ISLAMIC FINANCE

Current Legal and Regulatory Issues

S. Nazim Ali
Editor

With an Introduction by
Clement M. Henry

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Preface

This book is the first publication of the Islamic Finance Project (IFP) since we transferred to the Islamic Legal Studies Program (ILSP) at the Harvard Law School in January 2004. IFP's aim is to study the field of Islamic finance from the legal and shari`a points of view by analyzing contemporary scholarship, encouraging collaboration among scholars within and outside the Muslim world, and increasing the interaction between theory and practice in Islamic finance.

The Harvard University Forum on Islamic Finance continues to be one of IFP's principal activities. The authors included here originally presented their work at the Sixth Forum, held on May 8-9, 2004. Unlike previous years, we have published a volume of selected papers in lieu of complete Proceedings for the Forum. These papers are therefore only a fraction of the thirty-six papers presented at the Sixth Forum. The title reflects the theme of the Forum; the introduction has been provided by Clement M. Henry, to whom I am grateful.

It may be appropriate here to recall the senior addresses at the Sixth Forum, which have not been included in this volume. John B. Taylor, the Under Secretary for International Affairs in the United States Department of the Treasury, opened the Forum by expressing the U.S. Treasury's commitment to learning about and engaging with the Islamic financial services industry. He stressed the importance of transparency and disclosure and stated that, as with conventional financing, Islamic financing will benefit from transparency, good governance, and an internationally accepted regulatory framework.

Ahmad Mohamed Ali, president of the Islamic Development Bank (IDB) Group, emphasized effective supervision as a must for the success of the Islamic financial services industry. He identified risk management, disclosure and transparency, accounting and auditing, internal control systems, and corporate governance as areas where the formulation and adaptation of standards was required.

In his remarks at the Forum banquet, Nurcholish Madjid, Rector of Universitas Paramadina in Indonesia, elaborated on the morality and ethics of Islamic finance. He expressed the hope that the world community, in close global economic cooperation, would find a way to overcome injustices in the current financial system. He suggested that experimentation

with Islamic finance based on the shari`a would allow Muslims to offer productive solutions to contemporary economic predicaments and thereby benefit humanity as a whole.

The Forum is one of a wider set of IFP efforts to study the field of Islamic finance. Since its transfer to the law school, we have also conducted research on the effects of 9/11 on the Islamic finance industry, have hosted a seminar featuring Jeffrey Sachs on the long-term economic prospects of the Middle East, and are in the final stages of preparation for what is perhaps the first seminar that brings together Islamic financial institutions and regulatory agencies in the Unites States.

A number of individuals have supported the project and worked together to enhance and increase its activities. Most notable among them are Frank E. Vogel, Director of the Islamic Legal Studies Program, Harvard Law School; Samuel L. Hayes, Professor Emeritus, Harvard Business School; and Thomas D. Mullins, former Associate Director, Center for Middle Eastern Studies. Peri Bearman, Associate Director of the ILSP, was particularly helpful in the organization of the Forum and review of papers.

IFP sponsors deserve special mention for the vision they show in promoting Islamic finance by means of independent academic inquiry. They are Arcapita Bank B.S.C.of Bahrain, Kuwait Finance House of Kuwait, and HSBC Amanah of United Arab Emirates.

A number of devoted Harvard students at different schools in the university were of great assistance to IFP in the compilation of the databank, organization of the Forum and seminars, and help with research and publications. The Project owes special thanks to them, particularly Mansoor Shakil LLM ’04; M. S. Shaheen JD ’06; M. A. Vaid MBA ’05; Aamir Rehman MBA ’04; and Abdur-Rahman Syed AB ’99.

I would like also to acknowledge the assistance provided by M. S. Shaheen JD ’06, in compiling these papers and Sina Muscati LLM ’05 in carrying out the preliminary editing. Special thanks go to Peri Bearman for reviewing papers and providing suggestions for improvement. And I should finally like to thank the copyeditor, Matthew Seccombe, for his assistance.

S. Nazim Ali
Director
Islamic Finance Project

Introduction

Clement M. Henry[1]

It is an honor to introduce this book of fine essays originally presented at the Sixth Harvard University Forum on Islamic Finance, May 8-9, 2004. Their focus on current legal and regulatory issues comes at a critical time in the history of the industry for three reasons. Since the year 2000, responding in part, perhaps, to high oil revenues flooding the economies of the Gulf Cooperation Council (GCC) states, Islamic financiers have devised an array of controversial new securities. Secondly, they have also in these years completed an institutional architecture designed to regulate the industry with common standards. Thirdly, international concerns about the stability of the international banking system led in 2004 to the Basel II Accord issuing new guidelines concerning the capital adequacy requirements of banks. Meeting the new guidelines poses special challenges for Islamic banks.

The essays reflect a current controversy over the future of Islamic finance. Barely three decades old, the industry is coming of age and is grappling with issues of regulation arising from its initial successes. Its entire financial surface – estimated at about $250 billion in total assets divided among 261 banks – is only about one-fifth the size of Citigroup, but, although minuscule by world standards, it is growing at an annual rate of at least 10 percent. Islamic finance is now "firmly established as a key regional industry and an interesting global niche industry,"[2] according to the Union of Arab Banks. It is also too large and visible, especially since 9/11, to avoid scrutiny on the part of international as well as national authorities by disappearing into a misty informal international economy. And just as high oil prices contributed to the original demand in the mid-1970s for

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[1] Professor of Government and Middle Eastern Studies, Department of Government, University of Texas (Austin).

[2] Union of Arab Banks 2004. An announcement for the Fourth Annual Islamic Finance Summit sponsored in London by Euromoney claims that Islamic finance is growing 15 percent per year. See http://www.euromoneyseminars.com/pdfs/ELE667.pdf (last visited December 6, 2004).

Islamic banking, the new highs since 2000 seem to be stimulating another phase of rapid growth.

Islamic banks are rapidly gaining market share, especially in the Gulf Cooperation Council (GCC) countries. Conventional banks like the National Commercial Bank (NCB), Saudi Arabia's largest, are establishing Islamic windows.[3] Saudi American Bank (SAMBA) recently converted its Buraidah and Onaiza branches into "dedicated Islamic Banking locations," supervised like the NCB by an independent *shari'a* board. By 2004 interest ("commission")-free deposits and depositors' "investments" in Islamic banks and branches were probably accounting for close to half of the total market in Saudi Arabia.[4] In the smaller GCC countries the Islamic sector exceeded 15 percent, and it reached 10 percent in Jordan.

Its very successes have provoked much soul searching, as evidenced in Part III of this book. As originally conceived by some of its pioneers,[5] Islamic finance projected a distinctive ethic of risk-sharing, offering venture capital in the form of *mudaraba* and *musharaka* to small businesses.[6] Unlike conventional banks, Islamic banks were expected to engage in equity financing, sharing profits and losses with their clients. But venture capitalism was too risky, especially in Middle Eastern business environments, where the banks were also determined to compete with commercial banking systems. The transnational Islamic finance groups of Dar al Mal (headed by Prince Mohammed al-Faisal) and Al Baraka (headed by Saleh Kamel) quickly turned to less risky financial operations to compete with conventional banks. Even the less commercially driven Islamic Development Bank, a state-owned consortium, had to reduce its portfolio of *mudaraba* and *musharaka* to remain financially viable.

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[3] In its 2003 Annual Report, the National Commerce Bank explains that its retail banking "provides banking services, including consumer lending, current accounts and investment management services to individuals and small sized businesses in addition to Islamic products in compliance with *Shariah* rules and supervised by the independent *Shariah* Board." See http://www.ncb.com.sa/fin/03/notes2.pdf (last visited December 6, 2004).

[4] Al Rajhi Banking and Investment Corporation alone had 14 percent of the kingdom's commercial banking deposits in 2000, and some 30 percent of all commercial banking deposits were non-interest-bearing in 2001. See Henry and Wilson 2004: 7, 109-114.

[5] Ahmad Najjar founded the first rural cooperatives in Egypt in 1963, modeled on German *Sparkassen* employing profit sharing techniques for financing small enterprises. To stay out of political trouble with Nasser, who had repressed the Muslim Brotherhood, he did not make any references to Islam. But he subsequently played an active role as an adviser to the transnational group of banks established by Prince Mohammed Al Faisal until the mid-1980s, when they split over ideological and business differences. See Clement M. Henry, *The Mediterranean Debt Crescent* (University Press of Florida, 1996), 269-275.

[6] See *infra*, pp. 19-21 for definitions of these terms.

Competing with conventional banks in fact required Islamic banks to mimic conventional practices. Their main customers are Muslim depositors who reject interest as *riba* (usury) yet wish to receive profits from their investments that meet prevailing interest rates of return on deposits. To generate the necessary profits for their depositors, the banks were obliged from their inception to invest their funds in less risky assets than those targeted by venture capitalists.

Their bread-and-butter instrument is the *murabaha*, a contract whereby the bank purchases a good for the client and sells it to him on a deferred payment basis at cost plus profit. Instead of sharing uncertain profits with the client as in a *mudaraba*, the bank is to receive a fixed payment by a certain time. The client agrees, for example, to pay the bank $22,000 a year later for a car that costs $20,000. Practices vary among Islamic banks but they seek to minimize any risk associated with owning the vehicle because they are competing with conventional banks. In most countries, especially those influenced by British or American banking practices, the commercial banks are supposed to specialize in finance and not be involved in other businesses such as car dealing. To compete effectively, the Islamic bank must also distance itself as much as possible from other businesses. Yet the bank must deal with the physical merchandise – and in the above example actually own the vehicle for at least a second or two – if its operations are to be deemed truly Islamic. In that example the *murabaha* is equivalent to a consumer loan of $20,000 at 10 percent interest. Despite taking on added risk, the Islamic bank cannot earn more "profit" than the going interest rate because the consumer will otherwise prefer to take out a conventional loan.

However closely it mimics the conventional bank, the Islamic one remains at a slight disadvantage because of the commercial risks and transaction costs associated with the *murabaha*. Yet the more effectively it mimics the conventional bank, the greater its vulnerability to the charge that it has compromised its Islamic identity – even to the point of appearing in the eyes of some Muslim critics as less truly Islamic and transparent than conventional banks!

Islamic finance is thus torn between the need to preserve its distinctive identity and the needs of the marketplace. Yet as recently as 2000 in his pioneering book on the subject, Ibrahim Warde highlighted difficulties even in demarcating Islamic finance, much less defining its identity:

> No definition … is entirely satisfactory. To every general criterion – a financial institution owned by Muslims, catering to Muslims, supervised by a Shariah Board, belonging to the International Association of Islamic Banks (IAIB) etc. – one can find some significant exception. Indeed, even the criterion of self-identification – i.e., an Islamic institution is one that calls itself Islamic – would leave out the Turkish Finance Houses or Saudi Arabia's Al-Rajhi Banking and Investment Company, which … do not refer explicitly

> to their Islamic character. As for the principal focus on profit-and-loss sharing (PLS) activities, it remains more an ideal than a reality.[7]

The other major recent study of the subject is Frank E. Vogel and Samuel L. Hayes, III, *Islamic Law and Finance: Religion, Risk, and Return* (Kluwer Law International, 1998). They assert that "the structure of Islamic finance is firmly rooted in the Qur'an and the teachings of Muhammad, and the interpretation of these sources of revelation by his followers." They implicitly define the subject as "the application of Islamic law" to "an area of commercial life" or "a sector of modern commerce,"[8] but not specifically to the banking and finance sector. Presumably Islamic law cannot be applied to any conventional definition of this sector because, at least in their understanding, Islamic law is opposed to many conventional practices of banking and finance.

In effect, the Vogel-Hayes definition puts Islamic legal scholars in command of any further specification of a financial sector. Indeed, the body of their book deals with alternative legal rulings about various contracts that are central to the discipline of Islamic finance. The trouble with this approach, as Frank Vogel reveals in detailed analyses of cases and precedents, is that the legal scholars, including those on the various *shari'a* boards of the Islamic banks, disagree on many key points. A financial practice that one Islamic bank's *shari'a* board finds acceptable may be unacceptable to the board of another bank. Institutions with sufficient authority to make universally accepted definitions do not yet govern Islamic finance.

That is why the recent efforts to build a regulatory framework for Islamic finance are such a significant step forward. The Islamic Financial Services Board (IFSB), established in 2002 with sponsorship from the International Monetary Fund (IMF), is in effect mandated to define the industry by standardizing its products, and the International Islamic Rating Agency, established a year later, is to grade the financial management of its recognized agencies, the Islamic banks. These regulatory institutions have materialized just in time – amid an explosion of markets for new securities in response to booming demand from investors. But they are young, under-staffed and under-funded, more an expression of aspirations for Islamic financial order than an established industrial authority. The hope is that the IFSB can set and disseminate international standards for Islamic financial institutions. Its sixty members include fifteen central banks of predominantly Muslim countries, a variety of Islamic banks, and, as associate members, the IMF, the World Bank, the Bank of International Settlements, the People's Bank of China, and the Central Bank of the

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[7] Warde 2000: 5.
[8] Vogel and Hayes 1998: 1-2, 19, 23.

Philippines.[9] The standard-setter behind the scenes that successfully lobbied for the creation of the IFSB is the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), founded in Bahrain in 1991. To date it has issued fifty-seven standards on accounting, auditing, governance, and ethical and *shari'a* standards, most of them within the past two or three years.[10]

Were the IFSB to gain the full international authority required to define Islamic banking practices, however, they would still be subject to religious or ethically inspired objections to their "Islamic" identity. The present book goes over some of these objections, as well as the varying responses of different authors. Although we cannot resolve the authors' disagreements, a careful reader can acquire an objective understanding of the issues at stake. The practitioners tend to focus on operational interpretations of fourteen centuries of *fiqh* law, whereas the theorists, including some lawyers (Hegazy) as well as economists (El-Gamal and Siddiqi), contrast what they consider to be the spirit of the law with prevailing Islamic banking practices. It is encouraging to note at the outset that all of the authors appreciate the logic of the other parties to the debate.

In Part I of this book Ibrahim Warde offers the necessary background about the basic instruments of Islamic finance for understanding what follows. He introduces us to many of the early, still unresolved problems of corporate governance in the Islamic banking sector. "Moral hazard" applies as much to religious or ethical organizations as to conventional businesses: indeed regulation may be even more necessary here, Warde notes, because some crooks tend to seek cover in ethical or religious shelters – and this tendency is by no means confined to Muslims! Warde takes us to the crux of the special problem facing Islamic banks: they operate under conflicting logics. "Unlike secular systems, the legal system of Islam incorporates both an economic and a religious logic." The conflict will be further analyzed in Part III, but first it is useful to examine a sample of the explosive new developments in Islamic finance, which are displayed and analyzed in Part II.

Islamic banks faced growing problems of excess liquidity and mismatched maturities in their first two decades of operations. They could not by definition park funds in conventional interest-bearing financial instruments unless they were ready to commit financial suicide by forgoing the interest payments. They were in need of functional equivalents of T-bills and other tradable securities, overnight interbank instruments, and other facilities available as a matter of course to their conventional commercial bank competitors. Finally, in 2000, the Bahrain Monetary

[9] The current members are listed on the IFSB website at www.ifsb.org/index.php?ch=3&pg=7&ac=10 (last visited December 6, 2004).

[10] See the AAOIFI website at http://www.aaoifi.com/ (last visited December 6, 2004).

Agency introduced the first Islamic T-bill, a non-tradable *sukuk al-salam*. The following year Bahrain pioneered a way of bundling Islamically acceptable leases into the first tradable Islamic debt security, a *sukuk al-ijara*. Malaysia followed suit in 2002, this time creating an internationally tradable *sukuk* that met U.S. regulatory requirements for conventional global bonds and was rated by Standard & Poor's and Moody's. The Islamic Development Bank, Qatar, Kuwait, Dubai, and the German state of Saxony-Anhalt subsequently issued a succession of Islamic bonds. Dubai formally launched its $750 million *sukuk al-ijara* on October 10, 2004, in partnership with the Hong Kong Shanghai Banking Corporation (HSBC) and other major international and regional banks, and our first contributor to Part II, who works for HSBC, explains the financial architecture supporting these new instruments.

Mohamed Rafe Md. Haneef, with law degrees from both the International Islamic University, Malaysia and Harvard Law School, applies his formidable cross-cultural legal skills to the analysis of the *sukuk*. Qualified both by the Malaysian and the New York Bar Associations, he was associate director of the HSBC Amanah, Dubai and evidently has hands-on experience with these Islamic bonds. His chapter here dissects the structure of the *sukuk al-ijara* and also the slightly more complex *sukuk al-istithmar* issued by the Islamic Development Bank. The structures, centered on a Special Purpose Company or Vehicle (SPC or SPV), effectively insulate Islamic investors from interest-bearing instruments, while retaining fixed payouts like the *murabaha* or more complex variants thereof to the Islamic investor. The reader may follow Haneef's argument step-by-step, looking at the variety of contracts between the complex of partners that constitute the deal. At each step in describing the components relevant to the Islamic investors, *shari'a* law precedents are cited. Generally the Malaysians accept the relatively "liberal" (for these purposes) interpretations of the Shafi'i school of law.

Haneef's paper will fascinate financial engineers but it will also appeal to Islamic legal scholars because he is careful not to overlook the opposing arguments from Shafi'i and other schools of Islamic law. Although other authors directly criticize the legal dexterity illustrated in these case studies of financial engineering, Haneef anticipates the attacks and admits that there can be honest disagreements. His paper also points to certain traits of *shari'a* law that are more consonant with the Anglo-Saxon common law tradition than with civil law, and indeed invites scholars steeped in Western civil law traditions – as in Jordan and much of the GCC – to better appreciate their own Islamic traditions.

The following paper by Kilian Bälz develops this theme. Common law tends to share more affinities than civil law with Islam's "common law" tradition of *fiqh*. In particular, the Islamic banks' bread-and-butter instrument of *murabaha* finds closer family resemblances in British common law than in German civil law. Bälz focuses on the treatment of the

Islamic contracts in these two legal traditions. The bottom line is that they are enforceable in both systems if they are suitably worded. This chapter does not deal explicitly with *sukuk* but points to legal methodologies that should work in enforcing these new instruments as well as the more traditional ones. The underlying importance of these findings cannot be underestimated because much, probably the majority, of Islamic finance involves overseas investment, subject to litigation in London and other Western capitals rather than in Bahrain, Cairo, Jedda, or Kuala Lumpur.

Michael McMillen takes Islamic overseas investment a step further. McMillen is a trained obstetrician as well as a New York and London-based lawyer, but after delivering dozens of babies he is now midwife to controversial new Islamic financial instruments in consultation with top-of-the-line *shari'a* lawyers and scholars. In his paper he takes us through the steps, methodically building a brilliant, complex instrument whereby the junior bonds financing up to 30 percent of a South Korean real estate project comply with the *shari'a* and thus with the needs of an Islamic investor. McMillen backs up much of his analysis of the various contracts with the *shari'a* law codified by the *Majelle* of the British colonial administration in Palestine in 1933, but he also has the advice of many active scholars. Rather than resorting to conventional Islamic standbys of *murabaha* or *ijara* (leasing), he sanitizes the junior debenture by pointing to the *shari'a*'s recognition of the residual use of property. The rents acquire an equity component that legitimates the fixed rate of return on the bonds. Analyses along these lines open the way to many further innovations that may help Islamic finance to catch up with its conventional competitors.

Indeed, one aspect of the transaction described by McMillen involves an Islamic option, which fortuitously meets a desire expressed by Haneef in his chapter for *shari'a*-compatible derivatives.[11] McMillen concludes that *sukuk*, while promising and innovative, are not the only way that Islamic finance can diversify its instruments. With more creativity and "reconsideration," not in the sense of rejection but rather of bringing back the full range of Islamic jurisprudence, he thinks Islam can continue to redefine finance in ways that will vastly expand the range of *shari'a*-compliant financial products.

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[11] McMillen notes, "It is assumed for purposes of this essay that the *Shari'a*-Compliant Investor desires to achieve a specific internal rate of return (the '*Target IRR*') on its investment and is willing to participate at a level of risk that is generally associated with equity capital investments. It is further assumed that the *Shari'a*-Compliant Investor is willing to forgo returns in excess of the Target IRR." Those returns could be viewed as an option. Note Mahmoud Al-Gamal's observation: "Protected capital mutual funds marketed in Saudi Arabia tend to rely on non-Islamic partners or advisers to receive an option-like payment as management or advisory fees (e.g. by capping investor returns at some percentage, and giving the partner/adviser all excess returns above that level as fees, i.e. paying with a call option)."

Looking to the long-term future of Islamic finance, it may be significant that, as noted above, the People's Bank of China joined the Islamic Financial Services Board as an associate member, along with the World Bank and the IMF. But full integration of Islamic finance into the global economy also rouses fears among some theorists and practitioners of Islamic banking that the spirit of Islam is being lost along the way. The contributors of Part III articulate some of these fears in their debates about the ethical issues and concern that Islamic finance retain its cultural and religious authenticity.

M. Nejatullah Siddiqi recalls the basic outlines of the ethical debate introduced by Ibrahim Warde. For Siddiqi the religious logic is expressed by the injunction against *riba*, any hint of which leads down a slippery slope. He conflates *riba* with social injustice and considers its prohibition to be "the first threshold in deterring injustice and unfair practices." Yet, as a former economics professor and president of the International Association for Islamic Economics, he also recognizes international market forces and the profit motives of commercial banks, Islamic as well as conventional. He re-examines two perennial problems faced by Islamic banks: (1) coping with delays in repaying *murabaha* debts, and (2) the permissibility of securitizing *murabaha* and other Islamically acceptable contracts. Each case illustrates conflicts between "jurists bent on ensuring justice by avoiding anything similar to *riba*/interest and the economists keen to maintain efficient markets."

Siddiqi objects, however, to the handling of certain legal issues by the *shari'a* boards of "an industry in a hurry" under market pressures from conventional banks. He is not convinced, for instance, that the analogies that some boards make between certificates of ownership in a company and shares in *murabaha* assets really justify the securitization of debt. Instead of manipulating legal interpretations to meet economic pressures, he argues for public recognition and debate over the conflicting ethical and economic priorities in light of a deeper understanding of Islam.

Mahmoud A. El-Gamal, who is the Chair Professor of Islamic Economics, Finance, and Management at Rice University, sharpens the debate by not only reaffirming Siddiqi's concerns but also implicitly attacking the Vogel-Hayes conception of Islamic finance:

> … By approving and eventually codifying (through AAOIFI, IFSB, OIC *Fiqh* Academy, etc.) legal stratagems to replicate conventional financial practices, jurists and bankers eventually drown the substance of Islamic law in their contemporary reconstructions of medieval forms of classical jurisprudence. …
>
> By focusing on medieval juristic forms rather than eternal legal principles of Islam, the industry may in fact violate those principles and become less Islamic than prudent utilization of conventional financial products.

Furthermore, El-Gamal outlines a model of "*shari'a* arbitrage" that suggests how Islamic finance may be losing its identity in the reams of arcane contracts illustrated by Haneef and McMillen. *Shari'a* arbitrage is a variant of regulatory arbitrage whereby a financial practice allowed in country B is not allowed in country A. The country B product is restructured offshore in a manner acceptable to country A. Now imagine instead that the countries are SPVs and other entities depicted in Haneef's or McMillen's complex diagrams of the new Islamic securities. The interest-based contracts required by conventional bank regulators can be hived off from the *shari'a*-based contracts required by Islamic investors.

El-Gamal illustrates the logic of this form of arbitrage by examples of simple back-to-back contracts for the purchase of a stapler. Virtually any conventional financial instruments can be mimicked by various degrees of separation insulating Islamically acceptable contracts from other contracts that maybe Islamically unacceptable. He presents an abstract set of tools for securitizing debt and even generating Islamic put or call options, which El-Gamal, unlike Haneef, apparently deplores, because the Islamic investor is not permitted to control the risk by hedging. Virtually anything goes, as long as the *shari'a* boards of the banks selectively confine their attention to certain contracts within a project rather than analyzing the entire set of contracts and its underlying intentions.

El-Gamal joins Siddiqi in invoking "the spirit of Islam" to warn against these practices, and he goes so far as to compare the lawyers' artifices with those used in money laundering. His principal concern seems to be that instruments advertised as "Islamic" may engender among Muslims a greed for credit characteristic of American consumers. In a way he is echoing a concern expressed by Haneef, who viewed an Islamic mortgage instrument as acceptable for financing one's year-round home but not a summer place in southern France (or presumably a South Korean real estate project).

Just as it is refreshing to read economists voicing ethical concerns, it is interesting to read a lawyer, not an economist, exposing the political economy of *shari'a* arbitrage. Walid Hegazy, with law degrees from Harvard and Paris IX, is a member of both the Egyptian and American bar associations. In his paper he reinforces El-Gamal's reservations about Islamic legalisms by raising serious questions about conflicts of interests of the legal scholars who serve on the salaried *shari'a* boards of Islamic banks and make the rulings *(fatwa*s*)* concerning their financial practices.

He also critically examines their "circumventive methodologies" for interpreting the *shari'a*, namely the *hila* (juristic stratagem, pl. *hiyal*) and *talfiq* (biased amalgamation of previous opinions to circumvent a prohibition). The *hila* is "a juristic trick that aims at circumventing the

legislative intent behind a certain rule." As Ibn Khaldun[12] and many other scholars point out, however, not all *hila* are illegal, depending on the purpose behind circumventing a regulation. But Hegazy marshals many examples in which the underlying intent is merely to circumvent the law so as to indulge in *riba*. He casts doubt on a number of key building blocks of the complex bond issues discussed in Part II.

Talfiq is the other legal methodology he deplores. It is a patching operation that also in his eyes compromises the legitimacy of the financial muftis' rulings. One of his illustrations is the *fatwa* issued in 1978 and reconfirmed in 1988 that ensured the economic viability of the banks' bread-and-butter *murabaha*, representing over 70 percent of their financial transactions. Hegazy's analysis implies that Sayyid al-Tantawi, the Egyptian Shaikh al-Azhar, may have been pretty much on target in 1988 when, then serving as Mufti of Egypt, he issued a *fatwa* to the effect that conventional banks were legal whereas so-called "Islamic banks" were not.

As if Islamic finance does not face enough challenges on the home front, the banks are also especially vulnerable to the new capital adequacy measures set forth in the Basel II Accord. In Part IV of this book Mansoor Shakil and Kristin Smith examine the external threats and opportunities.

Shakil's paper presents the relevant aspects of Basel II. The good news for Islamic finance is that measures of capital adequacy may be more carefully tailored to the risk profiles of individual banks and thus take certain specificities of Islamic financial houses into account. The bad news is that Basel II discriminates in favor of large banks that have the resources needed to analyze their risk profiles. Further, assets of non-OECD countries are graded as riskier than OECD-based assets and consequently require greater capital backing. Although greater disclosure requirements probably favor Islamic banks, their small size and location may put them at an ever-greater disadvantage against their commercial competitors. To level the playing field, Shakil suggests dissociating the banks from their investment accounts and reducing the capital requirements from the latter. New securities companies or a second tier of Islamic investment banks would then have separate, lower capital adequacy requirements. They would include the bulk of the present balance sheets of Islamic banks.

Indeed, Smith's paper reports that a compromise may be in the works that would split the difference. In 2001 the Bahrain Monetary Agency (BMA) already accepted the argument that investment accounts were not normal bank deposits and that half their value could be subtracted from

[12] In *The Muqaddimah* (Bollingen edition, Princeton University Press, 1967), p. 300, Ibn Khaldoun observes that "Commerce is a natural way of making a living. However, most of its practices and methods are tricky and designed to obtain the (profit) margin between purchase prices and sale prices. This surplus makes it possible to earn a profit. Therefore the law permits cunning [hiyal] in commerce … [as long as it does not] mean taking away the property of others without giving anything in return."

risk-weighted assets in assessing an Islamic bank's capital adequacy. The chairman of the Islamic Financial Services Board (IFSB), who as secretary general of AAOIFI had originally negotiated the agreement with the BMA, is currently negotiating Islamic banking compliance with Basel II along similar lines with the international financial institutions.

Smith's paper goes well beyond Basel II, however, to present a concluding overview of the "harmonization" of Islamic finance with the global order. The reader may well be advised, in fact, to jump directly from Warde's introduction to Smith's paper so as to get the global picture before entering into the details of financial rulings and interpretations discussed in the other chapters. Smith does not go into the details but she presents institutional developments that may cut through the legal quagmires. As Walid Hegazy, the sternest of the critics in these pages recognizes, a proper institutionalization of Islamic finance may counteract the tendency of *shari'a* arbitrage to undermine its Islamic identity.

As a political scientist who has done extensive fieldwork in Kuwait and other GCC countries in the Islamic financial sector, Smith has examined the synergies between the bankers and Islamist politicians.[13] In the present volume she spells out the surprising political strategy employed by the bankers to pressure their national regulatory authorities: utilizing the affinities noted by Bälz and others between Anglo-American law and Islamic finance, they appealed directly to international financial institutions, dominated by Anglo-American traditions of banking, to lobby on their behalf. They gained influential international allies, notably in the IMF, and enlisted them to sponsor the IFSB and other transnational Islamic institutions that mirror conventional standard setting authorities. Smith tells the fascinating story of Islam's new financial architecture along with visions, since 9/11, of shifting the Islamic investment flows from West to East.

Between Warde and Smith, the two political scientists who introduce and conclude the discussion, the other contributors can be seen to represent an unruly "civil society" of OECD-based lawyers and bankers scrutinized by critical theorists. Collectively they express the remarkable power of the international civil society that underlies Islamic finance and that is pressing for its integration with conventional finance, and they also articulate major ideological contestation. The hope, shared by the entire sample of "civil society" represented in this volume, is that the new regulatory authorities may work to institutionalize the ongoing debate.

Such institutionalization, let me suggest by way of concluding this introduction, may carry broader political implications in the wake of 9/11. Islamic finance is giving rise to a new transnational political space in which a distinctively Islamic dialectic of globalization can be articulated. Even as the Bush Administration's responses to 9/11 have intensified Muslim

[13] See her chapter on Kuwait in Henry and Wilson 2004: 168-190.

perceptions of a clash of civilizations and provoked defensive jihad among growing numbers of Islamists,[14] other Islamists are redefining globalization in the financial sphere. Most of their respective states do not offer adequate political space for actors to articulate their theses and antitheses; indeed, authorities tend to skirt around the economic and political ("governance") reforms associated with globalization as well as repressing the related discourse about them. But the transnational financial sphere offers a new arena in which to play out the dialectics of globalization and overcome moralistic identifications of globalization with imperialism—by Islamizing the economic forces at work. Conversely, however, unless the United States adjusts its foreign policies, the forces of imperialism and anti-imperialism may destroy the fragile freedom of Islamic finance.

[14] The "must-read" analysis of the phenomenon is Anonymous (Michael Scheuer), *Imperial Hubris*: *Why the West is Losing the War on Terror* (Washington, D.C.: Brassey's, Inc. 2004).