Innovation and authenticity

Dr Nazim Ali, director of Islamic Finance Project at Harvard Law School, US, recaps the debates held by international academics, Shari'ah scholars and practitioners during the Eighth Harvard Forum on Islamic Finance.

Given modern technological advances, risk is now a separate managerial decision, and risk transfer innovations increase the efficiency of risk diversification. A potential for growth in Islamic finance, identified by Professor Robert C. Merton, is in utilising available conventional market innovations in a Shari'ah-compliant manner. A challenge for the industry is to further probe Shari'ah-compliant derivatives for risk-mitigating strategies. Merton illustrated the benefits of derivatives by building a hypothetical example, noting that Taiwan's heavy direct investment in the electronics industry may be diversified if it contracted with other countries to exchange similar returns from unrelated industries. This would effectively increase the risk-weighted return without requiring a long-term change in infrastructure. Furthermore, the contract may be enacted, as well as reversed, virtually overnight, thereby causing no disruptions to the country. The result would be the same amount of exposure in gross returns, yet a lower overall risk profile. This flexibility in risk mitigation and industry diversification was contrasted with more disruptive diversification strategies such as building new industries and infrastructures from scratch, which require a longer timeframe, and are harder to reverse. Applying risk to an Islamic finance context, innovation is often limited by structural impediments, and the task remains to balance the tension between the benefits of innovation and maintaining the infrastructural quality of Shari'ah.

Innovation is indispensable, as it is necessary for a society to move forward to prevent stagnation and decline. However, rapid developments have created a global financial system plagued by crises over the last 30 years. As the lack of adequate market discipline in the overall financial system causes excessive lending and high leverage, risk-sharing on an Islamic finance model can curb lax lending and instill greater market discipline. Islamic finance can help raise the share of equity in businesses and of profit-and-loss sharing (PLS) in projects and ventures through the mudarabah and musharakah modes of financing. To make such a system workable, Muslim countries should develop unified financial institutions such as a centralised Shari'ah board or a Shari'ah clearance and audit, and a secondary market for Islamic financial instruments. How Islamic finance struggles with authenticity and innovation raises significant questions about how Muslims choose to live by fiqh and Shari'ah in the modern era.

In a world dominated by non-Islamic capital markets, the challenge for Muslims is to practice their religious tradition in the context of a conventional western capital model. While there are many instances where the Islamic solution is only modestly different from that of a conventional western contract, the importance of finding a halal solution is the person's intent to conform to religious principles, not simply a sleight of hand to get around rules imposed by Shari'ah boards. According to Samuel Hayes (professor emeritus, Harvard Business School), what motivates Muslims is not the effort to westernise Islamic concepts but rather to maintain a relationship with God and invest in a way that they find to be morally in line with God's plan.

There are continuing debates on who has authority to speak on authenticity. For about a thousand years this authority has

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been in the hands of Islamic scholars of fiqh (fuqaha) practicing ijtihad according to the age-old science of usul al-fiqh; and it remains with them today. Should greater transparency as to fiqh decisions now be adopted so that the public can better make their decisions? Are fatwas issued to individual financial institutions by individual scholars or by small Shari'ah boards a sufficient guarantee of authenticity, or must institutions in the industry be created to evaluate individual fatwas and fortify them through reviews and votes by larger groups of scholars, among them non-fuqaha? An important issue is how broadly or narrowly authenticity is to be judged. Is Islamic finance's compliance with traditional fiqh a question to be addressed solely within the relatively micro sphere of commercial law? Or is Islamic finance to be judged by broader, more macro objectives believed to be maqasid al-Shari'ah, such as strengthening Muslim economies, aiding the underprivileged, or better distributing wealth?

The dilemma concerning authenticity and innovation is central to Shari'ah. Frank E. Vogel (founding director, Islamic Legal Studies Programme, Harvard) has pointed out that the authenticity of a proposed law depends on its grounding in the Quran and Sunnah. However, only a few Quranic verses deal with the issues in question and innovation becomes necessary. In modern times the tension between authenticity and innovation has grown sharper because colonialism's sweeping legal reformulations destroyed fiqh's capacity for organic adaptation to change at the very time when modern societies began to transform rapidly. The normal balance between Shari'ah authenticity and social change evaporated and created a gulf between modern daily life and the provisions of Islamic law.

According to Adnan al-Bahar, chairman and CEO of The International Investor (TII), an investment banking and non-banking financial services company in Kuwait, there are two distinct forms of innovation. One type is through the repackaging of existing tools to serve a new need or more efficiently serve an existing need. These include the hedging of currency positions with a swap-like transaction achieved through a simultaneous purchase and sale of the same commodity (deferred payment murabaha contract) denominated in two different currencies. The second type is through new fatwas and breakthroughs in Shari'ah thought, such as in the fatwa defining the Shari'ah-compliant listed shares and the associated formula of dividend cleansing.

While many share a vision of innovation, whether something is legally correct may be easy to answer, but questions of authenticity per se remain open to discussion, and this may be more about how an idea sounds and feels rather than its sheer legality. A minority assert that authenticity often comes down to ideas, products and concepts that are legally correct by the letter of Shari'ah while also having both scholarly and consumer (market) acceptance.

Neil Miller, partner at Norton Rose, a London-based law firm, believes that tension exists in providing legal advice while giving Shari'ah guidance. Product development occurs along a spectrum, and issues of innovation and authenticity run throughout that spectrum. As such, it may be best to move away from the idea of innovation and toward evolution, a more comprehensive concept that better encompasses the manner in which conventional products are made Shari'ah-compliant.

Shari'ah scholars' perspectives

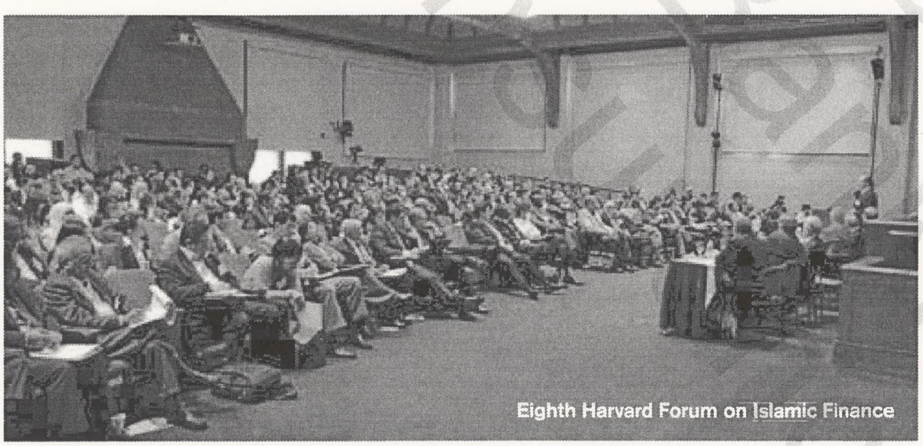
Shari'ah scholars agree that there needs to be a balance between innovation and authenticity, while stressing that Shari'ah welcomes innovation within boundaries. A view is that the room and the opportunity for innovation are infinite. Esam Ishaq, a Shari'ah scholar from Manama, Bahrain, says that 'there is no need to cut corners and not to observe what the Shari'ah requires, because the whole world is open for you. Just keep away from what is forbidden and essentially they are the contracts that contain gharar, maysir or riba.' Hussain Hassan, a Shari'ah scholar of Dubai Islamic Bank, believes, as do others, that the task of developing new products lies between bankers, Shari'ah scholars and lawyers, and that the greatest potential for useful, Shari'ah-compliant innovation lies with individuals who have dual knowledge in finance from a commercial and Islamic perspective. The key is cooperation between Shari'ah scholars and bankers.

The sub-prime mortgage crisis

According to Umer Chapra, well known for his scholarship in the field of Islamic economics, currently an adviser to the Islamic Development Bank research arm, Islamic Research and Training Institute in Jeddah, the crisis is a reflection of excessive lending. Although securitisation is a useful innovation, it allowed mortgage originators to pass the risk of default to the ultimate purchaser of the loan security. This created less incentive to undertake careful underwriting, and, consequently, loan volume gained priority over quality. The check that market discipline could have exercised on self-interest therefore did not come into play. A lack of market discipline leads first to excessive lending and then to financial crises. With the US Federal Reserve lowering interest rates to increase liquidity and avoid a recession, a risk is created exacerbating the vicious cycle of loose funding followed by further financial crisis. The solution, instead, exists in finding an effective way of introducing greater discipline into the financial system with an objective to check excessive and loose lending. This is the direction in which Islamic finance wishes to make a valuable contribution to the international financial system.

Law, policy and supervision

Islamic finance can be compared to other socially responsible forms of investment, such as socially or ethically oriented funds, in an effort to elucidate the common agenda between socially responsible investment and Islamic finance. The difference between the two industries is that the latter focuses on rules while the former focuses on values and principles. Kilian Bälz (visiting fellow, Islamic Legal Studies Programme, Harvard) believes that regulatory arbitrage between Shari'ah and local laws may be permissible, but formalistic adherence to Islamic legal rules may not be the only correct way forward. When addressing whether Islamic finance would enhance emissions trading, an issue that would arise is whether the right to pollute can be considered property in Shari'ah. Abdul Kadir Barkatulla, a Shari'ah consultant in London, questions whether the Islamic finance industry can move from the current model of using conventional product structures and simply adjusting them to gain Shari'ah approval, to creating original Shari'ah-based products for any market's benefit. Lines of products carrying high Shari'ah risk could include certain capital protected structured products, money markets, linked notes, hedge funds and exchange-traded funds. Abdurrahman Y. Habil, senior vice president at Abu Dhabi Islamic Bank, views authenticity of Islamic finance in light of maqasid al-Shari'ah (the higher objectives of Shari'ah). He opines that the definitions of riba and gharar are too broad to form any solid basis for agreement. The role of al-maslahah al-Shari'ah in contemporary Islamic finance discourse needs to examine how to determine the Shari'ah objectives in the modern age; the pursuit of human goals and the principle of utility based on human reason is not necessarily what is meant by maslahah or maqasid al-Shari'ah. Furthermore, maslahah may or may not be in compliance with commonly held beliefs of human reasoning, thereby addressing the topic of whether there is a need for an economic justification for the prohibition of riba.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When furthering a country's finance structures, much room for improvement still exists in developing products and models, with an eye to sustainability in the modern world, and, especially, with regard to industry transparency and access. According to Shamshad Akhtar, governor of the State Bank of Pakistan, the process of Islamic financial development is in its infancy in Pakistan, and the country is still developing a model of Islamic finance that serves its population's needs while remaining true to the principles of Islamic law.

Conceptual directions in Shari'ah

The wisdom of some current Islamic banking and finance practices that seek their legitimacy from adherence to only formalistic contractual requirements, as opposed to looking into the contractual substance and content, needs to be questioned. A more open-ended view on Shari'ah-compliant financial stability should deal with the application, interpretation, and impact of Shari'ah compliance in the Islamic financial services industry. Applying a more theoretical perspective, the renewal of waqfs as a pivotal player in the creation of a distinctively Islamic conception of development balances socioeconomic objectives with religious concerns. The subject of loans, or qard, is still seen as problematic in Shari'ah-compliant finance because they, at times, can be easily associated with riba. The boundaries of investment risk in Islamic finance also require analysing financial risk in terms of gain, temporality, and moral engagement in order to determine permissible investments under Islamic law.

Debt and equity modes of financing

Most Shari'ah scholars agree that mudarabah and musharakah as equity-based contracts can be used in many areas of financing and investment, including deposit-taking kinds of products, venture capital and sukuk. According to Daud Bakar, Shari'ah scholar from Kuala Lumpur, Malaysia, the problem with sukuk, in particular, arises as we strive to strike a balance between authenticity and innovation for Islamic fixed income investors. A minority opinion is that this is a non-issue. Since the comparison is between a Shari'ah-approved product and a Shari'ah-compliant product, there is little room for differentiation. The relevant issue is risk management and mitigation; thus we must look to the structuring of the instrument so that the instrument or the product retains its original purpose, remaining validly as mudarabah or musharakah. Nizam Yaquby, a Shari'ah scholar, urges caution in giving blanket pronouncements for such a wide range of products. To avoid Shari'ah-compliant products becoming disadvantaged when compared to conventional products, Islamic banks must be able to provide sophisticated tools to hedge against currency and interest rate fluctuations. On the other hand, Seif el-Din Tag el-Din of Markfield Institute of Higher Education, UK, asserts that the tension is not between conventional banking and Islamic finance, but rather between risk management and its proximity to a structured sort of gambling. As such, modern Islamic finance has yet to truly address the problem of risk assurance and avoidance in a Shari'ah-compliant framework.