insurance contracts: (1) commercial insurance with a fixed premium, which they deemed forbidden based on *gharar*; and (2) "cooperative insurance (*al-ta'min al-ta'awuni*) built on the principles of voluntary contribution (*tabarru'*) and mutual cooperation (*ta'awun*)," which they deemed permissible, since *gharar* does not affect non-commutative contracts.[7]

Interestingly, while the Islamic insurance industry has adopted a name suggestive of a mutual cooperative structure, *takaful* companies have generally been structured as for-profit shareholder-owned companies, or subdivisions thereof. In other words, the corporate form of those *takaful*

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[3] Osama Habib, "Saudi businessman tackles task of polishing Islam's image," *The Daily Star*, August 15, 2005.

[4] AAOIFI, *Accounting, Auditing and Governance Standards for Islamic Financial Institutions 2003-4* (Manama: AAOIFI, 2004a): 215; and AAOIFI, 2003-4 (Manama: AAOIFI, 2004b): 241.

[5] Mahmoud El-Gamal, *Islamic Finance: Law, Economics and Practice* (New York: Cambridge University Press, 2006). See Chapter 8.

[6] See M. al-Zarqa', *Nizam al-ta'min: haqiqatuhu, wa al-ra'y al-shar'i fihi* (Beirut: Mu'assasat al-Risalah, fourth printing, 1994): 8-9; and R. Y. al-Misri, *al-Khatar wa al-ta'min: hal al-ta'min al-tijari ja'iz shar'an?* (Damascus: Dar al-Qalam, 2001): 6.

[7] S. al-Darir, "*Al-Gharar* in Contracts and its Effects on Contemporary Transactions," IDB Eminent Scholars' Lecture Series, no. 16 (Jeddah: IDB/IRTI, 1997).

companies is identical to that of the commercial insurance companies whose contracts they forbade. *Takaful* companies invoke non-commutativity by stipulating that the shareholders pay policyholder claims as a form of voluntary contribution (*tabarru‘*), where the operator is usually set up in the form of silent partnership (*mudaraba*), with the exception of a few recent attempts at using agency (*wakala*)—while still falling short of mutual forms. In both structures, there are unresolved *fiqhi* issues about the bindingness of promises in such voluntary *tabarru‘*. It would appear, thus, that in the Islamic insurance (risk intermediation) industry as well as in the Islamic banking (credit intermediation) industry, mutuality can align rhetoric with reality and resolve simultaneously a number of corporate governance, religious, and financial problems. In the next section, we shall approach the problem from a risk-management view of all financial activity, including intermediation. Toward that end, we need to develop an encompassing model of *riba* (which is the reason for having Islamic banks) and *gharar* (the reason for having *takaful* companies).

A UNIFIED ECONOMIC MODEL OF *RIBA* AND *GHARAR*

Derivation of an economic understanding of *riba* and *gharar* is crucial for understanding Islamic finance. While rhetoric suggests that the scope of prohibitions is directly and unequivocally inferred from Islamic scripture, analyses by Rida (1986) and al-Zarqa (1984) clearly show that the scope and nature of *riba* and *gharar*, respectively, were developed over the centuries through mostly expansive juristic analyses.

The most economically oriented analyses of *riba* and *gharar* emphasized equity in exchange. Thus, Ibn Rushd argued that, “it is clear from the Law that what is targeted by the prohibition of *riba* is the excessive inequity (*ghubn fahish*) that it entails.”[8] Ibn Rushd proceeded to explain that equity in trading commodities of the same type should be determined through equality of amount. Otherwise, if equity will not or cannot be ensured through equality, it should be determined by market prices.

Based on that analysis as well as a different Prophetic tradition in which the Prophet forbade Bilal from trading dates for dates, ordering him instead to sell one and use the proceeds to buy the other, El-Gamal has argued that the prohibition aims to approach equity through marking to

[8] M. Ibn Rushd, *Bidayat al-mujtahid wa nihayat al-muqtasid* (Beirut: Dar al-Ma‘rifa, 1997), 3: 184.

market.[9] In credit sales (utilized in *murabaha*), leases (*ijara*), and other interest-based Islamic financial transactions, the existence of an underlying object of sale or lease allows the buyer and seller to mark the time value of the asset to market (for example, through actual market rent), thus avoiding the fear of excessive inequity in credit extension. Thus, one can conclude that the forbidden *riba* is mainly the practice of trading unbundled credit, wherein pricing that credit may be problematic, resulting in potential excessive inequity.[10]

Similarly, jurists have seen the prohibition of *gharar* as one aiming to avoid inequity in exchange. Juristic definitions of the forbidden *gharar* emphasize the uncertainty aspect.[11] Perhaps the most comprehensive definition is that of the late Dr. Mustafa al-Zarqa: "[the forbidden *bay' al-gharar*] is the sale of probable items whose existence or characteristics are uncertain, the risky nature of which makes the transaction akin to gambling." Since all contracts are incomplete and have an element of randomness in them, al-Baji al-Andalusi argued that "the meaning of *gharar* sale, and Allah knows best, is any sale in which *gharar* is the dominant component. . . . However, minor *gharar* would not render a sales contract defective, since no contract can be entirely free of *gharar*."[12]

Thus, jurists recognized one extreme form of the prohibited *gharar* to be gambling, which is categorically forbidden by the Qur'anic verse [5:90] "O people of faith: Wine, gambling, dedication of stones and divination with arrows are abominable works of the devil. Thus, avoid such activities that you may prosper." Al-Darir (1997) summarized the conditions required for *gharar* to render a contract invalid, and they imply an implicit tradeoff between the economic need for the contract and the amount of *gharar* therein. Thus, Ibn Taymiya argued, "it is known that this corrupting factor [i.e. *gharar*] would be overruled if it is opposed by a greater benefit."[13] Thus, gambling is pure *gharar* with very little economic benefit (as verse [2:219] states about wine and gambling: "Therein is great sin and some benefit, and their sin is greater than their benefit"), and it is

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[9] El-Gamal, *Islamic Finance*, Chapter 3; and M. El-Gamal, "An Economic Explication of the Prohibition of *Riba* in Classical Islamic Jurisprudence," *Proceedings of the Third Harvard University Forum on Islamic Finance* (Cambridge: Center for Middle Eastern Studies, Harvard University, 2000): 31-44.

[10] El-Gamal, "An Economic Explication of the Prohibition of *Riba*," 31-44.

[11] See W. al-Zuhayli, *Al-Fiqh al-islami wa adillatuhu* (Damascus: Dar al-Fikr, 1997), 5: 3415-3431.

[12] Ibid.

[13] For references and detailed discussion, see Al-Zuhayli, *Al-Fiqh al-islami;* M. El-Gamal, "An Economic Explication of the Prohibition of *Gharar* in Classical Islamic Jurisprudence," *Islamic Economic Studies* 8 (April 2001): 29-58 (see also note 9 above); and El-Gamal, *Islamic Finance,* 59-62.

categorically forbidden. More generally, the prohibition of *gharar* sale (*bay‘ ul-gharar*) is best understood, as stated by al-Zarqa, as being more applicable the closer we get to this extreme of gambling. Hence, one may conclude that the forbidden *gharar* sale is the unbundled sale of risk.

If we accept those two economic definitions of *riba* and *gharar*, then we recognize *riba* also as an extreme form of *gharar*: the sale or extension of unbundled credit (for example, in an unsecured loan) is a counter purchase of credit risk (which is a negatively-priced bad, the risk of debtor default, the price of which would be one of the main components of the interest charged). Credit risk includes substantial uncertainty, because the probability of default may be difficult to estimate, and the resulting losses in case of default (especially due to bankruptcy) can be quite substantial. One litmus test of this approach, which will also provide us with a simple unified solution for financial intermediation, is the non-commutativity solution discussed in the following section.

THE NON-COMMUTATIVITY SOLUTION

As shown by al-Darir (1997) and adopted by the OIC Fiqh Academy, it is generally accepted that the optimal way to avoid *gharar* is to ensure that the contract is non-commutative. Interestingly, the same applies to *riba*. For instance, it is considered good character for one who borrows any property to repay more than was borrowed, provided that the increase was not stipulated in the original contract or demanded by the lender. Indeed, the Prophet himself encouraged that practice, stating that the best people are the ones who are most generous in repaying their debts (*khiyaru al-nasi ahsanuhum qada’an*, narrated by Bukhari, Muslim, and al-Tirmidhi on the authority of Abu Hurayra). Al-Shafi‘i considered such repayment above the borrowed amount reprehensible only if it becomes habitual, to the point of being conventionally expected. Based on this principle, the National Bank of Egypt (*Al-Bank al-Ahli*) has for a number of years been offering certificates of deposit (literally, investment certificates or *shahadat al-istithmar*, type C) that guarantee only the principal, and pay “gifts” that are announced ex post but not promised at a fixed rate beforehand. Similarly, early Malaysian bonds known as Government Investment Certificates relied on this gift (*hiba*) principle to circumvent the prohibition of *riba*, which would be violated if the interest rate were to be announced ahead of time.

The most interesting analysis of non-commutativity as a solution to the problem of *riba* applies to the case of interest-free “goodly” or

"beautiful" loans (*qard hasan*). This analysis was provided by al-Qarafi.[14] In that analysis, al-Qarafi gave the example of interest-free loans to illustrate the differences between the loan contract (which is non-commutative according to his analysis, as will be shown shortly) and sale, or *bay'*, contracts (which are the canonical commutative financial contracts).

Note first that the famous *hadith* of the six commodities has two conditions: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt, [should be traded] hand to hand, and in equal amounts, and any increase is *riba*" (narrated by Muslim on the authority of Abu Sa'id al-Khudriy). The two conditions are "hand to hand" and "in equal amount." Therefore, even though an interest-free loan satisfies the equal-amount requirement, it violates the hand-to-hand provision, and therefore would be deemed *riba* by this canonical hadith.

However, for *qard hasan*, al-Qarafi argued in his "difference #201" as follows:[15]

> Know that in the juristic rule of loans, three other juristic rules were violated:
>
> [1] The rule of *riba* [is violated] if the lent property is subject to rules of *riba*, e.g. the two monies and foodstuffs; [2] the rule of *muzabana*, which is selling a known property for an unknown one of the same genus, [is violated] if the lent property is an animal or other non-fungible; and [3] the rule of selling that which you do not possess [is violated] if the lent property was fungible.
>
> The reason for allowing the violation of those three juristic rules is charitable (*al-ma'ruf*) benefit to people. Thus, if the contract is no longer charitable (*ma kharaja 'an bab al-ma'ruf*), it is forbidden, either on the basis of benefiting the lender, or on the basis of uncertainty about the traded compensations in violation of the rules of *salam* (*aw li-taraddudihi bayna al-thamani, wa al-salaf*); [it is forbidden because] the prohibition is present—in violating [the aforementioned three] juristic rules—but manifest charity is not present.

[14] See al-Qarafi, *Anwa' ul-buruqi fi anwa' il-furuq,* on difference #201, between the juristic rules of *qard* and *bay'*.
[15] Ibid., 3.

> (Question): A simple loan (*al-'ariya*) is also charitable like loans, and it is allowed for known term with compensation, even though it is no longer charitable. Why isn't the same applicable to the loan (*qard*), whereby it would be permissible if beneficial to the lender and thus not charitable?
> (Answer): If a simple loan (*'ariya*) is compensated, then it is transformed into a lease. In this regard, it is not foreseen that *riba* and the other two violations can occur in leases. In contrast, a compensated loan (*qard*) becomes a sale (*bay'*), wherein *riba* is possible, and thus it is forbidden unless independent evidence allows it [that is, when the rules of *salam* are satisfied].

The charitable nature of interest-free loans is well established, as documented in a footnote of al-Qarafi on the authority of Anas: "The Prophet said that lending a property (without interest) is better than giving it away in charity" (reported by Bayhaqi).[16]

From an economic viewpoint, note most interestingly that al-Qarafi has implicitly confirmed our characterization of *riba* as an extreme form of *gharar* (for which he has listed the juristic rules of *muzabana* [2] and selling what one does not possess [3]—two of the categories of *gharar*—as being present even in excusable interest-free loans). In this regard, when the lent property was not directly subject to the rules of *riba* as stipulated in the hadith of the six commodities (two monies, gold and silver, and four foodstuffs), he implicitly forbade interest on the basis of commutativity implied by benefit to the lender, and violation of the rules of *gharar* because of uncertainty about the deferred compensation (which is only allowed in the special case of satisfying the conditions of *salam* because of evidence from the Prophetic traditions that allow it).

Note also that al-Qarafi has identified the non-commutative (in this case charitable) nature of interest-free loans as the reason for overlooking the prohibition based on *riba* and/or *gharar*. Finally, note that his analysis of the difference between compensated-simple-loans (*'ariya*) as leases and compensated-loans (*qard*) as sales is no longer valid in today's economic environment. Indeed, the Office of the Comptroller of the Currency analyzed a U.S. lease-based model of home financing as follows:

> Today, banks structure leases so that they are equivalent to lending secured by private property. . . . [A] lease that has the economic attributes of a loan is within the business of banking. . . . Here it is clear that UBK's net lease is functionally equivalent to a financing

[16] Ibid.

> transaction in which the Branch occupies the position of a secured lender.[17]

Advances in structured finance have allowed many companies to take debts and interest payments on them off their balance sheets, re-characterizing interest payments as part of the rent. If we are to avoid perpetually turning Islamic jurisprudence into an instrument of rent-seeking legal arbitrage, those types of rents must be treated in the same way that other means of extending credit are treated.

One way to accomplish this goal is to look not at "interest" per se, but rather at the issue of "benefiting the lender." If the latter is interpreted as "profiting from the act of extending credit," then the provision would be ensuring that the financial intermediary is not for profit. Indeed, jurists in the past have not objected to Islamic banks extending interest-free or goodly loans (*qard hasan*) and collecting fees that cover their clerical expenses, without profiting from the extension of such loans. Likewise, one can think of the finance charges paid to non-profit financial mutuals as means of covering the cost of extending credit or risk reduction. To the extent that not-for-profit financial institutions also tend to be mutually owned (for example, mutual savings banks, credit unions, mutual insurance companies, and financial cooperatives), the combination of mutuality and lack of profit motive appears to provide an ideal economic solution for financial intermediation.[18]

CONCLUSION

A claim that mutuality in financial intermediation, very well established in the West, can provide a one-size-fits-all solution to all the problems addressed and caused by Islamic financial intermediation would be an overly simplistic and grandiose claim. However, there is ample evidence in traditional juristic analyses of *gharar* and *riba* to conclude that both prohibitions can be ameliorated through non-commutativity in financial intermediation, which lies at the heart of the non-profit and community-oriented philosophies of mutual financial intermediaries. Contemporary jurists have focused on this idea of non-commutativity in cooperative insurance, but have not in fact insisted on its mutual implementation in *takaful* companies, and have not yet addressed the usefulness of the same non-commutativity principles in credit intermediation. The analysis by al-

[17] See http://www.occ.treas.gov/interp/dec97/int806.pdf.
[18] For further discussion of the role of mutuality to avoid rent-seeking legal arbitrage in Islamic finance, see El-Gamal, *Islamic Finance*, Chapter 9.

Qarafi discussed in this paper appears to provide an opening for further *fiqh*-and-economics research on the benefits of mutualization in Islamic financial intermediation of credit and risk, and any additional Islamic prudential regulatory requirements that may be developed for this framework. It is interesting that many of the regulatory problems introduced by Islamic banks, especially treatment of investment account holders, arise from a structure that is different both from conventional commercial banks and from conventional mutual financial institutions. In contrast, Islamic mutual financial institutions, in which, for example, investment account holders will be shareholders of the financial intermediary itself, will be very similar in structure to conventional mutual financial institutions, for which an extensive regulatory framework has evolved in Europe and the United States over the past century. Hence, Islamic financial institutions that are built on mutuality can be encompassed under the existing mainstream regulatory framework.[19]

[19] For further discussion of the economic and Islamic merits of mutualization, see M. El-Gamal, "Mutuality as an Antidote to Rent-Seeking *Shariah* Arbitrage in Islamic Finance," *Thunderbird International Business Review* 49, no. 2, (2007a): 187-202; and M. El-Gamal, "Mutualization of Islamic Banks," in M. K. Hassan and M. Lewis, eds., *Handbook of Islamic Banking* (Cheltenham: Edward Elgar, 2007).

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List of Terms

Abu Hurayra **—** a Companion (*sahabi*) of the Prophet Muhammad known for narrating many *ahadith* (pl. of *hadith*)

al-'ariya **—** a neighborly loan

al-ma'ruf — good; a good deed

al-Shafi'i **—** Muhammad b. Idris (d. 204/820), the eponymous lead jurist of one of the four surviving *sunni* schools of *fiqh*

al-ta'lil al-maqasidi **—** a consequentialist ethical-legal method characterized by the jurist's consideration of one or more of the aims of the *shari'a* as the effective cause (`*ilal* sing, *illa*) of its ethical value (*hukm*)

al-ta'min al-ta'awuni **—** cooperative insurance

amana **—** the status or duty of a trusted person *(amin)*; one of two basic relationships toward property, which entails absence of liability for loss except in breach of duty; compare *daman*

***`araya*** (sing., `ariyya) **—** an exchange transaction in which one party assigns a fruit tree (e.g. a palm tree) to another party so that the latter can benefit by eating its moist fruit for a period of time and then return the tree to the former. By extension, a sale in which a person sell ripe fruit on the tree for dry fruit.

aw li-taraddudihi bayna al-thamani, wa al-salaf **—** lit. "or because of its oscillation between [being] the sale price and [being] loan"

bay' **—** sale

bay' al-gharar **—** a sale characterized by uncertainty in the transfer of possession of one of the exchange items

Bukhari — Muhammad b. Isma'il (256/870), a *hadith* master and the compiler of the *Sahih*, a renowned collection of rigorously authenticated (*sahih*) *ahadith*

daman — (1) contract of guarantee (also called *kafala*); (2) one of two basic relationships toward property, entailing bearing the risk of its loss; compare *amana*

darak — [*daman al-darak*] guaranty of redress in which a third party to a sale undertakes to cover the purchaser for loss of sales price if the sale item is seized by a claimant or is defective

faqih — legal scholar/ jurist

fatawa shar'iyya — *see fatwa*

fatwa (plur., *fatawa*) — an authoritative legal opinion issued by a scholar of *fiqh*

fiqh — Islamic jurisprudence

fiqh al-mu'amalat — the ethics and law of financial transactions

fiqhi — of or pertaining to *fiqh*

fitra — instinct

gharar — uncertainty

ghubn fahish — excessive deception in financial transaction

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

halal — allowed; lawful

hiba — contract of gift

hila — juristic stratagem

hisas — shares

hiyal (sing., *hila*) — legal artifices or stratagems

***`ibadat* —** acts of ritual worship

***ijara* —** operating lease

***ijara bond/sukuk* —** see *sukuk al-ijara*

***ijara muntahiya bi-tamlik* —** lease ending with purchase

***ijara wa iqtina'* —** financial lease

'ilal (sing., *'illa*) **—** the effective cause of the ethical-legal value (*hukm*) of a case

***Istihqaq* —** possessing a right

***Istirbah* —** profit seeking

***Istirdad* —** repossession of the price, item of sale, or any other property transfer in an exchange or unilateral disposition

***istisna'* —** contract providing for the manufacture and purchase of a specified item

***istisna' muwazin parallel istisna'* —** A contemporary synthetic transaction in which a financial institution (e.g. a bank) executes two nearly simultaneous istisna` transactions, acting as the purchaser of the manufactured object of sale in the first and the seller of the manufactured object of sale in the second. The financial institution profits from the difference in price between the second and first transaction. See *istisna`*

***khiyaru al-nasi ahsanuhum qada'an* —** The best of people are those who are best in repaying their debts

***ma kharaja 'an bab al-ma'ruf* —** A disposition that ceases to be charitable in nature

Mafsada (plur., *mafasid*) **—** *harm*

***Maisir* —** gambling

***mani'* —** a preventative, that is, something whose presence causes the absence of something else

***maqasid al-shari'a* —** objectives of the *shari'a*

maslaha (plur., *masalih*) — benefit

***mu'amalat* —** dealings or transactions among human beings; compare *'ibadat*

***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*)

Mudaraba (Muqarada) Bond/Sukuk — see *sukuk al-mudaraba*

***mudarib* —** a partner contributing labor in a *mudaraba*

***murabaha* —** sale at a percentage markup; 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*)

***musharaka* —** equity participation contract

***Muslim* —** Muslim b. al-Hajjaj al-Naysaburi (d. 261/875), a *hadith* master and compiler of a collection of rigorously authenticated (*sahih*) *ahadith*

***muzabana* —** a transaction in which the owner of fruit trees agrees to sell his fruit for an estimated equivalent amount of dried fruit, such as palm fruit for dates or grapes for raisins. *Muzabana* was an agricultural practice known to the people of Madina and prohibited by the Prophet (see *hadith* of Jabir b. `Abd Allah), ostensibly because of the strong element of *gharar* present in such a transaction. The special case of *araya* was exempted from this prohibition. Some *fuqaha,* particularly Maliki jurists, use the term *muzabana* to describe any sale in which the weight or volume of the exchange items is unspecified.

***qa'ida* —** an ethical-legal principle or maxim

***qard hasan* —** goodwill short term loans with no compensation whatsoever

***qunya* —** acquisition

***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

***re-takaful* —** Islamic reinsurance

sakk (plur., *sukuk*) —*shari'a*-compliant bond; check

salam **—** sale with deferred delivery of the sales item

Shafi'i **—** one of the four Sunni schools of law

shahadat al-istithmar **—** investment certificates

shar' **—** legal/law

shari'a **—** the divine law known from the Qur'an and Sunna

shart (plur., *shurut*) — a necessary condition; something that needs to exist in order for something, like a transaction, to be valid; a condition or stipulation in a contract

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 *mudaraba*

sukuk al-musharaka **—** a bond whose underlying activity is based on *musharaka*

sukuk al-salam **—** Islamic bond based on a *salam* contract such as the Islamic T-Bill introduced by the Bahrain Monetary Agency

Sunna **—** the Prophet Muhammad's normative example, as known from the *ahadith*; one of the four roots (*usul*) of *fiqh*

ta'awun **—** mutual cooperation

ta'awuni **—** cooperative, as in cooperative insurance

tabarru' **—** contribution, donation (voluntary contribution)

takaful — lit. mutual support. Islamic insurance; based on the concept of mutual financial support, an Islamically acceptable alternative to conventional commercial insurance

tawarruq **—** a practice in which a person buys something on credit and at once sells it for cash to a third party in a separate transaction

tijara **—** business

al-Tirmidhi **—** Imam Tirmidhi, Muhammad b. `Isa al-Sulami al-Tirmidhi (d. 279/892), *hadith* master and compiler of one of highly-regarded collection of *ahadith*

'ulama (sing., 'alim) **— Ulema,** Muslim religious scholars

Umma **—** the Muslim community

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.

wakil **—** agency

waqf (plur., *awqaf*) **—** legal trust (lit., 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

Guide to Contributors

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Kilian Bälz is among the pioneers of Islamic finance in Germany and has published widely on issues related to Islamic banking and other topics of Islamic and Middle Eastern law. He specializes in international M&A and capitals market with a particular focus on the MENA region. Gleiss Lutz is one of the leading German corporate law firms with international reach. Before joining the firm, Bälz taught law at the University of Frankfurt. Bälz studied law and Middle East studies at the University of Freiburg. He has also studied in Berlin (Dr. jur.), Damascus, Cairo, and London (LL.M., SOAS).

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"Islamic finance, long considered in the West as more of an oddity than an opportunity, is going mainstream." This observation, which was made in the *Economist* in December 2006, hints at an evolution of attitudes toward the emerging Islamic finance sector. Once considered an inconsequential byproduct of the oil boom, the question today regarding this barely three-decades-old industry is how to incorporate it into the mainstream of global finance.

A few months earlier, the Seventh Harvard University Islamic Finance Forum entitled "Integrating Islamic Finance into the Mainstream: Regulation, Standardization, and Transparency" dealt with this very issue: What challenges arise from the evolution of Islamic finance, and how to deal with them?

This volume, a selection of twelve papers presented at the Seventh Forum sponsored by the Islamic Finance Project at Harvard Law School, investigates the various issues surrounding the integration of Islamic finance into the mainstream. Some of the essays look at the regulatory dilemmas that come up in this process of integration, while others discuss a variety of perspectives—religious, legal, economic, and political—on integration. The phenomenal rise of *sukuk* is considered in other essays, and finally, two essays contemplate the controversies and perspectives that arise concerning the future of this fast-growing industry.