



HARVARD-LSE WORKSHOP:

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REAPPRAISING THE ISLAMIC FINANCIAL SECTOR: A SHORT REPORT

The Islamic Finance Project (IFP) of the Islamic Legal Studies Program (ILSP) of Harvard Law School, along with the London School of Economics and Political Science (LSE), co-hosted the fifth annual workshop on Islamic finance on 24 February 2011 at the LSE campus in London.

This year, participants chose “Reappraising the Islamic Financial Sector” as the workshop topic. A diverse group of twenty-five individuals attended the workshop, including distinguished shari’a scholars, Islamic economists, academicians, bankers, lawyers and portfolio managers.

Opening remarks were given by Dr. S. Nazim Ali, Director of IFP and Acting Executive Director of ILSP, Dr. Stuart Corbridge, Pro-Director LSE, and Dr. Frank E. Vogel, Founding Director Islamic Legal Studies Program (ILSP) and moderator of the workshop. The workshop then commenced with an overview of the written comments received from the participants.

Harvard-LSE Annual Workshops on Islamic finance

These annual workshops are a forum for in-depth and multidisciplinary discussion on some of the most pressing issues facing the Islamic financial sector. They are not meant to prescribe a particular course of action or reach definitive conclusions but to provide an open environment for discussion. The topic of the workshop is chosen based on a survey of the participants. Participants are then provided background information on the topic and they are requested to submit their comments. The comments received are compiled and distributed to all participants prior to the workshop. The workshop spans an entire day with several issues discussed in multiple sessions. To facilitate free and open discussion, the views expressed are not attributed to any participant.

Core issues and views expressed by the participants

The following are the core issues discussed in the workshop and the views of the participants as aired during the workshop and as stated in their written comments.

Islamic financial sector and the objectives of the Islamic law

The main issue addressed in the workshop was whether or not the convergence of Islamic finance and conventional finance means that the Islamic financial industry is not serving the objectives (maqasid)¹ of Islamic law (shari’a).

It was pointed out that there is no revealed list of the objectives and once a financial product or service is deemed licit (halal), it should not be against the objectives because both the objectives and criteria for determining licit are derived from the same sources, namely Quran, tradition of Prophet Mohammad (sunnah) and jurisprudence (fiqh).

It was argued that the objectives may only be relied upon when the interpretation of the Quran or the

¹ In the interest of time, participants did not discuss the objectives of shari’a. To give background information to the readers who may not be familiar with the objectives of the shari’a, the view adopted in this report is attributed to the Muslim philosopher Ghazali (died 1111) in “The Islamic Vision of Development in the Light of the Maqasid Al-Shari’ah” (2009) by M. Umer Chapra: “The very objective of the Shari’ah is to promote the well-being of the people, which lies in safeguarding their faith (din), their self (nafs), their intellect (‘aql), their posterity (nasl) and their wealth (mal). Whatever ensures the safeguard of these five serves public interest and is desirable and whatever hurts them is against public interest and its removal is desirable.”

tradition of the Prophet Mohammad is needed or where there is no definite ruling in jurisprudence and it requires expertise in shari'a to meaningfully understand and employ the objectives.

An alternative view was that the Islamic financial sector is not currently concerned with its impact -- benefit or harm -- on the society and the environment beyond avoiding sin industries, which is inconsistent with the objectives. As per this alternative view, the purpose for which finance is being used should be mapped to the achievement of the objectives. At present, however, when issuing a religious ruling, shari'a boards confine themselves to an analysis based only on Islamic commercial jurisprudence.

This alternative view was countered by the argument that considering the objectives is a subjective exercise. In giving a religious ruling (fatwa), shari'a boards are already considering the objectives as they interpret them but shari'a boards need evidence and not opinions before they can take into account the impact of financial transactions on the society and the environment. For instance, economists may disagree on whether debt created by monetization (tawarruq) is beneficial or harmful for the society; therefore, shari'a boards cannot take into account the impact of monetization in issuing a religious ruling.

The discussion revealed that the application of the objectives in economics and finance needs specification and clarity. For instance, poverty alleviation may be considered consistent with the objectives as well as the aspirations of the Muslims but it remains unclear what role, if any, the Islamic financial sector should play in poverty alleviation. Objectives may have to be understood in a dynamic, rather than a static way, given the changing needs and priorities of a society. Implementation of the objectives may require efforts by all stakeholders including customers and not just by institutions offering Islamic financial services.

Convergence of Islamic and conventional financial practice

The convergence of the practice of Islamic finance with conventional finance was a recurring issue in the discussion.

One view was that similarity to conventional finance is not a valid ground for criticizing Islamic financial sector. This view was supported by the argument that Prophet Mohammad accepted some transactions of his times without changing them, made some changes to others and prohibited some completely, just as the Islamic financial sector is doing now.

It was explained that convergence with the conventional financial sector could be both beneficial and harmful. For instance, convergence could be beneficial where Islamic finance follows best practices in conventional finance in good governance and corporate social responsibility. On the other hand, it could be harmful where compromises are made on the Islamic prohibitions of *riba* and *gharar*.

The alternative view was that the convergence of the Islamic and conventional financial sectors, where they were expected to be different, is rooted in narrow legalistic shari'a-compliance, which turns the prohibited into the permissible through a change in contractual form despite both having the same economic substance and consequences.

A more critical view was that Islamic finance has done little more than mimic conventional financial products albeit less efficiently through multiple spurious trades, leases, and special-purpose-vehicles, increasing rather than reducing social and financial risks. As per this view, humankind suffers from incurable collective myopia and greed which can pervert Islamic finance to serving the very profiteering masters from which it sought independence.

It was further contended that the convergence of the Islamic financial sector with the conventional financial sector is caused by a dichotomy between professed beliefs and practice, a problem which is also faced by Muslims in other spheres of life. "Islamization" of finance, like the "Islamization" of some Muslim-majority countries, has not brought a change in substance.

A similarly critical view was that if Islamic financial services have the same economic substance as conventional financial services, they will likely contribute to the same economic ills. The real estate speculative bubble experienced in Dubai was financed by both the conventional and Islamic financial sector.

It was suggested that the Islamic financial sector might have been better able to align with its objectives by pursuing risk-reward sharing had it followed narrow banking complemented by asset management. However, the sector largely comprises commercial banking that is subject to the same legal, regulatory, and tax framework meant for conventional finance, which, among other things, favors debt over equity. Under Basel-III, measures to tighten risk management in banking are expected to make risk-sharing even more difficult.

Some participants were convinced that in the current economic framework, it is unrealistic for Islamic banking to operate outside of the framework of fractional reserve banking and only extend financing based on classic investment contracts (*mudarba*, *musharka*).

Others, however, believed that the initial Islamic financial institutions, such as Tabung Haji and Mit Ghamar established in the 1960s, bore the promise of becoming something distinct, but the trillion dollar Islamic finance industry being reappraised does not. They held that the industry has been focusing on product development for too long and at the expense of building the institutions rooted in Islamic values and incentives.

Pursuit of non-financial objectives

Participants debated whether or not pursuing non-financial objectives is desirable and feasible for institutions offer-

ing Islamic finance services.

It was pointed out that the institutions offering Islamic financial services tend to be shareholder-owned for-profit entities and it is unfair to expect them to pursue social goals like equitable allocation of resources.

It was affirmed that the Islamic financial sector is much smaller in size compared to the conventional financial sector even in countries where it has the strongest presence. It is not a complete economic system but a developing financial system. Therefore, even if tried to, it could not solve larger economic and financial problems such as poverty and credit access.

One view was that in some emerging markets where Islamic finance has a relatively strong presence, there is a need for financing developmental infrastructure that serves the need for energy, transportation, water, and other vital services. While financing such infrastructure could be considered pursuit of the objectives, it may not be economically attractive for commercial entities.

Others held that wider economic issues are better addressed by the government through taxation and development spending or other routes Islam provides for addressing these issues, such as charitable lending (qard hassan), charitable giving (sadaqa), mandatory religious contribution (zakat) and charitable trust (waqf).

It was professed that customers of Islamic financial services do not necessarily seek the most idealistic form of Islamic finance. Customers may approve the social development ideals of Islamic economics which would be seen to be in line with the objectives, but it is unlikely that the customers would also be willing to accept lower return or higher risk for social development. The customers and shareholders in Islamic financial sector wishing to pursue development goals remain free to do so in their private lives.

The alternative view was that Islamic financial services will be unable to distinguish themselves from conventional financial services and offer a meaningful value proposition to potential customers if they are not concerned with aspirations of the people and larger social needs.

Some participants cautioned that the criticism facing the Islamic financial sector for converging with the conventional financial sector may affect its longer term sustainability. If the modern Islamic finance industry is mainly about avoiding a few 'sin industries' and replicating conventional finance by changing the form of contracts, then in the age of information where facts and opinions are spread easily, prospects for sustainable credibility and thus sustainable growth at a global level do not look bright.

Financing development while avoiding debt

Participants discussed that if commercial entities are not suitable for pursuing non-commercial objectives, how will development be financed without the proliferation of debt, which is a defining characteristic of conventional finance.

It was argued that if financing micro-enterprise and SME (Small & Medium Enterprises) is aligned with the objectives, such financing needs cannot be met through entities such as commercial banks. Providing such financing would require setting up financial institutions that are meant to provide such services. If the Islamic financial sector is required to finance micro-enterprises and SMEs while conventional financial sector is not, it would make the former less competitive.

It was claimed that conventional financial services are in some cases socially useless but they still receive unjustified benefits from tax payer's money such as bail outs in times of crisis. It was also held that the conventional finance system relies heavily on debt and the Islamic financial sector is doing the same, although such reliance on debt is considered to be inconsistent with the objectives.

Participants noted that the current economic system favors debt over equity and does not provide the two with a level playing field, making equity financing more difficult than would otherwise be the case.

One suggestion proposed was that regulators and other entities involved in licensing financial institutions strike an appropriate balance between the different types of financial institutions (commercial versus developmental) being licensed, after an analysis of the development needs in the economy. This could help in aligning finance with social needs and therefore the objectives.

Moving from lawful to ethical finance

Participants noted that there is a difference between lawful and ethical finance.

Some argued that pursuing the objectives means pursuing the ethical and being concerned with the impact of one's actions on others. What is lawful may or may not be ethical; for instance, in conventional finance, the bonuses paid to bankers are lawful, but they are often seen as unethical. Similarly, junk food could be licit on technical grounds, but that does not stop it from harming one's health, thus raising ethical issues.

Others asserted that Islamic ethics in finance should not be limited to technical compliance with the prohibition of riba. Islamic finance needs to be ethically conscious to be in line with the objectives and there is a need to go beyond minimum legal standards to the ethical, moving from licit to wholesome (tayyib).

It was highlighted that while commercial entities operating in the Islamic financial sector cannot solve the larger economic and social problems, pursuing the objectives could be interpreted as considering the impact of financial services on the society and environment, in addition to following the religious prohibitions in substance. For

example, in extending financing, it would mean using equity rather than debt and taking into account factors such as employment generation and carbon emissions.

It was suggested that building this impact orientation into religious rulings should lead to enhancing benefits and reducing harms. The question was how to assess and incorporate impact. While no conclusion was reached, it was argued that in the absence of specific standards and guidance on how to take impact into account, the Islamic financial sector should continue doing the best it can to use the knowledge and experience developed by some of the institutions in the conventional space.

Supplementary issues and views expressed by participants

While most of the discussion during the day focused on the broad themes relating to reappraising the industry, some more focused debates on supplementary issues also took place.

Shari'a Governance

Participants discussed issues related to shari'a governance, most notably conflicts of interest.

It was pointed out that attempts to address conflicts of interest in shari'a governance have thus far focused on the number of firms a scholar may represent and compensation arrangements. An alternative approach was suggested that would involve creating a professional organization of scholars that would set industry-wide practice rules, promote ethical standards of behavior and create a forum for knowledge sharing and debate.

Concern was raised that shari'a scholars who help develop products as members of shari'a boards are represented on AAOIFI's shari'a council. Because these shari'a scholars first act as advocates of innovative financial products at the financial institutions and then as judges of shari'a quality assurance at AAOIFI, there is a strong need for an independent quality assurance process. One possibility is to have a majority of independent scholars on AAOIFI's council who could be sponsored by central banks. Additionally, standard setting bodies are in the process of developing ways to address governance issues which merit due consideration.

Another concern was that the issuance of religious rulings and the subsequent monitoring and auditing for compliance with these rulings is being carried out by the same individuals. Shari'a scholars lack both the training and the time to carry out ex-post compliance and to raise its standards. Instead, this should be outsourced to professional auditors.

It was also argued that while the diversity of views in Islamic jurisprudence has been deemed a blessing by many scholars, it has been turned into a curse by market forces. For example, using this diversity, monetization is used to initiate a debt and then refinancing of existing debt (qalb al dayn) is used for debt to grow unrelated to a real transaction.

It was explained that countries are addressing issues in shari'a governance differently and what suits one may not suit another. For instance, central shari'a advisory councils may be appropriate in Malaysia but not in the UK.

Transparency of religious rulings

Participants were of the view that generally, financial institutions offering Islamic financial services disclose the religious rulings (fatawa) that have been obtained for their products and services.

Participants agreed that disclosure of these rulings is consistent with the commercial interest of the financial institution. However, it was pointed out that the details of the financial engineering involved in certain complex products is not made public in order to protect the competitive advantage gained for that investment in product development. In such situations, there could be a delayed disclosure of the details.

Others held that even when competitive advantage is not an issue, the underlying reasoning often remains undisclosed--a practice which needs to change.

It was mentioned that shari'a scholars often participate in forums that produce research on jurisprudence and detailed reasoning. However, those working in the industry usually are unaware of these efforts.

It was contended that the information on rulings is fragmented. It would be in the interest of the industry and the public to start a central database and compile the rulings together with the underlying reasoning.

Shari'a-compliant versus shari'a-based

In the context of reappraising the Islamic financial sector, participants also discussed these two seemingly conflicting terms. The discussion centered on the difference, if any, between the labels shari'a-compliant and shari'a-based.

One view was that there is no difference between the two terms beyond semantics. Both refer to something being legal in the context of shari'a. "Shari'a-based" may have been coined to criticize certain Islamic financial products by dubbing them merely compliant.

Another view was that the terms are in fact different: shari'a-compliant refers to relatively passive legal compliance (akin to legal box-checking to determine if something is impermissible), while shari'a-based refers to a proactive effort to achieve something economically positive that advances the objectives of shari'a.

Another view was that both terms refer to the relative strength of their religious authenticity. For example,

financing based on ijara could be seen as more authentic than financing based on commodity murabaha.

Some saw shari'a-compliant as the economic equivalent of something in conventional finance, such as credit sale (murabaha) which in its economic substance is similar to an interest bearing loan, whereas shari'a-based means that something is derived from the primary sources of Islam, such as a financial institution dedicated to zakat.

Fora to bring about institutional changes

It was noted that the points in the written comments by the participants submitted prior to the workshop were often expressed in a black and white manner than was the case in the many-sided discussions of these points during the day-long workshop. While some questioned whether this nuancing during the workshop was merely due to politeness; others pointed to the rarity of such many-sided open discussions in other venues.

Some participants felt that there is a need in the Islamic financial sector for a fora to conduct the type of many-sided discussion which took place during this day-long workshop. These fora should enable the observers and stakeholders of Islamic finance to seriously consider the needed institutional changes, such as setting up a professional body for shari'a scholars, to address the challenges facing the industry and to make it what it should ideally be.

Future Prospects

Towards the end of the fifth workshop, participants discussed the possible impact on the Islamic financial sector of the political protests, violence and regime change taking place in parts of the Middle East and North Africa where, in some cases, the Islamic financial sector has limited, if any, presence.

Some participants saw this as an opportunity for Islamic finance because, in their view, those who are rising up against oppressive regimes in these Muslim-majority countries are religiously inclined and will be favorably disposed to Islamic finance. These participants were of the view that in the past, Islamic finance was not supported by the regimes in some of these countries, though this may begin to change. Others pointed out that to capitalize on this opportunity, the challenge for Islamic finance would be to offer a meaningful proposition to the people of these countries that is consistent with Islamic values and justice.

<u>Harvard-LSE Annual Workshops</u>	
2011	Reappraising the Islamic Financial Sector
2010	Islamic Financial Ethics and Ethical Governance
2009	Microfinance: Toward a Sustainable Islamic Finance Model
2008	Sukuk: Economic and Jurisprudential Perspective
2007	Tawarruq: A Methodological Issue in Sharia-Compliant Finance