Harvard Law School Islamic Finance Panel
March 16, 2009

The Evolution Of The Global Financial System From The Current Crisis:

A Report On The Panel Discussion

The Islamic Finance Project (IFP) organized a panel discussion at Harvard Law School on March 16, 2009 in an effort to determine the relevance and merits of Islamic finance principles, in light of current global financial crisis. Given the relative insulation of Islamic financial institutions (IFI's) from the brunt of the crisis, IFI's may provide insights into the development of a more stable and morally-sensitive financial framework. The roots of the current crisis run deeply into ethical, legal, and economic issues, As such, only a multi-disciplinary approach can properly discern the foundational issues. Thus, the discussion was intended to provide a platform for robust discussion between various experts and present possible opportunities for a more values-based approach to finance.

The current financial crisis, with its worldwide reach, is causing a fundamental rethinking of the global financial system. Basic assumptions regarding the role of banks, the responsibilities of regulators, the treatment of customers, and the bounds of financial innovation are being examined and revisited. The Islamic finance sector has not been immune from this crisis, though it has experienced a level of insulation from market instability, due to its generally conservative operating models.

Given the internationalized aspects of today's diversified global economy, the Muslim world has been deeply affected by the global recession. While observers expect a "new financial order" to emerge from the crisis, one redesigned based on lessons currently being learned, we here at Harvard Law School's Islamic Finance Project hosted this event to analyze the crisis and consider the strengths and weaknesses of incorporating certain modalities of ethics-based finance, as envisioned in Islamic economics.

Samuel L. Hayes, III, Jacob H. Schiff Professor of Investment Banking, Emeritus of Harvard Business School, as moderator, set the tone by providing the history of investment banking, and linked the discussion to the current global financial crisis.

The panel discussion was based on a paper written and presented by Aamir Rehman, Director and Head of Strategy of Fajr Capital, entitled, The Relevance of Islamic Finance Principles to the Global Financial Crisis. This paper was written to attain an ethical understanding of the current economic malaise, which attributed a three-fold explanation to the crisis. Namely, excessive lending, opaque financial securities and failures in governance were the primary drivers of the crisis. Rehman argued that there were more fundamental ethical and technical problems associated with each issue. Consumer materialism and lenient attitudes towards borrowing allowed for overleveraging by banks and pervasive household debt. Failures to properly value mortgage-backed securities created conditions for irresponsible usage of derivatives. Finally, a misalignment of incentives, lack of supervision, and regulatory lapses combined to create a governmental failure in placing checks and balances in the financial industry. For each issue driving the crisis, Rehman pointed out the relevance these issues have in the theoretical and practical application of Islamic finance.

To address his first point regarding excessive lending, Rehman pointed out that due to the increased emphasis on asset-based lending, much of the over-leveraging that occurred before the crisis may not have been as far-reaching in Islamic finance.

Rehman illustrated his points on the failures to properly value securities by arguing that the since the loan originator and the loan provider were separate entities during the euphoric mortgage boom, there existed an inherent conflict of interest in the financial system. The interests of the loan originators were to structure and close loans to as many homebuyers as possible. This caused a relaxation in the ordinary due diligence process one would undergo when determining the credit worthiness of the borrower. The loan borrower, represented by owners of securitized mortgage-backed securities, by the same token, did not undergo a deep credit analysis due the heavy reliance on credit rating agencies. Due to these segregation of duties, credit risks became susceptible to becoming improperly ad-

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dressed. A majority of scholars in Islamic finance, on the other hand, deem the sale of debt impermissible. As such, the lack of the transfer of debt would nullify the separation of the role of the originator from the lender, and would theoretically lead to more careful origination on the part of the lender.

Lastly, Rehman deemed the "ethical supervisory boards" (i.e. Shari'a boards) that are charged with approving Shari'a-compliant products, serve as an added level of checks and balances to ensure financial transactions are conducted in accordance with the principles of Islamic finance. Rehman termed these boards as "CSR with teeth" due to the common goals that are shared with many corporate social responsibility bodies in ensuring values-based investing is properly performed. The Ethical Supervisory Boards are given distinct importance within the field of Islamic finance, and serve as a form of regulation within the field.

Overall, Rehman promoted a values-based financial system, and illustrated how the ethos of Islamic finance would serve as a model to consider in determining the potential improvement of the overall financial system. He summarized that the limitation of credit and debt-based securities within Islamic finance are in favor of a more asset-oriented approach. Rehman also argued that a general restriction on the sale of debt, which is rooted in its enormous religious gravity, is a way of increasing the stability of the financial system. Finally, the presence of Shari'a boards imbued with legitimate auditory powers allowed for rigorous regulation of financial instruments.

The discussion paper concluded with several suggestions from the presenting panelist. Among the Islamic finance practices that could potentially translate to more conventional financial concepts, he emphasized a turn from debt-based instruments to more asset-oriented finance. Next, he proposed a direct limitation on the sale of debt in order to insure greater transparency and less misinformation regarding investment risks. He concluded by advocating advisory councils similar to Shari'a boards in auditing the investment practices of their respective firms.

In response to the discussion paper and corresponding presentation, Baber Johansen, Acting Director, Islamic Legal Studies Program and Affiliated Professor of Law, Harvard Law School and E. Roger Owen, A.J. Meyer Professor of Middle East History, Harvard University raised several key issues. Johansen noted that operationalizing ethical principles within conventional Western markets will be the key issue. Moreover, the ethical concerns should be guided towards a reduction of debt and that Islamic financial principles do indeed encourage risk-bearing activity with parallel incentives. However, the prohibition of interest (riba) creates a large transference conundrum as sectors such as microfinance rely on heavy interest rates. Finally, debt-based structures do indeed exist within Islamic finance and historically one example of unfair exchange can be found in the salam contracts.

Owen's discussion points tended towards an examination of the broader Middle Eastern political economy. He noted the current crisis in the Dubai housing markets and corresponding government action as trending towards long-term increases in federal debt. Moreover, Owen pointed to a pervasive lack of trust resulting from the shocks to the Arab markets. This lack of trust was directly the result of prior overconfidence in the ability of government treasuries to insulate against economic downturns. Although the economies of the Middle East remain intertwined, the regulatory frameworks tended towards a national scale as evidenced by a general absence of regional banking franchises. Owen recommended increased economic cooperation between Middle Eastern states as a means of improving regional economic stability and accounting for intrinsic economic connectedness.

Following the panelist discussion, a general question and answer session was conducted with the audience. Several insightful questions were posited by audience members and these elicited significant thought from the panelists. First, there was the possibility of growth within an Islamic financial framework. Rehman granted that limitation on the sale debt did indeed carry a serious risk of economic contraction. Panelists also agreed with an audience member's suggestion that potential advisory boards in Western banks parallel the practices of "ethically responsible" investment firms. Owen also remarked on a general low level of financial education in the Middle East and that alleviating this ignorance would be crucial to creating wiser investment practices. The issue of account insurance was also brought up and Rehman responded with support for the insurance of non-risk bearing accounts but had ethical reservations with insuring risk-bearing accounts as Islamic financial principles are based on an acceptance of risk in the pursuit of profit.

Treasury investment in local equity markets also posed a significant issue in economic recovery. However, the panelists noted that a general paucity of derivatives allowed for a relatively less serve impact on markets. A significant issue was raised regarding the possibility of introducing Islamic financial instruments in conventional Western markets. Rehman approached the issue from a practical perspective arguing that the attractiveness of Islamic finance would be tied to structuring the instruments so as to parallel profit rates from more traditional products.

The latter portion of the question and answer session was devoted to querying the organizations supporting the Islamic finance project. Audience members inquired and commented on various items, such as the viability of a classical currency standard, (i.e. gold), as well as the potential conflicts of interest that may exist on Shari'a boards. In the case of potential conflicts of interests, Rehman pointed out that conflicts of interests are inherent when advising multiple clients, and the key is to acknowledge the existence of it, and to respect trade secrets among clients.

Given the recent public support of the Vatican towards Islamic finance, attendees were curious as to the possibility of joint-religious cooperation. Aamir Rehman also argued that the critical moment in raising the public profile of Islamic finance occurred with its adoption by Citibank and HSBC as viable business ventures.

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The closing remarks focused on a need to turn away from the general level of opaqueness associated with the financial industry in the last two decades. Rehman proposed a return to transparency, responsibility and confidence. He noted that such a shift would be incumbent on the capacity of government to effectively corral a runaway financial system and reorient it towards a value-based approach.
for the product, understand the needs of the institutions, and become more capable in offering alternatives and suggestions to work with the current regulatory scheme while maintaining the integrity of Islamic law.

There are very few books available that concisely and accurately describe Islamic finance, and some efforts should be made in order to compile this information and release it to regulators. Workshop participants representing regulatory agencies also seemed very open to the idea of having an informal gathering where an "Islamic Finance 101" session would be conducted. The research team at the Islamic Finance Project has already begun to consult with Richard Todd (Federal Reserve Bank of Minneapolis) and other regulators in order to achieve this goal in the near future.

More Cooperation Among Institutions

Because Islamic finance is a field that is still in its developing stages, cooperation among the current institutions is imperative to the future success of this industry. Some participants pointed to a collective action problem that many of the institutions independently face. Efforts made by one institution would be used at a much cheaper cost by other institutions. No institution would therefore want to take a leading role, preferring to wait until another institution took the initiative. Alternatively, when institutions have made some efforts that all institutions could benefit from at a cheaper cost, the leading institution will avoid revealing that information in order to keep its investment to itself.

It was determined that this problem could only be resolved through cooperation between institutions. The workshop offered an opportunity for extensive discussion about how to make this happen. One possibility discussed was to form a group with representatives from each of the respective institutions and a representative from one neutral body to maintain cohesion between the participants. The group would meet periodically to facilitate open communication and dissemination of information regarding Islamic finance in the industry.

Standardization

There was significant discussion during the workshop about the possibility of starting an Islamic Bank of USA. As many participants pointed out, it is a huge leap from the current status of Islamic finance in America, but it can be achieved as was demonstrated by Michael Hanlon, of the Islamic Bank of Britain, (albeit with a different, yet very similar, regulatory body).

Before such a goal can be accomplished there are some intermediary steps that will need to be taken. First, Islamic finance products and the Islamic law that supports them would need to be standardized. Islamic scholars may disagree on approaches to Islamic finance, but some general type of standardization must be reached and implemented among the various institutions. This is a goal that would be much easier to reach if point three (institutional cooperation) were accomplished, especially if cooperation is achieved between an established group of representatives from Islamic financial institutions. This would not only make it easier for regulators to understand Islamic finance and its demand, but it would likely help customers feel more comfortable with Islamic finance as an alternative to conventional financing. Second, the regulation of Islamic finance, which varies significantly depending on region, should be brought into line. Workshop participant Richard Todd suggested convening more informal gatherings, which would facilitate communication between the regulators and establish more standardized regulation of Islamic finance products.

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