REPORT SERIES

LSE WORKSHOPS ON ISLAMIC FINANCE &
LSE PUBLIC LECTURES ON ISLAMIC FINANCE

Organinzed in Partnership with

Harvard Law School, Harvard University from 2006-2014

Hamad Bin Khalifa University from 2015-2017

ACKNOWLEDGEMENT

Dr Syed Nazim Ali[1], Director, Harvard Islamic Finance Project (Harvard-IFP) was the organizer and convener of the London School of Economics (LSE) workshop and LSE public lectures. With Husam El-Khatib (LSE alumni) as the co-organizer and co-convener of these events, they both jointly undertook all the responsibilities from selecting the themes, conducting the sessions, producing reports to the detailed logistics in order to make the workshop a great success. In which have brought all the stakeholders and the selected themes to coincide with trends and development taking place in the Islamic finance sector.

Professor Frank Vogel, Founding Director, Islamic Legal Studies Program (ILSP), Harvard Law School (HLS) had played a pivotal role as Workshop Moderator, in fact, he was the magnet of attracting all stakeholders of Islamic finance. He earned a special place in the heart of Islamic finance industry stakeholders, including the Shariah scholars through his academic discourse, especially, his book (co-authored with Professor Samuel Hayes of Harvard Business School) *Islamic Law and Finance*: *Religious, Risk and Return*. In which is one of the highly cited books in Islamic Finance according to Google Scholar.

Professor Baber Johansen, Harvard Divinity School, who served the ILPS Director's role in (2007-2010), efforts of bringing the workshop to LSE will not be forgotten. It was he who contacted on behalf of Harvard IFP to Sir Howard Davies, LSE Director.

Sir Howard Davies, with his personal interest in Islamic finance, had boosted the morale of workshop attendees. As well as his charismatic leadership of chairing public lectures, his opening remarks at the workshop and his engagement to the written comments produced by the workshop attendees were all testimonies of his keen interest in the field.

After Sir Howard's departure, the LSE was represented by Professor David Kershaw. He kept the momentum created by his predecessor going, as both the workshops and the public lectures continue to flourish under his guardianship.

The two important personalities that need a special mention, Hon Justice William Blair and Hon Justice Ross Cranston. It was their endorsement and interest in Islamic finance at LSE which facilitated LSE Director to enter into the joint partnership. Their interest, enthusiasm and commitment to the making of the LSE events will never be forgotten. Their unconditional support and availability to chair the sessions and their concerns that safeguard the future of these two important events had to be commanded.

There are so many individuals (listed in this report "Selected List of Workshop Participants") from the Islamic finance sector and others who have been instrumental in bringing this workshop to its level. Without their support and involvement, these workshops would not have been successful. There are no words to express our deep appreciation and gratefulness to all the individuals. They are the true heroes of LSE events. The Islamic finance industry salutes their dedication, sincerity and commitment.

[1] Ccurrently Research Professor and Director, Center for Islamic Economics and Finance, College of Islamic Studies, Hamad Bin Khalifa University, Doha, Qatar

BACKGROUND OF THE WORKSHOP

The Islamic Legal Studies Program at Harvard Law School has housed a research project named, Islamic Finance Project (IFP) that is quite active and well known in its field. The idea behind the workshop was born in discussions with IFP associates about the future of Islamic finance and economics. It was recommended that engaging key scholars in a debate on the role of Islamic finance and Islamic law (Shariah) in the current trajectory of the Islamic finance industry are an important step to be undertaken. Insofar as these are the two parent disciplines of Islamic finance, the historical relevance of Islamic law and economics to the industry is well established. What is less clear, however, is the role they will and should play in the future. The purpose of the first workshop in 2006 was, therefore, to bring Shariah scholars and Islamic economists along with selected practitioners to the table to share their particular diagnoses and prognoses for the Islamic finance industry.

In conjunction with the Seventh Harvard University Forum on Islamic Finance in 2006, a full day-long event (as Pre-Forum Workshop) was held with no formal presentations, rather we asked all participants to prepare for an interactive dialogue. Frank E Vogel, Founding Director, Islamic Legal Studies Program, Harvard Law School had moderated the workshop. In this specialized workshop, we had invited selected participants on Friday, April 22, 2006, a day before the Forum officially begins. The following prominent scholars were present in this historical meeting: M Nejatuallah Siddiqi, Monzer Kahf, Nizam Yaquby, Baber Johansen, Mahmoud El-Gamal, Humayon Dar, AbdulKadir Barkatulla, M. Adam El-Sheikh, M. Kabir Hassan, Samuel L. Hayes III, Mohammad Iqbal Nadvi, M. Imran Usmani, Taha Abdul-Basser, S. Nazim Ali, and several other Islamic finance program affiliates.

This workshop purpose as stated was to have an ongoing and scholarly conversation between prominent economists and Shariah experts on certain pressing ethical and methodological issues in the field of Shariah-compliant finance. Specifically, the workshop was meant to address Shariah and economic issues associated with establishing Shariah-compliant finance products, services and practices. Issues included were 1) the use of legal stratagems by Shariah experts; 2) the consideration of the aims of the Shariah (maqāṣid al- shariah) by Shariah experts and economists; 3) ethical concerns about perceived conflicts of interest among Shariah experts, and 4) the philosophical and methodological ramifications of the multidisciplinary nature of the field. The meeting was a timely one since these issues had attracted increasing attention among specialists and non-specialists in Islamic finance over the last few years. Through this workshop, we managed to increase cooperation among each other in order to better understand the foregoing issues relating to Islamic finance, and some key ethical and methodological principles and processes that govern certain products or practices in Islamic finance.

The reviews of workshop participants were positive, this is due to the opportunity presented for all to enhance communication between each other and simultaneously hearing each other's point of view. It was a good beginning of the dialogue and ensued after the workshop to continue such gatherings, where academics and practitioners meet and speak openly and frankly behind closed doors, on matters of concern and developments within the field. Therefore, it was proposed that the next workshop be held in London, in view of its centrality. Baber Johansen, the ILSP Director wrote to London School of Economics (LSE) Director, Sir Howard Davies, requesting to partner with Harvard in the convening of the next workshop (2007).

As partner, Harvard –IFP only ask that the LSE to provide an on-site contact for logistics. The workshop was primarily by invitation only. Afterwards, since there was an interest for a public event at LSE, the LSE Public Lecture on Islamic Finance was inaugurated in 2007. The speakers for the first LSE public lecture were Michael Hanlon (Founding Managing Director of Islamic Bank of Britain), Dr Mohammed Elgari (Shariah Scholar), Frank E Vogel, Iqbal A Khan (currently CEO, Fajr Capital), and Chaired by Justice Ross Cranston. The public lecture is open to all, while the workshop was by invitation only.

The first Harvard-LSE Workshop on Islamic Finance in 2007 was on Tawarruq. As part of the proceedings following the workshop, it was recommended that another workshop that focuses on the issues surrounding a specific Islamic Finance instrument is to be held in Europe. The workshop on *Tawarruq* was a fulfilment of that vision, and also marked the beginning of a formidable partnership between Harvard and LSE in the area of Islamic Finance and Economics.

During 2007 to 2014, this joint Harvard-LSE workshop engaged numerous leading scholars, academicians, industry experts and legal luminaries in Islamic finance. In addition to contributions to international scholarship and industry, both IFP at Harvard and the LSE gained extensive benefits from this exercise. When Harvard-IFP closed in late 2014, the workshop organizer, Dr. Syed Nazim Ali, had moved to Qatar Foundation to assume a new role as Research Professor and Director at the Center for Islamic Economics and Finance (CIEF), College of Islamic Studies (CIS), Hamad bin Khalifa University (HBKU). The interest of LSE was ongoing and the workshop continued under a new collaboration with HBKU. The new partnership had continued to add value by bringing greater global academic exposure for HBKU.

Twelve workshops on a wide variety of themes have been hosted in total. The first eight workshops (2007-2014) were organized as collaboration between the IFP at Harvard University and the LSE. From the ninth workshop onward was organized as a joint workshop between HBKU and LSE. All past Islamic finance workshops organized are listed below:

Year	Theme
2017	FinTech and Islamic Finance
2016	Islamic Infrastructure Finance and Sustainable Development Goals
2015	Revisiting Islamic Securitization and Structured Products
2014	Revisiting Islamic Securitization and Structured Products
2013	Insolvency and Debt Restructuring in Islamic Finance
2012	Islamic Financial Intermediation: Revisiting the value proposition
2011	Reappraising the Islamic Financial Sector
2010	Islamic Financial Ethics and Ethical Governance
2009	Risk Management: Islamic Economic and Ethico-legal perspective on Risk Management
2008	Sukuk: Economic and Jurisprudential Perspective
2007	Tawarruq: A Methodological Issue in Sharia-Compliant Finance
2006	Select Ethical and Methodological Issues in Shari`a-Compliant Finance

WORKSHOP FORMAT

The impetus for this workshop came on the heels of our realization that the meteoric rise of Islamic Finance in recent years has caused a gap to emerge between the two groups of people required for its success, the Shariah scholars as well as the Islamic economists. Although both groups have seen significant developments in their respective fields, we felt that there remained a need for further understanding and cooperation between the two. For this reason, we have organized this workshop as a mean to bring both Shariah scholars and economists together in an academic environment to discuss the issues that have recently confronted the Islamic Finance industry. It is not our intention to pass judgment through this workshop. But rather, we hope that it will become an avenue for members of both parties to share their thoughts and opinions on this subject, in the spirit of cooperation and for the mutual benefit of the Islamic finance industry. Following in the tradition of scholarly gatherings, we also ask that you maintain the environment of mutual respect that is warranted in an assembly of intellectuals.

Approximately 30-35 highly selected experts and scholars are invited to contribute a paper on a pre-selected theme. They then would participate for the entire duration of the day through presentations and exchanges. The workshop dates are usually chosen to coincide with Euromoney Annual Islamic Finance Event, and ensures that most of the scholars who have gathered in London in connection for that event could participate in this workshop with minimal logistical challenges. The workshops also receive easy access to many other financial and industry experts, without the burden of bearing the cost of their travel and lodging. The participants will pay their own expenses of travel and lodging. Since 2013, Euromoney has stopped their conference while the workshop still continues its organization in the month of February.

All workshops from 2006 to 2017 were moderated by Prof Frank Vogel, the Founding Director of Islamic Legal Studies Program at Harvard Law School, an expert in both Law and Shariah.

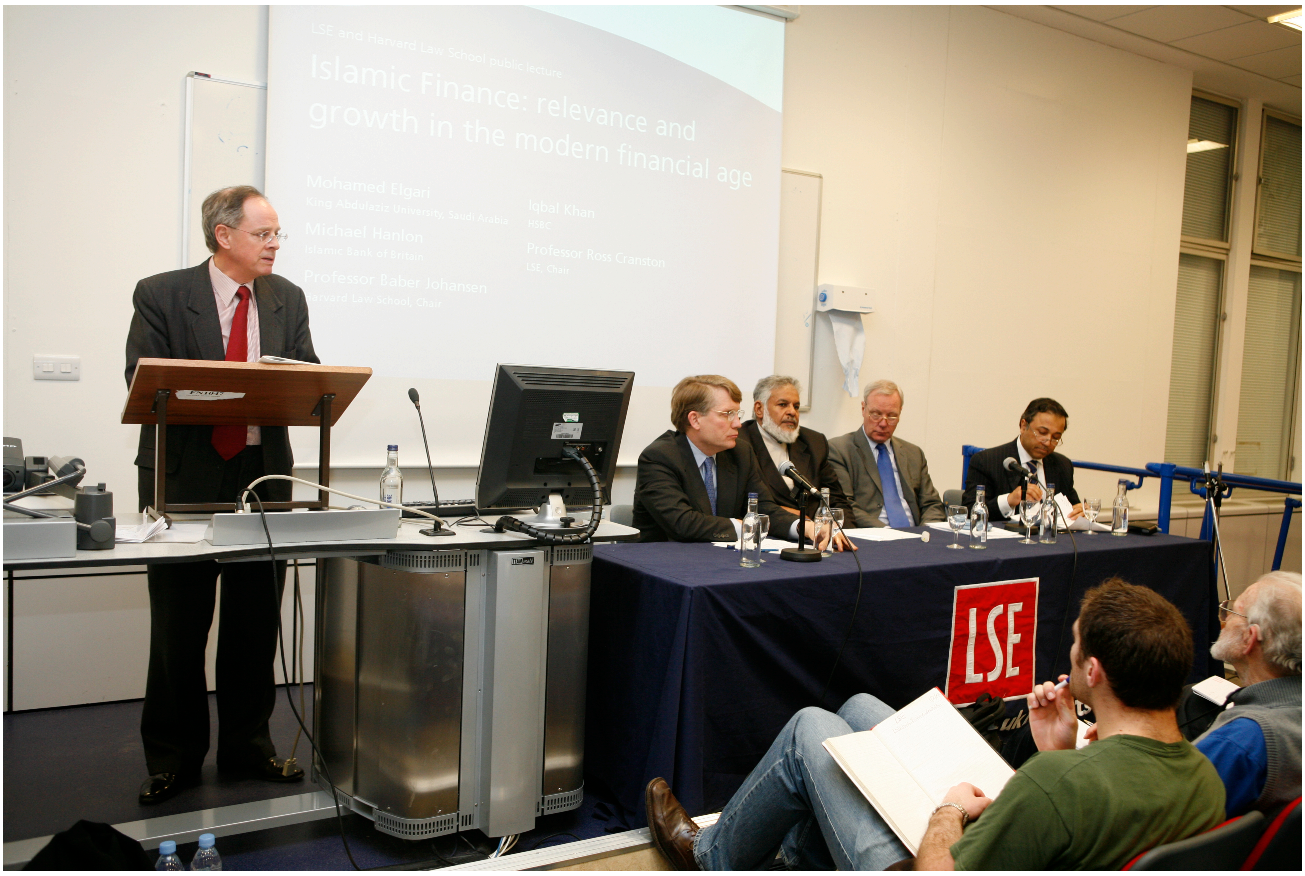
RESEARCH OUTPUT

Prior to the workshop, each participant will be asked to write comments on the issues that this paper has raised. In addition, each participant will be requested to read the comments of the other participants in order to better prepare for the discussions so that the workshop can proceed at a higher level. The comments will help to set the agenda for discussion.

After the conclusion of the workshop, the proceedings of the roundtable are published in the form of short reports.

PUBLIC LECTURE

LSE Public lectures is organized in the evening, prior to the workshop for the benefit of all students at LSE and the general public. The format of the lecture series, usually, is such that one expert is invited from academia and one from industry or a Shariah expert. Both speakers are given the same topic for their talk. This format greatly helps in appreciating the various perspectives to the same issue. Audios of all LSE public lecture are available on LSE website and some details of the public lectures are below:



Year	Chair	Industry Professional	Academician/Scholar	Theme of the Public Lecture
2017	Justice Ross Cranston	Volker Nienhaus	-	FinTech in Islamic Finance Shariah and Regulatory Aspects
2016	Justice William Blair	Aamir Rehman	Siraj Sait	Revitalising Islamic and Social Finance: Rising to Current Humanitarian Challenges
2015	Justice William Blair	Jaseem Ahmed	-	Islamic finance standardization: is it a mirage?
2014	Prof David R Kershaw	Farmida Bi	Paul Mills	Risk sharing and Cooperative Finance
2013	Justice William Blair	Azman Mokhtar	Frank E. Vogel	Islamic Finance and Shari'a Compliance: Reality and Expectation
2012	Justice Ross Cranston	Mukhtar Hussain	Volker Nienhaus	Global Calls for Economic Justice: The Potential for Islamic Finance
2011	Sir Howard Davies	Iqbal Khan	Haytham Tamimi	Building Bridges Across Financial Communities
2010	Sarah Worthington	Stephen Green	M Umer Chapra	Global Perspectives on Islamic Finance
2009	Sir Howard Davies	Ian Pearson	Esam Ishaq	Islamic Finance in the United Kingdom: Current Initiatives and Challenges
2008	Justice Ross Cranston	Usman Ahmed	Nizam Yaquby	Advancements in Contemporary Islamic Finance: From Practice to Scholarship
2007	Justice Ross Cranston	Michael Hanlon	Mohammed Elgari	Islamic Finance: Relevance and Growth in the Modern Financial Age

IMPACT OF THE ISLAMIC FINANCE WORKSHOPS AT LSE

These workshops on Islamic finance at the LSE have come at a critical moment. Several prominent Islamic economists express disappointment with certain aspects of the current practices in Islamic finance and seek innovative and authentic solutions. On the other hand, many Shariah scholars are frustrated with the significant increase in regulations and the complexity of business practices. At the same time, there is a strong need to enthuse and guide the next generation of professionals to engage constructively with the pivotal challenges facing the world.

The proposed leadership of HBKU, alongside the LSE, to organize closed-door workshops have provided the entire sector with a unique platform where all the different players can join together and discuss complex Shariah, legal, financial and social issues faced by the industry. With the facilitation of LSE and HBKU, specific themes would continue to be chosen through consensus and debated by Islamic finance professionals, economists, Shariah scholars and industry leaders. The immense popularity of previous workshops for the quality discussion and dialogue have been especially instrumental in closing the gap between academia and economists on the one hand, and between Shariah scholars and the industry on the other.

Selected List of Workshop Participants – 2006-2017

Taha Abdul-Basser
Rula Al-Abdulrazak
Saleh A. Alagla
Habib Ahmed
Khurshid Ahmed
Usman Ahmed
Mabid Al-Jarhi
Engku Rabiah Adawiah Bt Engku Al.
S Nazim Ali
Syed Salman Ali
Ijlal Alvi
Iqbal Asaria
Mehmet Asutay
Mufti A. Barkatullah
Daud Bakar
Farmida Bi
Gohar Bilal
William Blair
Williem Buiter
M. Umer Chapra
Ross Cranston
Humayon Dar
Howard Davies
Majid Dawood
Richard de Belder
Stella Cox
Seif Ibrahim Tag el-Din
Humayon Dar
Tarek El Diwany
Mohammed Elgari
Khaled Al Fakih
Mahmoud El-Gamal
Husam El-Khatib
Nick Foster
Michael Gassner
Aznan Hassan
Hussain Hamed Hassan
Hussein Hassan
Usman Hayat
Samuel Hayes
Harris Irfan
Esam Ishaq
Baber Johansen
Monzer Kahf
David Kershaw
Iqbal Khan
David Kershaw
Sajjad Khoshroo
Akram Laldin
JonathanLawrence
Michael McMillen
Hamed H Merah
Neil Miller
Mohammad Iqbal Nadvi
Volker Nienhaus
Shariq Nisar
Aamir Rehman
Siraj Sait
Omar Shaikh
Mansoor Shakeel
M. Nejatullah Siddiqi
Huma Sodher
Haitham Tamim
Wijdan Tariq
Abdullah Turkistani
Imran Usmani
Frank Vogel
Ibrahim Warde
Rodney Wilson
Nizam Yaquby
Anas Zarka

HARVARD LAW SCHOOL
Islamic Legal Studies Program

ISLAMIC FINANCE PROJECT

Workshop on

Select Ethical and Methodological Issues in Shari`a-Compliant Finance

Friday April 21, 2006

Morgan Courtroom, Austin Hall
Harvard Law School
Cambridge, Massachusetts, U.S.A.

Islamic Finance Project

Harvard Law School
Islamic Legal Studies Program

Special Workshop
Harvard Law School - April 21, 2006

Select Ethical and Methodological Issues in Sharī'a-Compliant Finance: A Short Report

<u>Purpose of the Workshop</u>

Islamic Finance (IF), by any standard, is a burgeoning industry. As with any industry, such fast progress demands a critical look. Particular to IF is the complex and integral relationship that Islamic law has with the field. The nature of *shariʻa* advisement has recently been brought into question, and there have particularly been questions about the role of Islamic economists vis-à-vis *shariʻa* scholars. With the encouragement of *shariʻa* scholars and prominent Islamic economists, the Islamic Finance Project decided to hold this workshop in order to spark a discussion that we deem crucial to the future of the field.

<u>Overview</u>

This workshop was designed to host an ongoing and scholarly conversation between prominent economists and *shariʻa* experts on pressing ethical and methodological issues in the field of *shariʻa*-compliant finance. Specifically, the workshop was meant to address *shariʻa* and economic issues associated with establishing *shariʻa*-compliant finance products, services, and practices. These issues include: (1) the use of legal stratagems by *shariʻa* experts, (2) the consideration of the aims of the *shariʻa* (*maqāsid al-sharī`a*) by *shariʻa* experts and economists, (3) ethical concerns about perceived conflicts of interest among *shariʻa* experts, and (4) the philosophical and methodological ramifications of the multidisciplinary nature of the field.

The goals of the workshop were to explore the methods by which economists and *shariʻa* experts can increase cooperation with each other in order to better understand the foregoing issues relating to IF, and to better understand some key ethical and methodological principles and processes that govern certain products or practices in IF. Participants discussed methods to enhance communication with each other in the future through, for example, the formation of committees to take up some of the issues that emerged from the workshop. This workshop was expected to be the beginning of a dialogue, and more such events should be expected to follow this one.

<u>Guiding Questions</u>

The following three sets of questions informed and guided the discussion:

1. What is the role of the consideration of "*maqasid al-sharī`a*" in Islamic Finance?
    a. Should m*aqāsid al-sharī`a* be considered when deciding whether to adopt a financial instrument? Is it consistent with *sharī`a* to discuss a financial instrument without estimating the economic and social consequences of using that instrument?
    b. What role has the "spirit of the *sharī`a*" (in contrast to the strict "letter of the law") played in modern Islamic finance?
    c. Is consumer protection the responsibility of *sharī`a* boards?
2. What is the optimal structure and mechanism of *sharī`a* supervision?
    a. How have the following modern trends affected *sharī`a* supervision?
        i. Push for standardization among various countries and locales
        ii. Competition among institutions
    b. Who is qualified to be a *sharī`a* supervisory board member and how are they accredited, identified, and

selected?

c. Can a process be set up by which the larger community of *shari'a* experts can engage in peer review of the work of the *shari'a* experts who are most active in the field? Should it be done?

3. How best can economists contribute to the supervision of the *shari'a* compliant finance sector?

a. What makes an "Islamic" economist (in contrast to any other economist)?

b. What should be the role of economic reasoning when formulating responses to requests for *fatwa*?

c. What is the preferred means for raising objections if non-*shari'a* experts are uncomfortable about the deci sions of some *fiqh* experts? In what forums should such reservations be shared and what is the most responsible and ethical way in which to share them?

d. What are the most important areas of collaboration between economists and *shari'a* experts?

Highlights of Discussion

Continuity and change in the history of Islamic Finance

Historical considerations frequently played a role in the discussion. Many participants referred to the role of the *fuqaha* in economic and financial matters in the pre-colonial Muslim world and considered certain structures and procedures of those times normative. Others disagreed, arguing that, considering the modern-day context and the situation of Muslims in it, it is unrealistic and not ideal to strive toward a model they consider dated. The rise of the field of IF and its development from the mid-twentieth century to the present was discussed as well.

The implementation of the maqāsid al-sharī`a

Participants agreed that the *maqāsid al-sharī`a* must play a significant role in *shari'a* advisement. However, some participants argued that many current IF institutions and products do not take *maqāsid* into consideration. All agreed that much more empirical economic research needs to be done when formulating the nature of *maqāsid* implementation. Some mentioned that there is a hierarchy of priorities when considering *maqāsid* and that it is unrealistic to put the burden on the relatively small IF institutions to implement all the *maqāsid* in the current context. The issue of whether debt-based financing is *shari'a*-compliant was also debated.

The application of sharī`a and economic expertise

Many agreed that *shari'a* and economic experts must work together in order for IF institutions to be effective. Some proposed that there should be specific programs that educate students on both the *fiqh* and economic perspectives, thus creating a new generation of IF experts. One participant felt it important to note that historically the *fuqaha* have had a strong relationship with relevant expert communities and proposed that such a relationship, especially with modern economists, is ideal for today's IF concerns.

The regulation and standardization of the structure of sharī`a advisement

Though all agreed on the significance of the *maqāsid al-sharī`a*, many maintained that the main concern is how to enforce the implementation of those maqāsid and how to regulate the Islamic aspect of IF. Some believed that only governmental power could enforce standards. Others advocated self-regulation within the IF industry. Some noted that centralized regulation hinders innovation in creating Islamic products. Others insisted that lack of standardization on some level will in the end hurt consumers and render *maqāsid*-implementation impractical.

Consensus

Despite all the opposing viewpoints, at the conclusion of the workshop, all participants agreed that there was a need for enhancing the process of *shari'a* advisement and offered several solutions and proposals:

1. Begin a journal on the *fiqh* of Islamic Finance
2. Have greater transparency about the *fatwa* function, processes, and compensation
3. Have future workshops focusing on specific products/instruments and ending with a unified decision
4. Increase empirical data for all independent sources
5. Reduce conflicts of interest in *shari'a* advisement.

In Attendance

Moderators:

Frank E. Vogel, Director, Islamic Legal Studies Program, Harvard Law School

M. Nejatullah Siddiqi, Independent Researcher and Consultant, Milpitas, CA

Participants:

Taha Abdul-Basser, Ph.D. Candidate, Near Eastern Languages & Civilization, Harvard University

Rashid Alam, Fulbright Scholar, Boston University, Boston, MA
S. Nazim Ali, Director, Islamic Finance Project, ILSP, Harvard Law School
Aziz Bakar, MBA Class of 2006, Harvard Business School, Boston, MA
AbdulKadir Barkatulla, Sharī`a Supervisor, London, United Kingdom
Humayon Dar, Managing Director, Dar Al Istithmaar, London, United Kingdom
Mahmoud A. El-Gamal, Professor, Rice University, Houston, Texas
Husam El-Khatib, Senior Manager, Royal Bank of Scotland, London, United Kingdom
Rafe Haneef, Head of Islamic Finance, ABN AMRO Bank, Dubai, U.A.E.
M. Kabir Hassan, Professor, University of New Orleans, New Orleans, LA
Samuel L. Hayes III, Professor Emeritus, Harvard Business School, Boston, MA
Baber Johansen, Professor, Harvard Divinity School, Cambridge, MA
Monzer Kahf, Private Consultant/Trainer and Court Expert, Westminster, CA
Ibrahim Majeed, MBA Class of 2006, Harvard Business School, Boston, MA
M. Iqbal Nadvi, Sharī`a Supervisor and Director, Al-Falah Islamic Center, Oakville, Canada
Shaheer Shaheen, J.D. Class of 2007, Harvard Law School, Cambridge, MA
Arsalan Suleman, J.D. Class of 2007, Harvard Law School, Cambridge, MA
Mohammad Ali Vaid, MBA Class of 2005, Harvard Business School, Boston, MA
Nizam Yaquby, Sharī`a Supervisor, Manama, Bahrain

HARVARD LAW SCHOOL
Islamic Legal Studies Program

and

LONDON SCHOOL OF ECONOMICS

Workshop on
Tawarruq
A Methodological Issue in Sharī`a-Compliant Finance

Thursday, February 1, 2007

London School of Economics
Building Tower #3, 5th Floor (BOX)
London, United Kingdom

Islamic Finance Project

Harvard Law School
Islamic Legal Studies Program

Harvard-LSE Workshop
London School of Economics, London, UK - February 1, 2007

TAWARRUQ: A Methodological Issue in Sharia-

Purpose of the Workshop

Tawarruq is a debt instrument that many *shari'a* scholars have approved and that the Islamic finance industry has since used extensively. Yet, as its popularity has increased, so has criticism of it. In response to these developments, the Islamic Finance Project of the Harvard Law School's Islamic Legal Studies Program organized a one-day workshop on *tawarruq*. The Islamic Finance Project is proud that the London School of Economics (LSE) agreed to act as joint sponsor for this workshop on *tawarruq*, and to host the workshop at the LSE campus in London. The workshop thus has opened up the prospect of a formidable partnership between the two academic institutions in the area of Islamic finance and economics. While seeking to advance understanding of *tawarruq*, the workshop was framed also to carry on methodological debates opened up at an earlier workshop, "Select Ethical and Methodological Issues in S*hari'a*-Compliant Finance," held April 21, 2006 at Harvard.

Due to the success of the workshop, as attested unanimously by its attendees, both institutions look forward to holding a further event on a significant Islamic finance topic within the next year.

Overview

Although various definitions of *tawarruq* have been offered in Islamic finance literature, it is generally used to describe a transaction in which a financial institution sells a commodity to a customer on deferred payment at cost plus profit, and the customer then sells the commodity on a spot basis to a third party for cash. Critics have questioned whether use of this instrument is even permissible under the *shari'a*. Many cite the economic similarities of the transaction to other prohibited transactions and the potentially deleterious effects of *tawarruq* on society. Nevertheless, its proponents adamantly view the instrument as not only permissible but also helping to advance the growth of Islamic finance.

The goals of this workshop were to: (1) identify the issues and areas of concern about *tawarruq* in order to gain a better understanding of how it is currently used and applied in the market from the view of practitioners, economists, *shari'a* scholars, consumers, and society; (2) critically evaluate *tawarruq*'s performance; (3) consider whether *tawarruq* should be restricted or not; (4) consider whether there were alternatives that could fulfill the same purpose; (5) further the conversation among the various parties present by enhancing mutual understanding and furthering links between their methodologies and approaches; and (6) make specific proposals of channels and venues through which to continue this conversation, including workshops on the development of other products.

Guiding Questions

After a morning session highlighting participants' views, the following sets of questions were gatered from the various points raised and used as the basis for an informed and guided discussion. However, due to time constraints not all issues were discussed.

1. The role of debt in Islamic finance
    a. Criticism of debt: Is debt not linked to the "real" goods/services economy?
    b. Does debt cause instability?

2. What kind of debt is permissible
    a. *Tawarruq* within consumer debt versus within commercial debt.
    b. Does it make any difference if one mode is used as against the other from an economics perspective?
3. What should the role of a bank be in *tawarruq*
    a. Should a bank determine whether the need is genuine or is it just to provide product services?
    b. If not the bank, then who should decide?
    c. What should be the parameters to make that decision?
4. *Tawarruq*: its application as an Islamic finance product
    a. Is there a *tawarruq* on which all agree as to its permissibility and advisability?
    b. Is there a need for it? (i) Does it help convert non-*shari'a* practices to Islamic finance? (ii) Due to con straints on some Islamic transactions, does *tawarruq* help provide for these needs as an alternative? (iii) Does it help meet the immediate needs for hedging and liquidity relief?
    c. What conditions, if any, should be placed (i) as to contractual terms, (ii) as to its use/purpose, (iii) as to other limits?
    d. What are macro- and microeconomic consequences of it? Should these dictate that restrictions be placed on it? Or does such logic stifle innovation?
    e. Can *tawarruq* evolve to become more widely accepted?
    f. What alternatives are conceivable for *tawarruq* where it meets needs?
5. How would participants define intention, form, and substance in Islamic finance
    a. *Fiqh*'s concerns with both form and substance: which one(s) apply with *tawarruq*?
    b. *Hīlah/makhraj*: (i) How is *hīlah* defined? (ii) How is *makhraj* defined? (iii) Must either be avoided and to what degree and how? (iv) Is *tawarruq* either of these two?
6. Economics and *fiqh*
    a. What is the status of economic theories in Islamic finance?
    b. Relation of macro- and microeconomics in Islamic product development?
    c. Relation between contract, institution, government, economy and society?
    d. Turning to economic models, do economists in Islamic finance have a model that they could agree on?
    e. Would the proposed model be agreed to by other economists?
7. Participation of non-*ulama* voices
    a. Lay persons: in the market, education required versus government role
    b. *Siyasa shar`iyya*
    c. Specialists, in particular, economists
8. Role of *shari'a* committees
    a. Should *shari'a* committees analyze issues from both a micro and a macro perspective with the aid of rel evant experts?
    b. Is Islamic finance to support economic goals or rather something else?
    c. What role should *shari'a* scholars play in determining policy as well as law?

<u>Summary</u>

The Islamic Finance Project (IFP) jointly with the London School of Economics hosted an all-day, closed-door workshop, "Tawarruq: A Methodological Issue in Sharī`a Compliant Finance," in the beautiful Box Room on the LSE London campus. Many leading economists, practitioners, and *shari'a* experts in the field attended and actively participated in the vibrant workshop discussion. The event began with a warm and inspiring opening by the LSE Deputy Director, Professor Sarah Worthington on behalf of the LSE and by Professor Frank Vogel on behalf of the Harvard Law School. They were immediately followed by presentations by *shari'a* scholar Dr. Mohammed Elgari and Islamic economist Professor Nejatullah Siddiqi, based on their written position papers, with additional co ments from others in their respective fields. A scholarly discussion of many of the issues raised then followed.

Summary of Dr. Mohammed Elgari's position paper

Contrary to twentieth century Islamic economic thought, Dr. Elgari believes that it is possible to fit an Islamic banking institution into an existing modern economic system, and this includes *tawarruq*. *Tawarruq*, he argued, does not violate the established principles of the *shari'a*; rather, *tawarruq* is permissible. A number of historical precedents were cited as evidence. Attempts to compare Islamic financial institutions with their conventional counterparts in terms of effciency, he warned, is counterproductive since the majority of Muslim consumers will still avoid the conventional forms due to reasons of faith. As the intention of those who use *tawarruq* is to refrain from *ribā* transactions, not to engage in them, *shari'a* scholars largely agree that *tawarruq* cannot be considered a *hīlah*, or an artifice. A *hīlah* is present only if the intention of the parties involved is to secure the prohibited transaction by using a permissible arrangement as a conduit. Given the abundance and choice of interest-bearing transactions currently available, there is no need for anyone to resort to deceit in order to engage in a lender-borrower transaction. Given the current advances in Islamic finance, he argued that *tawarruq* is actually a positive solution for a banking system that has adopted the *shari'a* as the guiding principle for its contracts and procedures. Though he did agree that in itself it is not ideal, the proliferation of *tawarruq* transactions in an economy will probably have a positive overall macroeconomic outcome.

Summary of Professor M. Nejatullah Siddiqi's position paper

Adopting a macroeconomic point of view, Professor Siddiqi argued that the impact of *tawarruq*, a debt product, on the economy was far more harmful than beneficial. For that reason, he contends *tawarruq* should unequivocally be banned. *Tawarruq* creates new debts and moreover debts far larger than the cash received. Tawarruq moves the economy from the asset market toward the money (debt) market, where the underlying signaling and equilibrating mechanisms are no longer linked to the real market. Debt creation does not increase the net wealth of a society because every addition to social wealth is cancelled by a similar amount of wealth owed in the future. Therefore, the compulsion for economic growth is created by the need to repay these larger amounts of debt owed. Debt proliferation also leads to gambling-like speculation and greater instability in the economy. Furthermore, debt leads to inequality in the distribution of income and wealth and inefficiencies in the allocation of resources, raises anxiety levels, and causes destruction of the environment. Though he acknowledged there are certain short-term benefits to it for the individual, the harmful effects on the society overall are far greater.

Role of debt in Islamic finance

The discussion session at first developed from Professor Siddiqi's points mentioned above. It revolved around how the institutionalization of modern-day debt and its application relates to the historical precedents commonly cited by scholars. Economists contend that due to financial and social advances, the two are diametrically different. Hence, any link between the two is tenuous. *Shari'a* scholars argued that the two were compatible and the precedents still relevant. Further questions evolved as to whether the acceptance and usage of debt-based products like *tawarruq* are changing the paradigm of Islamic finance from a development form of banking to a more debt-based banking system, mimicking that of conventional financial products. It was further feared that Islamic ideals of stability, efficiency, and economic equality would be jeopardized by the purported negative effects of debt products like *tawarruq*. However, arguments linking debt markets to inherent instability need further in-depth empirical evidence. Furthermore, participants demonstrated little unanimity as to what alternative products or models would successfully fill that debt gap.

The issue of form versus substance in relation to tawarruq

As with the previous workshop, the topic of form versus substance played a major role, this time in the debate pertaining to *tawarruq*, its application and its alternatives. In the context of this discussion, some *shari'a* scholars raised the Islamic Finance Project point that though *tawarruq* was mentioned only in the Hanbali school of thought, its substance under other names is found in all schools of thought. Moreover, some pointed out that practice of it could be found throughout history, including within Arabia (such as in Najd). Discussion on intention and the *maslaha* behind the prohibition of interest, in the context of *tawarruq*, were also critically addressed. Questions further developed as to who should be the ones to judge as to the *masalih* and the *maqasid* in the matter of *tawarruq*. Nevertheless, it was put forth that there is a need to minimize the intellectual tension between formalism and essentialism, as between the approaches that *shari'a* scholars and economists take to the subject of Islamic finance.

Advisability of tawarruq

Though many agreed that *tawarruq*'s permissibility from a *shari'a* point of view was not in dispute, most agreed that its advisability as to its scope of usage and its application should be revisited. Many argued that its usage was linked, in the case of individuals, to the immediate dire need for cash where *shari'a*-compliant alternatives were lacking. Some viewed *tawarruq* as allowed only in cases of dire necessity, whereas others viewed it less restrictively. The discussion led the participants to ask whether a distinction should be made between *tawarruq* for commercial consumption versus individual consumption. With the notable exceptions of a few economists who still felt *tawarruq* should not be permitted under any circumstances, most felt that *tawarruq* practiced at the individual level is acceptable. Most also agreed that it was acceptable if it would help convert conventional banks into *shari'a*-compliant ones.

Restrictions to tawarruq

Many felt that *tawarruq* practiced at the institutional systemic level is more of a problem. Some felt that placing restrictive conditions on its use, like that linking it to "real" goods and services transactions, are necessary. Some *shari'a* scholars argued against having different sets of rules according to levels of wealth. Other *shari'a* scholars feared that placing restrictions or prohibitions on its use would inadvertently prohibit something that is permitted and that leads to something "good," hence violating a major principle of Islam. Many felt strongly that government and regulatory policies placing limits on its usage would be best.

Banks' roles

Islamic financial institutions' responsibilities and duties were discussed within the context of selling *tawarruq*. One participant proposed that institutional consumers be required to use alternatives first before use of *tawarruq* is considered, and that for individual consumers, a more flexible, bespoke approach to each customer should be adopted, based on what is genuinely needed or desirable for them. It was unclear whether the burden of regulating *tawarruq* and informing customers of the risks should lie with the financial institutions that sell it, or rather with government and regulatory bodies. The role of banks in educating the public on *tawarruq* and the problems of debt was also raised. However, participants highlighted that though banks are able to help educate the public on the product itself, they could not take up the responsibility to provide guidance on *sharï'a* matters.

Viable alternatives to tawarruq

Alternative products cited were *qard hasan, ijara, salam, istisna'*, service *ijara*, *bay' al-inah*, commodity *murabaha*, and even non-Islamic conventional loans. The participants examined and debated the merits of each product, though no consensus emerged and no alternative working models were proposed. Some continued to argue for banning *tawarruq*, while others argued that restricting it would stifle innovation and development of Islamic finance. It was nevertheless agreed that Islamic finance including *tawarruq* suffered from a perception and misrepresentation problem.

Degree of consensus

Despite all the points made, at the conclusion of the workshop, participants' views remained largely divergent. Most agreed that though *tawarruq* is not ideal, it is on the other hand not *haram*. Most also agreed that *tawarruq* should have some form of policy parameters. Some continue to believe that *tawarruq* presents risks to the Islamic banking paradigm while others felt that *tawarruq* has helped to expand and further Islamic finance, citing the example of Saudi Arabia's growth in this area. Almost everyone agreed that the objection to *tawarruq* was more to its advisability rather than its permissibility. Further research is needed on the role of debt, its risks, and the extent to which it is causing a negative paradigm shift for Islamic finance as a whole. Differences remain as to whether different rules apply to individual consumers compared to commercial players.

All participants agreed that there was a need for enhancing the discussions between *sharï'a* advisers and economists and offered several solutions and proposals: (1) continued work on a journal on the *fiqh* of Islamic finance; (2) further research into the role of debt as well as on how to implement ideal Islamic economic models; (3) increased empirical data from all independent sources; and (4) holding future workshops, including sessions with the London School of Economics, to discuss related issues and specific products and instruments, with the goal of achieving unified recommendations or decisions.

In Attendance

Opening:

Sarah Worthington, LSE Deputy Director and Professor of Law, London School of Economics

Moderator:

Frank E. Vogel, Founding Director, Islamic Legal Studies Program, Harvard Law School

Attendees:

Khurshid Ahmad, Member State of Pakistan, Islamabad, Pakistan
Manazir Ahsan, Director, Islamic Foundation, Markfield, Leicestershire, U.K.
S. Nazim Ali, Director, Islamic Finance Project, Harvard Law School, Cambridge, MA, USA
Iqbal Asaria, Consultant, Lloyd Bank and Bank of England Committee, London, U.K.
M. Muhammed Al-Awan, Professor, INCEIF, Kuala Lumpur, Malaysia
AbdulKadir Barkatulla, Sharī`a Supervisor; London, U.K.
Gohar Bilal, BNP Paribas, London, United Kingdom
M.A. Mohaimin Chowdhury, European Islamic Investment Bank Plc, London, U.K.
Stella Cox, Managing Director, DDGI Limited, London, U.K.
Ross Cranston, Centennial Professor of Law, London School of Economics, London, U.K.
Humayon Dar, Managing Director, Dar Al Istithmaar; London, U.K.
Majid Dawood, Chief Executive Officer, Yassar Limited, London, U.K.
Mohammed Elgari, Sharī`a Supervisor & Professor, King Abdulaziz University, Jeddah, Saudi Arabia
Essam M. Ishaq, Sharī`a Supervisor; Manama, Bahrain
Husam El-Khatib, DentonWildeSapte, London, U.K.
Rafe Haneef, Islamic Banking Division, Citigroup, Kuala Lumpur, Malaysia
Michael R. Hanlon, Former Managing Director, Islamic Bank of Britain, London, U.K.

Hussain Hamed Hassan, Sharī`a Supervisor, Dubai Islamic Bank, Dubai, United Arab Emirates
Mabid Al-Jarhi, President, IAIE and Financial Expert, Emirates Islamic Bank, Dubai, UAE
Iqbal A. Khan, Founding CEO, HSBC Amanah, London, U.K.
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Mohammad Akram Laldin, Sharī`a Supervisor, HSBC Amanah, Kuala Lumpur, Malaysia
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M. Nejatullah Siddiqi, Independent Researcher and Consultant; Milpitas, California, USA
Seif el-Din Tag el-Din, Associate Professor, Markfield Institute of Higher Education, Leicestershire, U.K.
M. Imran Usmani, Sharī`a Supervisor; Karachi, Pakistan
Rodney Wilson, Professor of Economics, University of Durham, Durham, U.K.
Nizam Yaquby, Sharī`a Supervisor; Manama, Bahrain
Anas Zarqa, Advisor, The International Investor, Kuwait

Harvard Law School
Islamic Legal Studies Program

and

London School of Economics

Workshop on Sukuk

Economic and Jurisprudential Perspectives

Thursday, February 7, 2008

London School of Economics
Tower #3, 5th Floor (BOX)
London, United Kingdom

Harvard-LSE Workshop:
London School of Economics, London, UK - February 7, 2008

Sukuk: Economic and Jurisprudential Perspective:
A Short Report

Purpose of the Workshop

As a follow-up to the workshop on *tawarruq* held on February 1, 2007 on the London School of Economics campus, the Islamic Finance Project (IFP), a project under the auspices of the Islamic Legal Studies Program at Harvard Law School, and the London School of Economics (LSE) decided to work together again to gather a group of influential Islamic legal scholars, economists and bankers for a workshop on *sukuk*, instruments that have attained considerable prominence in Islamic finance. The goal of the workshop is to conduct an in-depth examination of *sukuk*, while furthering the conversation between *fuqaha* and economists begun in earlier IFP workshops.

Overview

Sukuk are generally structured as debt instruments approved by most *shari'a* scholars, but as their general popularity has increased, so has criticism of them. Although various definitions of *sukuk* have been offered in Islamic finance literature and various forms have been used in practice, generally they are instruments used in Islamic finance to tap capital markets. Critics have questioned whether the manner in which these instruments are used lives up to the ideals envisaged by *shari`a*. The criticism has come from two fronts. Economists, who have objected to such instruments being debt based and certain scholars who have voiced criticism of some interpretations of certain jurisprudential concepts employed in structuring the recent wave of *sukuks*.

Through this workshop, it is hoped that a better understanding of *sukuk* in theory and in practice and of their advisability will be achieved while at the same time enhancing the dialogue between the various experts in the field of Islamic finance.

Workshop Objectives

1. To understand the purpose and application of *sukuk*
 * To gain a better understanding of how *sukuk* are theoretically understood, conceptually structured, and practically applied in the market
 * How they have or have not met Islamic finance ideals

2. To identify the issues and areas of concern, theoretical and practical, that arise regarding *sukuk*
 * Macroeconomic factors of concern
 * Jurisprudential factors of concern

3. Critically evaluate *sukuk*'s performance visàvis:
 * current practice
 * intended practice
 * future practice

4. To consider any suggested theoretical solutions to the issues and concerns raised, including any alternatives to *sukuk* as now practiced

5. To further the conversation among the various parties present by enhancing mutual understanding and links between their methodologies and approaches. Explicit attention will be given to this aspect throughout the more concrete discussions of *sukuk*

6. To make specific proposals of channels and venues through which to continue this conversation, including workshops on the development of other future products

Guiding Questions

In advance of the workshop, participants were requested to submit their responses to the below guiding questions, with the intention of enabling a focused discussion on the issues and a prior understanding of the opinions surrounding the workshop topic.

Key discussion points on sukuk:

1. *Sukuks* are and will have to be structured like debt.
2. *Sukuk* behave like debt today but should be structured to behave as equity.
3. *Sukuks* should conform to the principles of Islamic law. The market should determine the question of their behavior.

Macroeconomic concerns regarding sukuk:

1. Why the preference of Equity versus Debt for *sukuks* and is there a preference in Islam for equity vs. debt instruments; why?
2. What are the economic results/effects of *sukuks*?
3. What are the substitutes for *sukuk*, if any?

Structural concerns regarding sukuk:

1. *Sukuk* ownership / asset title transfer
2. Purchase undertakings to repurchase *sukuk*
3. Principal repayment guarantees
4. Fixed periodic payments : LIBOR alternatives
5. Market value versus fixed price value
6. Ratings alternatives

Summary

Following on from last year's well-received and inaugural workshop, the London School of Economics (LSE) once again hosted an all-day, closed-door workshop focused on *sukuk* – in conjunction with Harvard Islamic Finance Project (IFP) = held in the Box Room of the LSE London campus. The workshop was well attended, with leading economists, practitioners, and *sharī`a* experts actively participating in the vibrant workshop discussion.

The event began with a warm welcome by the LSE Director, Sir Howard Davies on behalf of the LSE and by Professor Baber Johansen on behalf of the Harvard Law School.

Introduction

Professor Frank E. Vogel, in his capacity as moderator, introduced the workshop and highlighted overarching contemporary issues facing the industry which the workshop discussion would inevitably touch – such as the reconciling of an Islamic finance profit-making industry with the Islam-inspired social goals imperatives, and the institutional framework and levels of cross policymaker interaction and collaboration for deciding the permissibility and acceptance of industry products.

Mansoor Shakil began by presenting a summary of current practices and issues surrounding *sukuk* by synthesizing submitted participant comments. Participant views presented at the outset a healthy divergence and spread of concerns - from the immoral and inefficient nature of a risk-less wealth creation product and the inherent equitable risk-return nature of Islamic financial transactions with their linkage to real assets - which is seen to be steadily diluting with the current developments in the *sukuk* market - to the need to first contain the *mafasid* in *sukuk* and gain overall Islamic finance market share before implementing changes that would otherwise disturb the current takeup of Islamic financial products. Views also expressed the lack of evidence for the desirability and requirement of the inter-linkage between the real and monetary sector from the *shari'a* point of view, to the position and role of debt in Islam. Given the legitimacy of an Islamic debt market, there is a need to match the risk-return profile of the average consumer, who would progress to return-maximizing equity-finance products with their inherent risk structure, only with surplus cash beyond their short-to-medium requirements. In summarizing the spectrum of issues raised by participants, a common theme was the fundamental need to balance legal form and substance, with the fact that *ijtihad* cannot be exercised in the presence of an explicit text injunction – requiring a reconciliation of the essence but not at the cost of the form. Given the consensus goal of a just, equitable and efficient Islamic economy, there remains a divergence on the correct path to take and the overall place of the Islamic financial system in such an economic system.

Every *sukuk* is issued with an underlying contract (e.g. *mudaraba, murabaha, ijara*), and should behave with the same characteristics as the underlying contract. The workshop scholarly discussion focused on the breakaways from this fundamental tenant, firstly touching on the macroeconomic issues raised surrounding *sukuk*.

The role of debt

Participants agreed that *shari'a* provides alternatives to conventional loan products in the forms of participatory finance and sale-based financing. However, there is a clear demarcation between the Islamic and conventional debt structures, which need to be adhered to. Islamic debt is unlike conventional in that it cannot be resold and cannot be discounted. The emphasis on the ills of debt – *mafasid* – has arisen primarily from the market for trading debt, which can give rise to the value of claims being greater than the actual value of the underlying physical asset. What debt is sold against is a key feature of the differentiation between Islamic and conventional debt – as Islamic debt is asset-backed and not money-for-money trades.

The participants discussed the characteristics of debt in the Islamic system as being fundamentally different – such as the leniency factored on the performance of obligation and the prohibition on occurrence of *riba* in the debt transaction – which make for debt more as an assistance product for the "needy". Debt as an income-generating instrument to provide returns for investors, blurs this original characteristic of debt within Islamic principles. Equity-based *sukuks* such as *sukuk al-mudaraba* and *sukuk al-musharaka* are further effected in this blurring of roles and are expected to hold the debt characteristics and manner of their conventional ilk, despite the underlying contract being an equity-financing agreement.

Participants acknowledged the wider remit of "debt" in Islam. Debt in principle can form a tool in alleviating hardship with loan contracts (*qard*). However the underlying issue surrounding debt in Islam stems from how it was created and subsequently how it will be treated – highlighted in the difference between a loan (*qard*) and its subsequent debt formation (*dayn*). Every loan (*qard*) will become a debt (*dayn*). However, not every debt was the result of a loan contract – with possible originations from an underlying share contract (*musharaha*) or a lease contract (*ijara*). This debt obligation will be considered as a *dayn*. How debt is generated and treated (trading, sale and exchange with commodities) should be the crux of the debate.

Given the overarching Islamic principles and ethos the Islamic financial industry has to abide and reside within, the ethics and morality of debt has to be considered. Inherently there is nothing wrong with debt per se, however it can be abused. The workshop touched on the concept of debt discouragement – which has ramifications for an Islamic economic ideal of a profit-and-loss sharing system. Participants were referred to an example by way of an *hadith* (narration) which highlighted the fact that members of the household of the Prophet (pbuh) would seek to take on debt without the necessity for it, but only for the purposes of gaining the *hasanaat* (good deed) of repaying the debt. The *sukuk* structures, which bring about debt, such as *istisna'* and *murabaha* contracts, and emulate advanced payments and deferred payments similar to conventional characteristics, should not summarily be dismissed without due consideration. The ability to optimize the sources of capital should still be available in Islamic structuring. *Sukuk* are essentially a granular form of giving investors the risk related to ownership of assets. As long as investors are taking risk, there is nothing wrong with mitigating risk. Participants noted that it shouldn't be the case that the structure is not "pure" enough because it is not risky enough.

Dichotomy between the real and financial economy

The discussion proceeded to address the underlying nature of the Islamic economic system – the role and relationship the financial economy plays in the real economy, and why debt was created in the first place, and the difference between an interest based loan and the purchase of a good at a higher price.

Participants noted that *sukuk* has the potential to be deemed as the first instrument to break the real-financial economy linkage, disengaging from the underlying transaction with the possibility of a "pyramid of claims" upon an underlying receivables asset whose value has diminished over time – a *sukuk* on *sukuks* - leading to a conventional derivatives market scenario.

The disengagement of transactions from their underlying originating asset is highlighted as the fundamental economic problem concerning *riba* – the immoral and inefficient justification of a lender claiming a guaranteed stake in newly created wealth beyond the capital lent.

Participants acknowledged that *sukuk* expose certificate holders to ownership risk, and the existence of purchase undertakings does not fully remove this risk susceptibility. *Sukuk* are based on their underlying contract, with the *shari'a* providing a balance between equity (*mudaraba, musharaka*) and sale (*murabaha, istisn'a, salam*) contracts which lead to debt, which is both needed and required. The participants acknowledged the permissibility of debt-financing, and the need to focus the discussion on its tradability. The "pyramid of claims" is a viable threat to delinking the real and financial economy through a *sukuk* fund setup – with *sukuks* of less than 100% tangibility - which would create a situation with a variable value base of the underlying asset to the claims generated on it.

The role of economists in Islamic finance

Islamic economic thought at the macro level has not kept up with the rapid micro-level product development of the Islamic finance industry. There is a need to re-energize the field and thought-contributions, and bring harmony and collaboration with the product level development – an example being the impact of Islamic contracts on business cycles – which the *sukuk* structures presently in market do not seem to mitigate. Reaching par with conventional product characteristics is foreseen to lead to par economic results.

There is then a missing link between translating divine guidance into economic guidelines, and economic guidelines into specific Islamic finance rules and practices. Guidelines can be gleaned, however they are not enforceable as rulings. The participants acknowledged the role of economists in partaking in the analysis and development of products beyond the legalistic analysis of the scholars, with the example of the insight that contract monitoring costs play a crucial role in deciding between investor financing structures – with debt products suited to high monitoring costs in contracts and equity contracts viable in low monitoring cost environments. Contracts underlying transactions need to be *shari'a*-compliant, legally enforceable and importantly, commercially viable. *Shari'a* structuring, credit rating and legal documentation should support bankers and economists in initiating commercially viable concepts, as well as developing and improving the current suite. However, there is a need for political will to oversee an embracing and enabling regulatory framework.

The participants noted that there has been a lack of study on *maqasid* - perhaps given the relatively young timeframe of industry development. The focus on product development has primarily been focused on the legalistic form by the scholars. What is needed is the movement to including "*maqasid* standards" where economists would lead the holistic study and review of industry products and their wider effects. Participants acknowledged the goal is to develop the *maqasid* of products, but given the limited Islamic market capture which would limit their implementation due to market forces, the focus should be on curtailing the *mafasid* of products, engaging in responsible marketing of debt-based products for example. A limiting factor which needs to be addressed to enable the shift to adopting the underlying *maqasid* of products are a lack of educational institutions to provide the depth to the study of *maqasid* which would enable economists to understand the merits of products in light of Islamic injunctions, and whether permissible contracts are economically viable in the long run, and evaluating the balance between the *maslaha* and *mafsada* of a treatise. There is a lack of *maqasid* training on the part of contemporary Islamic economists, who embue socialist tendencies, and hence a requirement of a hybrid of skills to guide micro-level developments, which are gleaned from the macroeconomic rulings provided in the *quran*.

Professor William Blair of LSE's Law Department provided comments summarizing the direction of the discussions so far with additional insights, highlighting the recent "credit crunch" being the result of the delinkage from the real economy and the learnings the group could solicit from this phenomenon, with risk only able to be passed on and not removed; the standardization of products and the self-regulation of the industry to interlock perspectives and standards; and the convergence trend with the overall international financial industry – spanning from transactional, structural and regulatory convergence.

Structural concerns regarding sukuk

The participants then directed the discussions to the structural concerns regarding sukuk which are deemed in conflict with the underlying contracts which form their basis; in particular, the purchase undertaking, the periodic returns, and the ownership rights.

Regarding the first issue of purchase undertakings prominent in *sukuk* contracts, participants discussed the presence of meaningful ownership risk inherent in such contract - the meaningful ownership risk of the destruction of assets, and in the change in the value of the underlying. The contract structure as a *sharikah al-milk* (co-ownership), which allows purchase undertaking, and *sharikah al-'aqd* (partnership) was then discussed and its validity as a meaningful distinction. The discussion also included the prohibition of a capital guarantee by an *ameen*, who is not put into that obligation. The participants also discussed the structural characteristic of the *sukuk* enabling purchase at face value, noting there is no dispute if conducted at market value; its permissibility as a necessity and whether there are any alternatives, given transactions will otherwise not be dynamic or face regulatory or ratings agency issues without it.

The participants proceeded to address the second issue of periodic returns, and whether there is a requirement under *shari'a* to compare the *sukuks* performance with market peers rather than with a benchmark like LIBOR, while considering incentive structures for the investment agent (*mudarib*), and the treatment of the reserves as a *qard hasan* as an enabler of a liquidity facility.

The discussion proceeded to address the third issue of ownership rights in contemporary *sukuks*, in particular the divergence between the *shari'a* treatment and tax treatment, as well as the civil law jurisdictions not recognizing beneficial ownership.

Workshop End

Participants acknowledged the unique contribution of the Harvard-LSE IFP Workshop in enabling an open debate on contemporary issues in the Islamic finance industry, with the aim of providing greater analysis and research into the subjects discussed. The participants looked forward to an invitation to a similar annual Workshop setting and agreed upon a specturm of topics to be discussed. The Harvard IFP is also in the process of creating an academic journal of Islamic *fiqh* issues in Islamic finance, with a view to publishing thought research pertinent to the legal aspects of the industry – and an update of the program was provided by Dr Nazim Ali.

In Attendance

Usman Ahmed, CEO, Citi Islamic Investment Bank, Dubai, United Arab Emirates
Daud Bakr, Shari'a Supervisor, Kuala Lumpur, Malaysia
AbdulKadir Barkatulla, Shari'a Supervisor; London, United Kingdom
William Blair, Professor of Law, London School of Economics, United Kingdom
Humayon Dar, Chief Executive Officer, BMB Islamic UK Limited, London, United Kingdom
Majid Dawood, Chief Executive Officer, Yassar Limited, Dubai, United Arab Emirates
Husam El-Khatib, DentonWildeSapte LLP, London, United Kingdom
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Hussain Hamed Hassan, Shari'a Supervisor, Dubai Islamic Bank, Dubai, United Arab Emirates
Hussein A. Hassan, Vice President, Deutsche Bank AG; Dubai, United Arab Emirates
Esam M. Ishaq, Shari'a Supervisor; Manama, Kingdom of Bahrain
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Frank E. Vogel, Founding Director, Islamic Legal Studies Program; Harvard Law School
Nizam Yaquby, Shari'a Supervisor; Manama, Kingdom of Bahrain
Anas Zarka, Senior Economist & Shari'a Advisor, The International Investor, Kuwait
S. Nazim Ali, Director, Islamic Finance Project, Harvard Law School

HARVARD LAW SCHOOL
Islamic Legal Studies Program

and

LONDON SCHOOL OF ECONOMICS

Workshop on *Risk Management*

Islamic Economic and Ethico-Legal Perspectives on Risk Management

Thursday, February 26, 2009

London School of Economics
Tower #3, 5th Floor (BOX)
London, United Kingdom

ISLAMIC FINANCE PROJECT

HARVARD LAW SCHOOL
ISLAMIC LEGAL STUDIES PROGRAM

HarvardLSE Workshop:

London School of Economics February 26, 2009

Workshop on Risk Management:

Islamic Economic and Islamic EthicoLegal Perspectives on the Current Financial Crisis

A short Report

Prepared by
Husam El-Khatib

Introduction by Zohaib Patel

THE WORKSHOP

Continuing with the successful model of earlier workshops in 2007 and 2008 – on the topics of *tawarruq* and *sukuk*, respectively - the Harvard Islamic Finance Project (IFP), formed under the auspices of the Islamic Legal Studies Program at Harvard Law School, jointly hosted with the London School of Economics (LSE) a workshop on risk management in Islamic finance on February 26, 2009.

IFP engaged an influential group of academicians, economists, industry practitioners and Islamic legal scholars, to discuss the features and tools of risk management in Islamic finance and to understand how the current economic and financial crisis might reshape future development.

This report is a summary of the key issues and concepts discussed during the workshop and points raised by participants in their pre-workshop comments.

THE AGENDA

1. The Current Financial and Economic Crisis within the Conventional Markets: An Overview

- What are the primary factors behind the crisis?
- What lessons can be learned from the crisis?
- How will risk management change as a result of the crisis?

2. Definitions and Principles of Risk Management in Islamic Finance

- What does risk management attempt to achieve within the Islamic financial framework and how does this differ from its conventional counterparts?
- What do classical legal norms and rulings tell us about the general principles that should govern the objectives and practices of risk management in Islamic finance?
- Is the distinction between risk-sharing and risk-shifting useful and important?
- How to balance the equation: "Risk management for one is speculation for the other." Clarifying the boundaries of speculation.

3. Features and Tools of Risk Management in Islamic Finance:

- Case studies of hedging mechanisms used for risk management in Islamic finance: Profit Rate Swaps, Currency Rate Hedges, Total Return Swaps, and Options (*Arboon*).
- Do these current products conform to the principles and objectives of risk management in Islamic finance as discussed above?
- What is the economic impact of these products?

4. The Future of Risk Management in Islamic Finance

- How may the current financial crisis reshape the concept of risk management in Islamic finance?
- What new transactional tools or mechanisms should be developed?
- What institutional or regulatory arrangements would be desirable?
- What trends and issues are we likely to see in the next five to ten years?

INTRODUCTION

The workshop was attended by a group of influential Islamic legal scholars, academicians, economists, bankers and industry practitioners, who were welcomed by the Directors of IFP and LSE, Dr. Nazim Ali and Sir Howard Davies, respectively.

The financial crisis, which was the backdrop of the discussions, and the need to revisit risk management practices were underscored in the opening addresses. The crisis, at its core, demonstrates the dangers of "group think" and over-optimism in clouding corporate decision-making and risk reigning. Before the crisis, it was viewed as risky not to been seen participating in this market. There was an assumption that house prices would increase indefinitely and the credit risks were all mitigated. In this regard, risk managers and board members of risk committees would have better served institutions as contrarians in their assessment approach.

Understanding risk is key to managing risk. However, undermining this key tenet was the over-complexity of many financial instruments, which even managers failed to understand. The resulting underassessment fed into misaligned models concerning the true risk interactions of various securities within portfolios, causing misleading accounting and enterprise risk measures and hedges. It also highlighted the importance of looking at gross numbers and not just net figures.

The Islamic finance industry is an important part of the global financial fabric. As such, it too is not immune from many of the challenges faced by the global financial industry. This risk management topic takes on a greater level of importance as everyone ties to review and to reflect on the lessons learned from this crisis.

WORKSHOP OPENING

Professor Frank E. Vogel, moderating the workshop, introduced the structure for the discussions and the overarching issues concerning risk management and the financial crisis that burden even the Islamic financial industry today. The workshop participants were directed to touch upon the permissibility and advisability of certain Islamic concepts and principles as applied to modern finance and risk management practices.

LESSONS FROM THE FINANCIAL CRISIS

Conventional Thoughts on the Financial Crisis

Professor Willem Buiter, Professor of Political Economy at the LSE, set the context of the workshop discussion by presenting an introduction to the financial crisis and highlighting its regulatory shortcomings from the perspective of a senior conventional economist.

The scale and the vehemence of the problems faced by the financial community, without a doubt, reflect a real crisis of the financial system itself. The near collapse of the global financial architecture reveals the true extent of the excesses going on at the time and the near absence of the global regulators.

The previous trend toward liberalization and the "light touch" regulation of the financial markets have now quickly reversed into a sudden case of regulatory capture in an effort to warrant closer scrutiny of the financial system. National regulators intentionally had softened regulations as a way to attract business to their nation. Furthermore, regulations had remained at the national level, failing to aggregate the actions of individual institutions and global instruments. The overall effect of which, led to staggering levels of dishonesty, partial truths and a general lack of ethics in business.

Most affected by the crisis are the global 'border-crossing' financial institutions. In the current stressful financial and political climate, nationalistic priorities quickly dominate and prevail. Thus, central banks were quick to save only their own national institutions. Overly generous government subsidies in the form of state aid were provided to those entities at the expense of a distortion in competition, leaving other global financial institutions to fend for themselves.

The financial crisis could also be considered a crisis of the current 'Anglo-Saxon' model of finance. On the one hand, there is the relationship banking arm– or the 'originator-hold' model – which is good for developing and building trust. However, it is inherently based on an 'insider protection' model. On the other hand, you have the investment banking arm - or the 'originator-distribute' model – which deals with liquid and tradable securities. The current crisis has now flipped the two models, so what was liquid became illiquid, and vice versa. It also created a mismatch between liabilities and liquidity.

Substantial misunderstanding and mismanagement of risks, at the institutional and organizational levels as well as at the instrument level, is another cause. The trading of risk became easily falsified and the transfer of risk was made to parties willing to, rather than able to, bear risk. For example, AIG, as an insurer was already highly risky and yet, the investment bank component of the insurance company was not regulated, as it was part of the overarching holding company. Yet, AIG took on more risk than it could feasibly bear.

Factors that everyone thought would help regulate the market actually helped destabilize the markets, such as Basel 2 and an over-reliance on financial models. With such financial models, risk management boiled down to risk quantification. This then led to the illusion of 'precision' - as if the risk quantified is accurate and flawless – providing a false sense of security among senior managers and watchdogs. From now on, financial regulators should have to micro-manage all financial matters, for example, consider imposing leverage ceilings.

Complex instruments, like credit default swaps and other derivatives, incorrectly attempted to achieve minimal risks for attractive returns. Moreover, their documentation was not easy to understand.

The crisis highlighted the systemic problem of institutions 'too big to fail'. Stronger competition regulation is required in order to limit their future size. Anti-trust regulations need to be enforced along with conflicts of interest rules. If institutions are kept small enough to fail (as opposed to too big to fail), the risks of widespread market failure are reduced. Individually, the covariance of small banks has less significance on the financial system. However, collectively they do.

The crisis exposed the universal problem of conflicts of interest, such as with the rating agencies. It is clear, financial 'Chinese walls' simply do not work. Banks have become terribly conflicted institutions as they act on behalf of both principal and agent on numerous transactions, even in some cases when they are highly conflicted. The same problem applies to auditing and accounting firms; the auditing business is just a loss leader to bring in the customers to their accounting business. So, there is an existing institutional conflict of interest here. Now, there will be a general drive to minimize conflicts of interest.

This leads to the enduring Glass-Steagall debate of separating the functions of investment banking with that of the commercial deposits/lending arm. There could be a return to Glass-Steagall as well as an initiative to a return to narrow banking. The scope of global banking could become much more limited and this may become a permanent shift. There could very well be more tight deposit making activities with narrow banking type lending. Everything else would become properly supervised, like that of the investment banking activities.

There is also a need to overhaul the reward and bonus systems. Greed caused investors to buy complex structured products so as to chase high returns but without regard to what they were purchasing and little or no understanding of the risks. Greed also inspired the dealers and investment bankers to sell such products so as to reap the arrangement fees. Greed also motivated top executives to over-rely on poor financial risk models and to take on added risks.

Arguably, this is the best time to bring in strong regulatory rules, since all the institutions are down. The risk of over-regulation is far easier to deal with than trying to impose new regulations when the market is on the rise again. In other words, it is easier to remove regulations than to impose them when the markets are up. Also, regulating innovation and new products will require many actors, not just the regulators.

As a suggested solution, by drawing comparisons with the pharmaceutical industry and the rigorous regulatory approval process for new pharmaceutical products, financial instrument innovations going forth should be required to go through a similar regulated process for initial assessment and investigations into their systemic impacts before general acceptance and introduction into the wider financial system. A financial contract which has not received regulatory approval is one way of demonstrating that it should be avoided.

Islamic Finance Perspectives - Systemic Factors

Throughout the day, participants expressed their individual views of the financial crisis, their thoughts on its causes, it solutions and its impact for the Islamic finance industry.

Though Islamic finance practitioners do feel in a sense vindicated by the crisis, at the same time they were all shocked by the scale of it and of the global impact it is having on all, including that of Islamic finance. All agreed it was very important to be constructive and to bring to the table ideas that can be useful in solving the current financial problems for everyone and not just for the industry.

At the same, there was still a lingering sense of loss of trust. Many were left asking: should Islamic banking be following the conventional model of banks itself?

Some participants felt that the large stimulus packages were just cosmetic aid to more fundamental, root problems within the system. One participant remarked that the global economic crisis has actually been going on for many years now in the form of the growing polarity between the 'haves' and the 'have nots'. As an alternative to the bailout money to financial institutions, one suggested that these same funds should go directly to the poor. Doing so would naturally cause the funds to be recycled back to the banks in the form of actual deposits from the initial recipients, thus both stimulating demand by a new large segment of the population at the same time helping to move the engines of the economy again.

Other suggested lessons of the crisis, in particular with respect to risk management, include: lax risk management practices; under-pricing of risks; high leverage (low capitalization); transferring of risks; creating newer risks; difficulty in assessing risks in new structures and instruments; the break-down of relationships between lender and borrower; excessive risk taking at the originator level; and lack of control and understanding of the exact nature of assets underlying the securities by investors.

One participant believed the cause of the current crisis was a failure of bank regulation, and not of speculative activity in the stock or currency markets. However, most others felt speculation was a root cause.

All agreed that there were a number of principles in Islamic finance that could have helped avoid many of the issues faced in this current crisis. Also, there are many points that Islamic finance can offer to all. The Islamic finance industry just needs the confidence to assert its points and hopefully people will listen.

Islamic Finance Perspectives - Suggested Solutions

Solutions suggested by workshop participants include: the prohibition of the sale of goods that one does not own (as with short sales); the sharing of risks between all transactional parties; tying all financial transactions to the real economy and productivity; the focus on transactions that create real value, real productivity and real goods & services; the promotion of entrepreneurship in ways that is not at odds with the overriding public interest; and the avoidance of excessive speculative transactions. All parties, intermediaries and investors alike, should mutually share risks and profits, and not simply take the profits while transferring the risks to others. In theory, this action should help prevent the growing rift between the very rich and the very poor. Other Islamic solutions include stressing the ethics of saving; living within one's means; the virtues of sacrifice; and both long term as well as short term planning. One very important solution is to improve trust and trust generating mechanisms.

Other practical suggestions not specific to Islamic finance include: monitoring corporate governance and ensuring the protection of rights of all stakeholders in joint stock enterprises; ensuring transparency, accountability and the flow of information to all concerned; preventing the combination of excessive risk taking coupled with excessive leverage; preventing moral hazard situations whereby profit is privatised and risk is socialized; setting up investment criteria to prevent excessive risk-taking; imposing stringent regulatory capital requirements; requiring greater retention of assets or risks by originators (to minimize credit risks); improving the powers of regulatory bodies for all financial products; imposing more efficient legal and regulatory conditions on the issuing and exchanging of securities or *sukuk* on properly supervised exchanges; tackling the complacency attitudes toward risk, risk calculations and risk assumptions in financial models; encouraging simplicity, clarity and ease of use in financial products; appointing a risk officer on the board of directors for each corporation; ensuring that innovation brings more benefit than harm (to be determined by better screening of financial products); cultivating a risk assumption rather than a risk elimination or risk transfer culture; matching actual projects with their financing facilities; curbing the money creation factor by introducing 100% reserve requirements for on demand deposits; stricter control over inflation and money issuance; emphasize wealth creation and distribution to all and not just the few; assessing systemic and market risk in each transaction as well as the risks specific to that transaction; increasing trust by better guarding reputational risk and better public education; improving human capital skills and training; guarding moral, religious & ethical values to improve trust and reputation; developing broad principles and industry best practices in risk management as well as for finance (especially for Islamic finance); and generally adopting all the positive aspects found in all global financial systems while avoiding the more dubious elements.

Monetary and Economic Considerations

Some felt that current discussions should be about renewing the financial system but not to replace it. While others opted for a new start more along the lines of Islamic ideals.

One practitioner asked, given what has happened, is the Islamic finance industry on the right trajectory. Someone should set the trajectory for each area of Islamic finance, especially for risk management.

For many, the problems being witnessed with the conventional financial system are due fundamentally to the inherent structural problems in the concepts of money and wealth creation. Key to these problems is the disconnect between money itself and the real economy. To create extra legal claims against a reserve is in effect, as one put it, amounts to ‘fraud’. Furthermore, the use of interest generates artificial levels of supply and demand for money and risk products, which in turn, affect their inaccurate pricing.

In Islamic theory, risk bearing and risk participation modes of finance and investment are always connected to the real economy. Excess wealth is recycled for use in actual trade, production, manufacture or construction as opposed to simply into interest bearing money instruments. As such, there should be no liabilities mismatch between wealth, resources and goods.

Another important comparison between conventional finance with that in Islamic is that in the former, risk can be separated from the asset. Since risk itself can be separated, packaged and sold on, that in itself creates usury, which is strictly prohibited in Islam. It also highlights the divorce between the economic system and the financial system.

It was suggested that if the value of paper continues to fall due to the exponential printing of money, alternatives like going back to the gold standard should really be looked into. A few participants suggested we should move towards a 100% capital reserve ratio model. Another mentioned a study undertaken in the US whereby sustainable growth without any debt intermediation at all was in fact feasible. Though, the unanswered question remains as to whether it is practical to implement given the rooted global debt culture.

Most argued in favour of separating the commercial banking functions from that of the investment banking activities; financial intermediation would be split between the deposit receiving/payment mechanisms from that of the risk taking investment activities. A number of questions were raised on the issue of narrowing bank and Glass Steagall. But, if one were to adopt a model of narrow banking, it would be extremely difficult to have global banks and to have global banking. Everyone agreed that the financial system should at the very least be an intermediary linking the real economy with it and not morphing on its own.

Morality & Ethics

Part of this crisis is regulatory, part is moral. One argued that the industry should look at the demand side as well and not just the supply side.

In conventional finance, the fundamental failure of the moral sphere is a real issue. Consumers were receiving mortgages they cannot afford, which in Islam is unethical. For the sellers of financial products, greed is a moral issue and is a root cause of the actions contributing to the financial meltdown. Before the crisis, financiers faced a classical moral hazard situation in which taking excessive financial risks was encouraged simply because it was other people’s money and the rewards were high.

Islamic finance does focus on demand side issues as well as the supply side. This can include for instance, promoting responsibility among consumers; promoting accountability; providing guidelines on the take up, use and payment of debt; and providing warnings to the dangers of excess. Islamic banking is not just a financial institution but is a spiritual form of worship. Thus, accountability to the Creator is the supreme form of accountability, which in turn forms as a natural enforcement mechanism of such moral ideals. So, regulating the well being of consumers is deemed an important part of the equation. In convention financial, no one governs this sphere.

Nevertheless, there is a global reaction to this crisis on moral terms as well. There are already some initiatives in this respect with the IMF, the World Bank and with the Global Governance Principles as outlined in Davos. One asked, is this a time for all financial industries to join ethical movements and ethical finance and make a common cause for all with the regulators?

Behavioural regulation through the use of law is however notoriously ineffective. In the UK, morality can be influenced by law. But it will not work through direct regulation of morals as people will generally disobey. An analogy of the Victorians was used. They did not legislate morality and behaviour per se, but they did set in place a lot of restrictions, barriers and incentives to guide people into good behaviour.

Shari'a on the other hand legislates morality, but largely through the adherence of specific rules, *ahkaam*, which in turn takes care of issues of morality in the same process. However, the legislation of morality has been one of the great divergences between the West and the Islamic world, as the former really objects to it, but the Islamic states stand for it.

But then again, are not modern conventional financial rules and codes on corporate governance and ethics, as well as professional standards of behaviour already forms of legislated morality in the West? With this financial crisis, current discussions in the market have been gravitating toward ways of strengthening these moral codes.

Introspective Lessons for Islamic Finance

Despite a more tempered impact of the global crisis on the Islamic finance industry, participants acknowledged that no one was immune. There was even recognition that the risk of default still loomed for the Islamic finance industry. It was understood that any Islamic financial system could not separate itself entirely from its conventional counterpart. It was confined and bound to work within that dominant conventional framework.

For instance, one participant believed that Islamic Banks were not flexible enough when markets are in turmoil, such as the current situation, placing them at a disadvantage to conventional banks. When interest rates rise quickly, there is factual evidence to suggest that customers tend to switch their deposits from Islamic banks to higher paying conventional banks. Conventional banks recoup these extra funding costs by increasing their lending margins.

One suggested the industry ought to put out a study on how bad the industry is being (or was) affected by the crisis. It was important to understand the exact cost of the financial crisis to the Islamic finance world and how quick the industry can recover from it. Another purpose behind this study was to serve as a basis for self-examination of the industry's own assumptions and perceptions about itself.

One argued that participants were already incorrectly working from the assumption and perception that the Islamic finance industry was badly affected by the global crisis. Some were already presuming that something with the industry's risk management policies has veered off, or that its financial products are not good enough, or even, that the industry is heading towards the same fate as conventional finance.

For many however, the crisis demonstrated that Islamic finance could avoid many of the errors of its conventional counterpart. Some felt that Islamic finance's own systemic and structural make-up is sufficient to avoid any such pitfalls.

Some even went as far as to say that Islamic finance could fill the global systemic void in finance in the wake of the failure of conventional norms. Or at least, they believed that the post financial crisis world would be one that adopts or benefits from the principles of Islamic finance - though not specifically referring to 'Islam' per se - but under the banner of 'justice, equity and human welfare'.

But such optimism came with a warning. Many believed that if Islamic finance continues to mimic the conventional modes and forms of finance, the industry would easily fall into the same systemic crisis and face the same underlying economic concerns. Many feared that the current range of Islamic risk management tools was already a step too far in that direction. This warning that the industry was already on that slippery track was reiterated throughout the day's discussions.

As such, a number repeatedly cited that the fundamental lesson learned from this crisis was not to mimic its conventional counterpart and to remain faithful to the basic Islamic precepts and principles. One added that the industry should not set out or seek to prove it can replicate Islamic versions of conventional risk management products. Rather, product development should start afresh and start from the point of what is permissible in Islam and create what naturally flows from it. In other words, it is important to create and devise something new rather than to try to replicate or mimic something that is already prohibited. Doing so, would naturally help evolve the industry for the better.

One *shari'a* scholar suggested that the best approach would be to ask the Islamic banks to be more forthcoming of the exact issues and obstacles faced in their operations so that *shari'a*-compliant solutions could be more readily found. This transparency and open dialogue between all those in the industry would enable in theory for such banks to remain to true to the vision of upholding the pure Islamic principles, rather than going it alone and falling into prohibitive traps.

Ideals versus Reality

It was presented that there is an ideal model for Islamic finance and then there is a separate, realistic one. Current industry practice with its array of available products constrained by an overpowering conventional interest-bearing framework could safely be categorised as the realistic model.

The major difficulty for all was defining what exactly the ideal was. One participant put it as meeting the *maqasid al-shari'a*. Yet, no exact models were presented nor any detailed explanation was provided other than stressing the ideal merits of a debt free society linked to the real economy.

Most of the participants believed that that they should work on achieving both models but gradually move toward the idealistic. A few felt that no systemic change was required – in fact the industry should not change anything - but continue as is. Whereas a few others felt that the emphasis should be on moving toward the ideal immediately.

Most agreed that Islamic financial institutions were not working in a vacuum. But had they been doing so, it would have been better than working with the current financial environment. The absence of many of the conventional financial laws and operational systems which are so adversarial or at least inhibiting many of the details, norms and statutes of *shari'a* compliant finance, would arguably have been much better, or at least easier for Islamic finance. An environment free from such obstacles, it is argued, would make it far easier for Islamic finance to operate and to function according to its ideals.

A number of practitioners felt that the industry had inherited and been confined to an 'impure' conventional interest-bearing system, whereby Islam's ideal economic system, its fiscal policies, its legal systems, its accounting framework is all driven by and built upon an interest based framework. As such, it is proving increasingly difficult if not impossible to continue to solve many of the growing challenges the industry faces.

Of those who wanted to move immediately to the ideal, the current crisis served as a great opportunity to do so. Now is the time if the industry wants to be more assertive because the conventional sphere is going through an existential crisis. Furthermore, regulators may be more apt to listen to the industry's suggestions. One participant suggested this is the best timing opportunity to move the standard toward *mudaraba* and *musharaka* type products instead of debt.

Of those who advocated a more gradual approach towards the ideal, one strategy suggested was to continue to gain market share until a significant regulatory shift could be advocated in favour of the ideal. Yet, in the interim process of trying to gain market share, the industry should protect the investments it has made, and therefore use structures and tools that have been taken as a form of legal exception, *makhraj*. As summed up by one practitioner, it all goes back to the issue of principles versus practice.

Others argued that the industry should give itself realistic targets. Beyond that, the industry should have a specific systemic change plan otherwise the current situation will not shift. Policy is something that needs to be thought about and practitioners sometimes unnecessarily burden the *shari'a* scholars with all the decisions of a monetary system.

Many felt the entire matter itself was really an issue of frame of mind. The industry should develop its own mindset and think solely through its own lens. In other words, rather than continuing with the model of trying to learn and to adapt from conventional products (or to 'Islamize conventional products' as one put it), the industry should think outside of the box and develop its own solutions. The industry needs to 'think Islamically' as many put it and to stop being so defensive. This lack of its own financial mindset and of a separate financial thought process inhibited the industry from developing its own organic Islamic solutions and its own course.

However, the negative mindset of some regulators toward Islamic finance even in some Islamic countries, for some, was a major obstacle to achieving progress even on the 'realistic' level of introducing the current array of Islamic financial products.

It's all in the mindset.

ISLAMIC RISK MANAGEMENT

Defining & Categorising Risk

A discussion on the definition of 'risk' and its forms took place throughout the day. One participant defined risk as 'the probability of something undesirable happening that reduces value.'

For some, risk was easy to understand and to categorise. For others, the variety of risks and its distinctions in finance were still being understood. As such, many grappled with the concepts of risk that could be shared and risks that can be shifted or transferred, both in conventional finance as well as in Islamic.

In classical Islamic law, it was suggested that the *shari'a* classifies all risks into three meaningful categories:

1. Essential risk and *al-kharāj bi-dhaman*, which can be roughly translated as 'the profit belongs to him who bears responsibility'. This maxim encapsulates the concept of risk for return (*al ghunm bil ghurm).* Parties who enter into an agreement are entitled to its benefit as long as there is some form of associated risk. Without the risk, the transaction would not be *shari'a* compliant. Any condition to the contrary would make the transaction void, such as anything contrary to the rule on (شرط ينافي مقتضى العقد), a total or partial loss or decrease in value of an asset is on account of its owner). If one requires a return of some form, then one should be able to take on the associated level of risk.

In an Islamic sales contract, the seller bears all the risks of loss of the asset until title is transferred to the buyer who then in turn takes on the full risks, including risks of defect, damage or depreciation arising thereafter. In an Islamic leasing arrangement, the lessor assumes all risks of loss (not caused by the lessee) and the risks of maintenance and payments of taxes. Whereas the lessee assumes the risks of rental payment, of any loss of profit and of under-utilisation associated with the rental of the asset. In a *mudaraba* arrangement, the risk of loss, damage or decrease in value of the *mudaraba* assets and capital is borne by the investor (*rab al mal*) as long as there is no default, misconduct or breach by the investment manager (*mudarib*). This is on the basis of the maxim (المال يهلك ويتلف وتنقص قيمته على مالكه).

2. *Gharar Katheer*, which can be roughly translated as 'excessive/gross uncertainty or speculation'. Muslims are strictly prohibited from entering into this second category of risks as such risks make a transaction or a contract void from a *shari'a* perspective. Whereas in conventional finance, this is a form of tradable risk which can be separated and sold on, or, which can be mitigated against.

This form of risk is also known as *gharar jaseem* (غرر جسيم) and it can be further classified into the following sub-types of prohibited risks:

a. Risk in Existence (غرر في الوجود) (i.e., the sale of an non-existent item, such as crops, on a future basis);
b. Risk in taking Possession (غرر في الحصول) (i.e., the sale of a run-away camel or commodity / property that has to be repossessed);
c. Risk in Quantity (غرر في المقدار) (i.e., sale price or rent being unknown in a sale or lease contract);
d. Risk in Quality (غرر في الصفة) (i.e., type, quantity or specifications of the subject matter of contract being unknown); and
e. Risk in Time of Payment (غررفي الأجل) (i.e., a deferred sale without fixing the exact period).

Involvement of any of the above types of risks make contracts of consideration or exchange (*aqood al muawadat*) void with the unanimous opinion of the jurists. In contracts of gifts or donations (*aqood al tabarro'at*), the majority of jurists are of the opinion that these risks make such forms of contracts void, with the exception of Maliki jurists who view risks in contracts of gifts are permissible. From this Maliki opinion, contemporary jurists have derived that *takaful* is permitted despite containing Risks in Existence, Possession, Quantity and Period.

These risks are deemed excessive and gross in nature as they fall into the categories of gambling and speculation, being some of the causes for the current global financial crisis. Short sales for instance are prohibited on the basis they fall foul of the rule on Risk of Possession; they involve the sale of something (i.e., shares) which are not owned by the seller at the time of the initial sale. Also, the sale and trading of debt falls foul of the above prohibited categories of risks as such activities carry with them additional ('gross') levels of risks, such as the possibility of non-payment of the debt by the actual debtor.

An important corollary to the prohibition on excessive risk is that *shari'a* does not permit a party to intentionally take on such forms of excessive risks and then to hedge against those same risks with the help of some form of hedging or risk management tool, irrespective of whether the actual hedging/risk management tool is *shari'a* compliant in itself or not.

3. The third category can be described as a level in between the former two. This can include a variety of forms of risk, including market risk and operational risk. This is not a risk that is part of a financing tool's inherent structure per se. Therefore, this type of risk can be mitigated against or avoided.

It is recommended that these types of risks, their nature and their classification in Islamic finance be kept always in mind, as they do help when trying to distinguish Islamic perspectives on risk and risk management from those in conventional finance. As such, due to these definitions of risk, some conventional risk management tools and techniques may not always be applicable to Islamic modes of investment and finance.

As mentioned earlier, key *shari'a* principles that should be kept in mind within any discussion of Islamic risk management tools include: that the risk follows the return (الخراج بالضمان); the benefit should involve liability (الغنم بالغرم); and, a total or partial loss or decrease in value of an asset is on account of its owner (المال يهلك ويتلف وتنقص قيمته على مالكه).

With respect to derivatives, the UK Financial Services Authority defines derivatives as forms of contracts for differences. The fundamental problem of the use of derivatives in Islamic finance per se is that in conventional derivatives, there is no intention to trade the underlying but only the difference; whereas this is not possible under Islamic *shari'a*. Hence, this critical distinction is one of the major obstacles to developing this area of risk management.

Defining Islamic Risk Management

Risk management, also known as hedging of risks, can generally be viewed as analyzing the exposure to risks and then either managing, mitigating, transferring, retaining, reducing or avoiding such risks in finance. Some define hedging as any transaction that decreases the risk of one's portfolio. While others argue that simply diversifying a portfolio qualifies as hedging.

A definition of speculation proves even more difficult as a variety of definitions exist. In finance, it may be viewed as assuming the risk of loss for the uncertain probability of receiving some form of reward. The difference is that hedging tends to reduce risk, whereas speculation tends to have the opposite effect of increasing it.

Speculation has always been troublesome in Islam, especially due to the principle restrictions on *gharar* (excessive uncertainty) and *maysir* (excessive speculation/gambling). Moreover, speculative transactions are criticised for not having a real underlying asset or for not being linked to a real economic activity. Given such restrictions and concerns, the development of risk management instruments in Islamic finance has been slow and cumbersome.

With the advent of the financial derivatives market in the 1970s, risk management was promoted as the use of derivatives to hedge or customize market-risk exposures. Thus, sometimes derivatives instruments are referred to as risk management products.

In Islam, there is a lack of consensus among Islamic finance practitioners on what constitutes the 'principles and objectives of risk management', in other words, the *maqasid al-shari'a* of Islamic risk management.

In an ideal sense, Islamic risk management can be considered a highly commendable mechanism. Among other things, it seeks to achieve 'prudence' in the use of resources and the avoidance of waste and damage (which includes economic waste and financial losses). Islamic prudence means the 'aversion of damages and generation of utilities' (*dara' a-mafasid w jalb al-masalih*). In other words, the risk of financial loss is a damage which is assigned a higher priority than the prospect of profit.

However, one participant viewed the very term 'risk management' as misleading and an oxymoron as 'risk' is already an inherent part of all Islamic financial products. Instead, they believed that it should be termed 'risk assumption'. When investors agree to invest, they have actually agreed to assume the risks, in the same way they have agreed to accept profit from the investment. Thus, the principle of managing risk in Islam is to accept the correct proportions of risk in a normal part of a business equation, and to internalize the fact that risk assumption, like profit making, is a natural expectation of investors in all business transactions.

Thus, a paradigm shift in terminology and in practice is needed in Islamic finance. Such a shift it is argued would help create more principled, tangible and financially sound products tied to real assets and productivity. Furthermore, this shift would help prevent the creation of exotic and speculative instruments designed to 'manage' risk, rather than create real value.

Despite this ideal view, most modern Islamic financial tools have been created or are still being created with the purpose of mitigating against specific risks. Islamic financial institutions have to manage a number of pressing risks, such as credit risk, liquidity risk, market risk, foreign exchange risk, and even rate of return/profit risk, similar to the interest rate risk conventional institutions face. Though the assets and liabilities of Islamic banks are distinctive, mismatch risk is still a big threat. Business risks and operational risks which can generate unexpected losses also need to be managed or hedged. Moreover, in practice, Islamic finance faces some additional risks such as ownership risk in *murabaha* and *ijara* contracts, which do not occur in conventional banking. The argument being put forth here is that until suitable alternative and innovative tools are discovered, scholars cannot expect the parties to wait and do nothing.

But, some products like that of total profit swaps were also created to serve as investment tools, which has created further controversy. A few case study examples of each were provided to workshop participants for analysis and comment, results of which are discussed later in this paper.

The Case for Islamic Risk Management

Even by the close of the workshop, it was clear that there were general misgivings about the current array of Islamic risk management tools. As mentioned earlier in this paper, there was a general sense of concern among participants that the Islamic finance industry was simply mimicking conventional products and was not really living up to its own ideals. Much of this criticism has been directed at the current range of Islamic risk management and derivatives products. Most felt that something was not ideal about them, or even, that they may not be ideal at all and should be entirely avoided if possible.

Yet, several participants were in favour of derivatives largely because they could help, among other things, to better manage the liabilities and assets mismatch on banks' balance sheets. Moreover, even if one undertakes a *shari'a*-compliant investment, the liabilities will always determine what the assets are worth. So if a trade loses value, one's underlying assets as an investor also fall in value, and vice versa.

The need to manage such mismatches arises from the premise that the Islamic banks do not exist in a vacuum. The Islamic finance industry remains a very small part of the entire conventional global finance fabric. Islamic financial institutions therefore are not immune to the effects of global interest rate and currency fluctuations and many of the underlying risks associated with conventional, interest-bearing finance. The issue therefore goes back to the discussion on the monetary system.

In theory, Islam should not even be held responsible for proscribing any solutions since the underlying cause, be it interest or currency fluctuations, is impermissible to begin with. As several put it, these problems were created by factors outside of the remit of Islamic finance and the industry is left to itself to devise solutions to them, be it by a form of *hila* or *makhraj* (defined below).

The equation is further complicated by consumer expectations. Most consumers expect to receive a risk management product that is not only *shari'a* compliant but priced comparable to that of a conventional mechanism. Islamic finance is not immune to basic economic factors such as price competition and consumer choice. According to a joke overheard by some in the Islamic financial community, some consumers mistakenly perceive or expect that: "The best Islamic bank is the one with the best rates; wherever one gets the best interest (profit) rate that is the best Islamic bank." Even if not true, Islamic financial institutions are pressured to deliver products that meet high consumer expectations on price comparable to that of its conventional banking counterparts.

In terms of actual risk hedging instruments, there was a difference of opinion as to whether or not use of conventional hedging instruments such as forward transactions were acceptable tools for practitioners to deal with such risks. Most participants felt that it was better to use existing *shari'a*-complaint tools, in spite of their limited applicability and rigid conditions. *Shari'a* based contracts include use of *arboun*, *salam. wa'd* and parallel *salam* contracts. But again, such tools are not a cure for all modern financial risks. Trading in currency futures and options is still prohibited.

The main differentiators between conventional and Islamic risk management is the potential for greater risk sharing in latter. Islamic clients are also exposed to residual price risk in the underlying asset, along with the equity risk when and if the bank provides equity finance. As such, a higher understanding of risk management and of their effects is required, as is understanding of the regulatory substance of Islamic and other religious provisions.

Finally, one participant was fearful of the actual use of these risk management products. They feared that use of derivatives was a greater risk in of itself, as witnessed by the fallout caused by derivatives in the current financial crisis. It was agreed that this factor needs to be looked into further.

Given all the above issues, it can be generally concluded that hedging is permissible in *shari'a* if the following three conditions are met:

1. The risks being managed or mitigated should themselves be *shari'a* compliant;
2. Risk management should be by way of *shari'a* compliant means, modes and contracts (as opposed to the use of conventional risk management products); and
3. The objective should be the management, mitigation or lowering of risk only, but not to fully eliminate or to earn profits from such risk by use of conventional styled investment products.

Makharij **and** Hiyal

To meet the current need for risk management tools a number of ideas were put forward, including the use of legal exceptions, *makharij* and legal strategems, *hiyal*.

Most agreed that there is a clear difference between the use of *hila* and *makhraj* when it comes to risk management. The difference lies between creating tools of exception in order to avoid an imminent and unavoidable *haram* through the use of *makharij* versus creating such tools simply to promote regular profit making through the use of *hiyal*.

Some used the analogy that Islamic finance is currently an industry that is forced to work within an 'impure' system, acting defensively. In order to make it 'pure', complex tools such as those devised through *makharij* are required. Though rare, they happen to meet real needs.

Participants were reminded by a scholar that *maqasid* do not in themselves decide individual cases; one cannot decide a real case with *maqasid*. A *shari'a* scholar does not practice *ijtihad* on *maqasid* alone.

Many advocated for everyone to make a clear and visible distinction between transactions made permissible by the use of exceptional *shari'a* principles, such as in situations of real need or dire necessity, and highlight them as such to the public, and those transactions which do not employ such mechanisms.

Other suggestions included, promoting the use of strict conditions with derivative transactions (but implementation of which was agreed a challenge in itself); limiting situations where they can be used for pure speculation; and openly discouraging customers from asking for these devices.

Another suggested approach in developing suitable products was to focus on just striking a balance between reducing the corruptive elements, the *mafsada*, and realizing those elements for the common good, the *maslih*, to the extent that even if this approach meant having to include some doubtful matters, *shubuhaat*, but not any explicit prohibitions, the *haraam*. It was reminded that the concept of gradualism, *tadrij*, was utilized to implement some of the more stringent prohibitions to society in early Islam. The key was to produce Islamic financial guidelines and to promote risk sharing, *mukhatara*, that serve to restore or to maintain a constant, natural equilibrium between sustenance, *rizq*, and risk itself.

The principle of *sadd al-dharai*, or blocking the means to evil, as a mechanism to justify the use of some Islamic risk management tools as a form of protection was also cited.

However, use of all these mechanisms came with a bleak warning. One participant highlighted the fact that historically the Christians used similar exceptional legal devices for certain prohibitions and ended up permanently accommodating such exceptions into mainstream practice.

As such, some participants were very concerned that many of the exceptional *shari'a* principles and mechanisms employed in the design of Islamic financial products are now becoming the norm. In other words, these exceptions are the new norm. For many, this is a very worrying trend.

Market Risks and Credit Risks

Though finance, Islamic finance included, involves a number of types of risks, the workshop discussion looked into whether the emphasis in Islamic risk management should be on market risks or rather on credit risks, which is usually the case for conventional products. The importance of this distinction affected the discussion on risk shifting versus risk sharing, as referred to later in this paper.

The triggering factors in the current crisis have been market risks. Derivative products such as credit default swaps are market risks. So, there was an urgent need to talk about market risks.

The first types of conventional derivatives initially looked at market risks, such as underlying asset price risk. However, more recently, the focus has shifted to credit risks. Given the Islamic finance industry's junior comparative size, it too is following this trend.

Many Islamic products, which are equity based in nature, require credit risk management tools simply because they are intentionally mispriced like that of debt (as discussed later in this report). Therefore, one participant asked whether credit risk is really any different from any other kind of risk.

Another participant took the view that credit risk is an extreme form of risk, which is tantamount to excessive prohibitive uncertainty, *gharar fahish*. In this regard, it is even worse than pure gambling, *maysir*, that is because the probabilities of winning and losing are known in gambling, but are generally very difficult to quantify in the case of credit risk.

Moreover, one cannot tackle credit risk given the nature of interest bearing debt contracts. It is very difficult to manage credit risk regardless of the risk management tools used. For example, this can be seen when the world attempted to tackle the huge size of the under-developed world's debt.

One participant recommended that one of the best risk shifting tools for credit risk is *dhaman*. He also recommended that *ajr bil-dhaman* be used. However, due to problems of control, they should come with a strict condition or warning that they are to be only used out of necessity for hedging and not for purposes of speculation. The fear is that speculators can gamble and take over its synthetic risk, which is not linked to the real economy. However, a number of *shari'a* scholars took issue with the concept of *ajr al-dhaman* and argued this was not even permissible in Islam. Yet, other scholars seem to warm to it if used out of necessity.

Several other forms of risk were discussed including operational risks and systemic risks. One suggested that concentration risk into one key client as opposed to diversifying the client base, remains a key concern for many Islamic financial institutions.

As a related side point, current financial and mathematical models to conduct risk analysis, such as stress testing may need to be revised given this crisis and perhaps build moral issues and factors into the models themselves.

Risk Shifting versus Risk Sharing

Integral to the day's discussions was a debate over the permissibility and preference of risk sharing over risk shifting. Risk shifting plays a major part of conventional finance and forms the basis of many of the controversial risk management products in the financial crisis, including, securitisation and credit derivatives.

As one participant put it, the entire financial system since its inception has been based on one fundamental product: interest, in the form of interest bearing facilities. Risk shifting has been the essence of the structural support maintaining and controlling this product. Furthermore, liabilities in the form of debt handled by the conventional banks, carry significant risks that need to be shifted away from the banks' books; hence, the need for risk shifting.

Investment products in pure Islamic finance theory on the other hand are not liabilities. For instance, in *mudaraba*, depositors of an Islamic bank account using this method have to share the risks as *rab al-mal*; therefore, no risk shifting is involved. There are no liabilities in *musharaka* and *mudaraba* products, but once they are treated as debt products, for purposes of the balance sheet they are classified as liabilities. If one treats these products as equity products, then one is only confined to commercial risk.

It is argued therefore that Islamic finance is all about risk sharing and not risk shifting. Transferring the risk, or risk shifting, is deemed less efficient, unjust and inequitable. Moreover, transferring all the risks on to the producer-entrepreneurs by financiers creates pressure for accelerated growth that is deleterious to the environment. Whereas a system of production and finance based on risk sharing would be more efficient and more equitable in terms of distribution of income and wealth.

Nevertheless, Islamic finance has struggled to operate in the modern financial framework using simply risk sharing methods. Thus, a debate ensued as to the *shari'a* compliant mechanisms and tools to shift the risk.

Some *shari'a* scholars felt that there were ample examples of principles in the *shari'a* and *fiqh* to do both, risk sharing and risk shifting. Thus, it was not a case of one preference over the other.

However, one scholar took issue with this point and advised that there is no shifting of risk in Islam because one could not make an income without sharing or bearing some risk in the process. Moreover, shifting the risk to the borrower but with recourse to the assignor is only permitted within the Hanbali school of *fiqh* and not with the others. Otherwise, if one is to shift risk, one has to have recourse to the assignee and not to the assignor. The assignee has to bear that risk because the associated risk was transferred along with the asset from the assignor as a whole. Otherwise, one must use risk sharing.

In those Islamic financing modes which result in a debt obligation on the customer, it is not correct to argue that all the risks (other than credit risk) are 'transferred' from the financial institution to the customer because these risks have not been transferred by way of contractual debt but by way of an underlying asset sale and purchase from the financial institution to the customer. The customer acquires title and possession of the asset in a *murabaha*, *istisna'* or *salam* contract with the debt obligation and all the associated risks. In other words, the financial institution first bears all the risks related to the asset purchase, and then 'sells' the commodity to the customer with all the risks attached.

One participant suggested a need to re-examine the concept of risk versus return in relation to this discussion of risk sharing or risk shifting. Once an asset has been sold, the new buyer is to assume its associated risks. Furthermore, everyone was reminded that Ibn Rushd once said that every condition in a contract has a consideration and a price. But also risk can be transferred without consideration, as seen in the waad and the *dhaman* structures.

Another suggested the need to differentiate between the creation of new risks and the transfer of existing risks. While another advocated that a distinction should be made between the various forms of risk within each different Islamic financial product. For example, in the case of *mudaraba*, the risks associated with the *mudarib* differ from those of the *rab al-maal*. As such, it would be easier to create tools to reduce or to mitigate against these specific risks.

Another scholar argued that the *shari'a* does allow transactions that assume risk transfer because no human activity could take place without some form of risk associated with it. All human activity carries some forms of risk. Even the equity in a *mudaraba* is a form of risk. Yet he qualified his statement by saying that if anyone could find any basis in *Shari'a* to create products solely for shifting of risk for a price, doing so would give Islamic banking a real opportunity to grow in risk management. There was a suggestion of one possible *fiqh* lead, however, the scholar did not elaborate.

As mentioned repeatedly by most of the scholars, as long as there is a genuine economic activity involved, with real assets or an economic benefit to society, in the form of a *shari'a* compliant transaction (as opposed to mere financial transfers), one would face little objections from *shari'a* scholars to such forms of risk management techniques.

One scholar clarified that shifting the risk from the asset may not add *gharar* or *maysir* to the issue. Whereas, in a contract of *muawada*, if one party's profit is based on the other's loss, it is deemed *maysir*. In other words, if one party's return is dependent on or primarily determined on the other party's loss, then one falls foul of the *maysir* prohibition rule.

One participant pointed out that when risk is shifted in practice, Islamic banks do not adhere to the *parri passu* principle; tranching is used instead. Tranching therefore is a cause of the problems here.

Despite the arguments put forth on the issue of risk shifting, participants did feel that the emphasis should still be on trying to promote a culture of risk sharing. Product solutions proposed included structured use of *takaful*, which employs the sharing of risks.

But, even if one were permitted to shift risk, one of the reasons behind the current financial crisis is largely due to problematic shifting of risk.

Hedging & Speculation

Hedging

One participant made an important legal distinction between hedging the types of risks that are actually created by *shari'a* compliant transactions versus hedging against those risks created by non-Islamic factors.

This distinction is critical when practitioners ask for a *shari'a* opinion to hedge against risks involved in prohibited transactions not under *shari'a*, as those would not be sanctioned, versus for an opinion on hedging risks coming out of *shari'a* compliant transactions with *shari'a* complaint tools and mechanisms, which most likely would be authorised. Moreover, by sticking to the permitted categories of risk in *shari'a*, this should itself naturally prevent banks from entering into excessive or speculative products and risks.

One scholar suggested to anticipate risks from the start of any transaction and to work in risk mitigating solutions into the structure, rather than addressing risk management through separate risk management products, as he had done in prior transactions. However, another *shari'a* scholar dissented stating that such an approach would not be feasible in all circumstances or appropriate for all hedging concerns.

Speculation

Many felt that risk management products should be confined to the realms of just hedging and not speculation. However, one participant pointed to the fact that one cannot have hedging without someone speculating on the other side of the transaction. So by just entering into a derivatives contract, one is already encouraging another party to speculate.

In a normal, liquid conventional financial market there are three types of actors: hedgers, speculators, and arbitrageurs. The hedgers try to reduce risk with use of risk management tools, the speculators take on the risk that the hedgers want to avoid and the arbitrageurs look for opportunities arising from market inefficiencies, which lead to pricing differentials. Each plays an important role in their own respect. The arbitrageurs ensure that prices in different markets converge leading to more efficiency. The speculators provide liquidity to the market.

Another participant took a slightly different view on speculators. The behaviour and interests of risk takers (speculators) are very different from those of one taking risks involved in his/her own business, producers, fund owners and financial intermediaries. All four gain by stability in the markets. But the buyer of risks gains by instability. Thus, buying risks involved in other people's business is a speculative activity akin to gambling.

Another warned that with all fixed and floating swaps, all parties seek simply to take advantage of the financial comparative advantages.

Thus, the challenge for the industry is that these risk management products can only work if there are speculators in the market as well. So the question remains: is the industry therefore prepared to facilitate speculation indirectly?

To counter the problems associated with direct speculators in the market, a creative suggestion was made to incorporate conditions into a legal contract stating that there should be a real economic activity behind the transaction in question. Additionally, it was recommended that practitioners undertake careful due diligence of the actual business behind the transaction.

Equity Risks

According to one scholar, *shari'a* has unlimited non-debt based products and not just *mudarabah* and *musharaka*. However, while practitioners use equity based tools like *musharaka* and *mudaraba*, they do not actually use them for equity purposes. Instead, these tools are used in the majority of cases for debt generating purposes, including for *sukuk*. Thus, these equity based products were in effect debt based products. This therefore impacts on the risks and the relevant risk management tools required of them.

By treating them as debt products, bankers are able to price these equity products close to conventional debt rates as opposed to normal higher charge associated with equity risk levels. Moreover, banks by their very nature as debt institutions are in many ways restricted from pricing them as equity products, which in itself, as one participant pointed out, is a major concern for all the modern conventional economists including Keynes and Freedman. Banks cannot focus on doing equity financing because they cannot take on any additional risks onto their books. Again, this is a by-product due the make-up of fractional reserve banking.

Since many Islamic equity based products are treated as debt products, there was a need to discuss why the industry has yet to come up with the right equity risk management assessments to bring these products in line. It was argued that equity risk should be added to the risk management policies of all Islamic financial institutions. Equity risk management goes to the very heart of *shari'a* compliant products in Islamic finance. Participants were unaware of any banks that do this.

Pricing of risk

One major concern about the use of derivatives generally, be they Islamic or not, emanates from the determination of their pricing. Pricing in Islamic banking is still confined to the liabilities and assets on its books.

According to some participants, Islamic banks face an unlevel playing field in terms of pricing dynamics compared with conventional banking. Fractional reserve banking cannot survive without a lender of last resort and/or deposit insurance schemes, which effectively misprices the risk. Moreover, the lender of last resort in effect has a monopoly over money.

Thus, interest bearing debt based on libor or the base rate is really the cheapest price one can attain in the financial markets for financial products. One can try to come up with a better pricing benchmark, such as on commodities or a basket of goods and services; however, it will always be more expensive than the subsidized interest rate. Furthermore, every time one attempts to devise a more *shari'a* compliant pricing mechanism, the market will always skew toward to this subsidized pricing rate.

Fundamentally, conventional leverage is not only cheaply priced but there are tax break incentives for using debt. Few would want to use expensive equity based products and few would want to share their upside profits as under a classical *mudaraba* financing when one can obtain cheap loans from the subsidized conventional arena. At more attractive rates, debt creates a "buy-now pay-later" consumer culture, and assists corporates to increase their return on equity for their shareholders. In other words, debt based products are cheaper and make better commercial sense. Moreover, savers are not incentivised to invest in classical *mudaraba* investments. These highlight some of the practical limitations and problems of using equity based products like *mudaraba* and *musharaka*.

With competition from this subsidized rate, Islamic financial institutions are forced to re-design their product offerings. Muslim savers demand the benefits of risk-free accounts in addition to returns. Islamic products therefore become hybrids of the original basic structure. Thus, a *mudaraba*, would in actual practice become a hybrid *murabaha* and an *ijara*, would in actual practice become a hybrid *ijara* product. Normal risks associated with an asset under the original Islamic structures would be removed, such as for example asset and market risks, and the product is just left with that of credit risk. Therefore, the challenge for Islamic practitioners in order to move away from this 'hybrid practice' is to find viable alternatives to compete on price compared to the subsidized conventional pricing mechanism. Currently, there isn't any.

One other practitioner revealed that how he prices a derivative is based on how his bank expects it to behave in the future. The concern with this method is that when he prices it on such a determination, the price itself also affects or even helps to determine the actual real price of the derivative in the future. And this can be a serious concern in *shari'a* as the pricing process is a form of speculation within itself, in effect potentially violating the principles of *maysir* and *gharar*.

Principal – Agent Issues

Issues of conflicts of interest between principal and agent are a real major issue in finance and in law. Even in Islamic finance, the industry has had to make difficult decisions based on these issues.

For instance, there are lingering agency problems with products like *mudaraba*. Regulators do not take into account problems associated with the principal also being the agent. Also, there is the issue of whether to report *mudarabas* as on-balance or off-balance sheet as well as the problem of comingling of depositors' funds with those of the shareholders' capital. Thus, in each of these issues, one is left asking, where does one draws the line?

In the Hanbali *fiqh* (jurisprudential) school, it is permissible for a party to be both the principal and the agent. However, this permission is only available with several stringent qualifications. All schools however say that this conflict of interest can be prevented by proper disclosure and transparency of the full risks involved in this kind of relationship. Parties should be made fully aware of the facts, made aware of the potential for conflicts of interest and should all consent to this form of relationship at the start. But again, without such stringent qualifications, no *fiqh* school permits the principal can be the agent alone.

Regulation

Regulation was discussed at length by participants, both the need for regulatory reform to help move the current market to the macroeconomic ideals as well as regulation to improve the current array of risk management tools and guidelines.

Many agreed that the economic crisis as well as advances in global Islamic finance provides a window of opportunity to stress and to explain adherence to rules and regulations like those published by the IFSB and AIOIFI to everyone, which under normal circumstances would have been detrimental in a competitive environment with conventional markets. Thus, a wholesale market initiative to adopt the AAOIFI standards or similar would be an important contribution. Though, one reminded everyone there are both good and bad economic and financial reasons for taking on a lot of regulation as well as for not taking on any regulation.

There were a couple voices of dissent that were actually very wary of any further regulation (in addition to those imposed by conventional regulators). Another participant believed that the Islamic industry has learned early on what is good for it and what scholars have been always asking it to adhere to.

Instead, there was an appeal to the industry to follow more of the letter and spirit of the *shari'a*.

But what institutional and regulatory arrangements would be desirable? One advocated a move from favouring the debt contracts to more risk sharing, as in the examples of models found in the United States and the United Kingdom for home ownership. Another suggested that Islamic banks should be given the incentives by the regulators to come up with solutions to reflect the *maqasid al-shari'a*. Another discussed the need for a regulator to guard against asset price bubbles generally and to devise a bonus system whereby it is only paid out on a deferred depending on earnings and increasing personal liability.

Even with the current array of Islamic risk management tools, there is a clear need to improve the existing legal documentation and regulatory frameworks. Documentary issues such as early termination provisions, close out netting and collateral arrangements still require improvement as with their enforceability. Moreover, regulatory capital and accounting treatment for Islamic hedging instruments need to be considered. Thus, greater active participation of regulators in this field is required as are the *shari'a* input from Islamic finance practitioners.

Contractual Conditions

There was some discussion of setting conditions with the use of risk management products. By imposing conditions, either in the contract or by regulators, this in theory, could stymie the actions of speculators, risk takers and the ensuing volatility such products could cause if left astray (as witnessed in the current financial crisis with some conventional derivatives).

There was some debate among practitioners as to whether conditions could be stated in the contract themselves as opposed to mere guidelines or regulatory suggestions.

But there was a concern that perhaps these conditions may not work, with an interesting discussion among the practitioners saying if one imposes a condition in the derivative agreements, such conditions may be unenforceable especially to third parties or to subsequent trading parties of those agreements. Moreover, if a condition is added requiring the transaction to have a genuine business need, practically, if there is no ongoing business transaction, then the importance of the condition would fade away.

Then there was one final solution put out: the sharing of risks with *takaful*. But the feeling was that such as a solution may be expensive and would not occur without some kind of systemic limit on other kinds of risk management tools involved. However, there was a follow up suggestion that the regulators should undertake to facilitate such ideas and structures.

Waad**, Commodity** Murabaha **and** Tawarruq

One *shari'a* scholar recommended that the industry use *waad* for hedging purposes, but not for speculative purposes. But again, with hedging, there is usually a speculator on the other side as well. While another participant had specific concerns with the current usage of *waad*, arguing that it can actually amount to an impermissible forward contract.

One *shari'a* scholar recommended that the industry should try to avoid continued use of commodity *murabaha* as much as possible. The reason being is due to how it was devised. A commodity *murabaha* was originally designed on the basis of a legal exception and to be used only in dire need and necessity. Its continued utilisation also has many other unintended and difficult *shari'a* and legal consequences to deal with. For instance, a parallel commodity *murabaha* can potentially face *shari'a* challenge if for instance there is a default in one part of the structure, this can automatically default the rest of the structure, which is impermissible in *shari'a*.

Furthermore, there was a call to further investigate the ramifications of the use of two-tier *mudarbas*. It was felt that there was still a clear disconnect between the structure and its use.
At the same time, it was suggested (by practitioners) that the industry should not over-burden the *shari'a* scholars with queries as to why they permitted commodity *murabahas*. Yet at the same time, the industry should be asking itself whether there is a real need to develop better alternatives or not.

It was also revealed that practitioners themselves face a lot of criticism as to why they need to use a *tawarruq* transaction in order to provide any rate hedging solution. The difficulty of finding alternatives lies with the dilemma that from a *shari'a* perspective, banks can only pass the intended benefit and proceed through an asset sale mechanism. Otherwise, without this sale transaction, financial institutions are either giving the money away as a loan, which is strictly not permissible in *shari'a*, or there is no real economic transaction occurring between the parties. Therefore, it has been argued that the current best and easiest solution and to meet a real genuine need for such products, hedging is undertaken through use of a *tawarruq* transaction. Nevertheless, bankers were amenable to discovering better mechanisms to achieve the same purpose, but without the negative complications associated with a *tawarruq* transaction.

Takaful as Hedging Tools

Another solution to managing risks, both without the use of controversial structures such as *tawarruq* and which is still in line with basic (*shari'a*) models, is that of a *takaful* solution.

The concept of guaranteed insurance was suggested by a participant. These structures may be used for cooperative hedging purposes. However, a number of practical problems to their implementation were highlighted.

First they are difficult to regulate and to monitor. Another issue is that there is hardly anyone on a global level to underwrite this form of risk. Many of the companies who were underwriting, either on the secondary re-insurance market or on the re-*takaful* market, said they didn't understand this business model. Thus a major market education hurdle needs to be achieved.

Additionally, the risk to be underwritten is a lot more expensive than can be found in the derivatives market. Thus, even if the *takaful* was agreeable, it could be as one practitioner advised, 50 or 100 basis points more expensive than what one could achieve using a basic *tawarruq* structure. The question is, as with other 'equity based' risk management products, are consumers willing to pay for such an added premium? Even if the answer is yes, due to pure on demand/supply factors, the take up such products could be less than that of *tawarruq* or other cheaper debt alternatives.

As has been repeatedly discussed, there is a need to seek alternative solutions to the current Islamic risk management tools. Alternatives might be in the beginning costlier, more difficult to implement or even still have loose ends from a *shari'a* point of view, but the initiative to find such alternatives is worth, the risk, so to speak.

Concluding Thoughts

As one participant correctly summed the workshop, what is emerging here is a plea; a plea for intelligible *quwa'id* (theoretical maxims) middle level explanations from the Islamic finance industry, both for solving its own risk management dilemmas but also to aid the conventional arena with its own thinking especially after this financial crisis.

The *makharij* are provisional tools to meet actual needs. Moreover, there are changes happening through the application of various proscriptive rules, *ahkaam*, with exceptions. As one scholar stated, the industry is trying to design a system that has the mechanical way of keeping itself. But, without the reliance on ethics and without ethics, no system can work.

Some of the participants have said, let us be realistic, we have to move ahead, either abandon Islamic finance altogether, or use these creative means to bypass the obstacles in the interim. For this group, the industry has to look forward to a change as Islamic finance grows in the future and is faced with more complex challenges.

But others felt that nothing can fundamentally change substantively in Islamic risk management or perhaps in any other field pertaining to Islamic finance, as with *tawarruq*, until more systemic, regulatory changes are made, with an immediate end of the debt culture.

CASE STUDY – Review of the Main Islamic Risk Management Structures

(Profit Rate Swap, Currency Swap and Total Return Swap)

Participants were all provided with a case study prior to the workshop which asked a number of questions pertaining to three common structures used in Islamic finance risk management, namely, profit rate swaps, currency swaps and total return swaps. The following is a collation of the answers provided by some of the workshop participants to the questions raised in this case study. (11 of the 33+ participants only completed the study).

Concerns and key issues raised by participants on these three structures:

- Risk versus returns is important.
- Derivatives transfer risks, but sometimes the parties don't fully understand those risks.
- Assets are not speculative, but those who trade or own them are speculating, which is the real cause of the risk, not the structure itself.
- Limitations on the pricing and risk calculation models as the cause of the mistrust and systemic risk.
- They mimic conventional products – there is a need for the products to be based on real assets and we need to move away from mimicking conventional products.

Solutions proposed by participants to the above concerns:

- Limit risk management tools for hedging purposes and not for speculation;
- Some say avoiding speculative products altogether and better regulation of them;
- Some suggested better education and understanding of the affects of these products, better understanding of the actual exposures and the terms of the contract that parties are actually entering into;
- Need for better evaluation of the assets;
- Better to identify the conflicts of interest at the outset;
- Suggest for an alternative pricing authority, but no need for a central pricing authority;
- Parties can take greater responsibility and a more balance approach, which will lead to better operational risk management;
- More effective regulation;
- Better legal frameworks;
- Clearer instructions of the purpose and the risks and the default scenarios that the parties are entering into;
- Reducing undesired risk, even if it means reducing the expected return;
- Cooperative hedging forms have to be started;
- Restricting Islamic hedging products to only those who have only real economic exposure to the hedge.

CASE STUDY - Review of the Main Islamic Risk Management Structures (Profit Rate Swap, Currency Swap and Total Return Swap)

Q 1: Why do you like about these structures?

- Same reasons as in conventional: These products are good for managing mismatches of balance sheet liabilities and assets, the ability to swap fixed for floating returns, we have to start from somewhere to manage risks and as flawed as they may be – they are a start;
- Some suggested they were easy to understand;
- Some suggested they can be used for fixed/variable rate financing;
- The profit rate swap and currency rate swap structures are more widely accepted than the use of *waad*;
- They help to mitigate risks;
- Again, some felt they were good for swapping fixed for floating returns;
- For the total rate swaps – the more controversial structure - some felt they were flexible and could give a good rate of return on an index.

Q2: What are the concerns for these structures?

- Concerns for the link between real assets and real economic activities;
- An over-reliance on *tawarruq* and all the issues we discussed in the previous Harvard-LSE workshop on *tawarruq*;
- These products (profit rate swaps) may lead to free gambling as no link to a true economic activity is required;
- Endorses higher transaction costs and higher operational efforts to achieve than that equivalent of an interest rate swap;
- Commodities bought at the beginning of the period affect the balance sheets. When using a *murabaha* structure, one is holding a large amount of assets on one's balance sheet before it is sold off as per the *murabaha* structure. As such, this can be a real problem for many;
- The fixed portion is for the whole period of the transaction, so there are issues and difficulties with terminating/unwinding the transaction;
- Currency rate swaps - Though they give some value, even if they are Islamic, they involve two separate currencies and thus two separate interest rates economically in order to determine the exchange rate level;
- Total Return Swaps – Concerns that its structure can lead to excessive uncertainty and Basel II capital adequacy requirements;
- They can be used to produce returns from non-*shari'a* complaint indices;
- Someone suggested that a *shari'a*-arbitrage in the waad structure, where one party views it as a binding contract while the other views it only as a promise, is a serious issue;
- Someone suggested this structure may amount to a forward contract which is impermissible;
- It unwinds all *shari'a* prohibitions and makes Islamic finance limitless. So to use this structure, the door is open for anything;
- Q3 skipped because it does not and any value.

Q 4: Although the structures may be deemed shari'a **compliant, there may be a priced according to conventional interest rate movements. Can Islamic finance ever break free from this and what concrete alternatives do you propose?**

- Breaking free from conventional pricing requires regulatory intervention, a theme proposed many times this morning;
- *shari'a* arbitrage in the waad, on party views it as binding contract and the other only sees it as a promise;

- There is natural demand/supply factors in the Islamic swap market, so let the pricing be determined naturally in the market and this issue will solve itself;
- Someone suggested we really need to focus on finding alternatives to libor and interest rates as reference benchmark for pricing – this itself is the key to developing Islamic derivatives properly;
- Independent pricing can only be done when the back end trades are done the same;
- Sovereigns can take the paths by offering GDP linked bonds to create new markets which will encourage this new alternative pricing mechanism;
- Since there is no liquid market for Islamic forwards and because the arbitrage pricing theory does not apply here, this is why pricing is still based on conventional parameters.

ATTENDANCE

- Habib Ahmed, Sharjah Chair in Islamic Law and Finance, Durham University, Durham, United Kingdom
- Mohamad Nedal Alchaar, Secretary-General, AAOIFI, Manama, Bahrain
- Ijlal Alvi, Chief Executive Officer, International Islamic Financial Market, Manama, Kingdom of Bahrain
- Saud Ammari, Minister Plenipotentiary, Royal Embassy of Saudi Arabia, London, United Kingdom
- Daud Bakr, Sharī'a Supervisor, Kuala Lumpur, Malaysia
- AbdulKadir Barkatulla, Sharī'a Supervisor; London, United Kingdom
- Ahmed Belouafi, King Abdul Aziz University, Jeddah, Saudi Arabia
- William Blair, Professor of Law, London School of Economics, London, United Kingdom
- Willem H. Buiter, Professor of European Political Economy, LSE, London, United Kingdom
- Howard Davies, Director, London School of Economics, London, United Kingdom
- David Dew, Dy Chief Executive Officer, HSBC Amanah, Dubai, United Arab Emirates
- Tarek El Diwany, Zest Advisory LLP, London, United Kingdom
- Mohammed Elgari, Sharī'a Supervisor & Professor, King Abdulaziz University, Jeddah, Saudi Arabia
- Husam El-Khatib, Mayer Brown International LLP, London, United Kingdom
- Nicholas Foster, Director, Centre of Islamic & Middle Eastern Law, SOAS, London, United Kingdom
- Michael Gassner, Vice President, Bank Sarasin & Co. Ltd., Zurich, Switzerland
- Rafe Haneef, Executive Director, Fajr Capital, Kuala Lumpur, Malaysia
- Hussain Hamed Hassan, Sharī'a Supervisor, Dubai Islamic Bank, Dubai, United Arab Emirates
- Masarrat Hussein, Group Chief Risk Officer, Abu Dhabi Islamic Bank, Abu Dhabi, United Arab Emirates
- Imran Iqbal, Head, Islamic Products, Saudi Hollandi Bank, Riyadh, Saudi Arabia
- Esam M. Ishaq, Sharī'a Supervisor; Manama, Kingdom of Bahrain
- Mohamad A Laldin, Executive Director, Int. Shari'a Research Academy for Islamic Finance, KL, Malaysia
- Kamal Mian, Head, Islamic Finance, Saudi Hollandi Bank, Riyadh, Saudi Arabia
- Mohammad Iqbal Nadvi, Shari'a Scholar & Chairman, Islamic Finance Advisory Board, Toronto, Canada
- Mansoor Shakil, Director, Al Rayan Investment LLC, Doha, State of Qatar
- Laiq Siddiqui, CEO, Amana Canada Holding Inc., Toronto, Canada
- Zohaib Patel, Fajr Capital Limited, London, United Kingdom
- Seif el-Din Tag el-Din, International Association of Islamic Economics, Leicester, United Kingdom
- Haytham Tamim, Chairman, Islamic Consultant & Shari'a Scholar, London, United Kingdom
- M. Imran Usmani, Sharī'a Supervisor; Karachi, Pakistan
- Frank E. Vogel, Founding Director, Islamic Legal Studies Program; Harvard Law School
- Nizam Yaquby, Sharī'a Supervisor; Manama, Kingdom of Bahrain
- S. Nazim Ali, Director, Islamic Finance Project, ILSP, Harvard Law School

HARVARD LAW SCHOOL
Islamic Legal Studies Program

and

LONDON SCHOOL OF ECONOMICS

Workshop on

Ethics and Governance

Islamic Economic and Ethico-Legal Perspectives

Thursday, February 25, 2010

London School of Economics
Tower #3, 5th Floor (BOX)
London, United Kingdom

Harvard-LSE Workshop:
London School of Economics, London, UK - February 25, 2010

Workshop on Islamic Financial Ethics and Governance : A short Report

The Islamic Finance Project (IFP), under the auspices of the Islamic Legal Studies Program (ILSP), and the London School of Economics and Political Science (LSE), jointly hosted their fourth annual daylong workshop on the 25th of February 2010 at the LSE campus in London. Leading Islamic ethico-legal scholars (more commonly known as Shari'a scholars), Islamic economists, and Islamic finance professionals came together to address a pressing topic in the field of Islamic finance: ethics and governance. Before this conversation commenced, participants were requested to submit their comments and concerns on this topic to the organizers and over 100 pages of comments were received. To advance the discussions on the day and to ensure that everyone was well-versed on the subject matter, these comments were compiled and distributed to all participants prior to the workshop. As intended, the workshop dialogue focused on these valuable contributions and insights.

Last year's workshop focused on risk management, a timely topic in light of the global financial crisis, and it highlighted the shortcomings of risk management practices. This year's workshop focused on ethics and governance from Islamic economic and ethico-legal perspectives. As thought-leaders in the conventional finance sector are re-examining the relationship between ethics and governance in an attempt to repair damaged neo-liberal models, many have been considering the adoption of concepts and practices from the Shari'a-compliant financial sector. Furthermore, as institutions offering Shari'a-compliant financial products come under increasing pressures associated with product innovation and standardization, this is a watershed moment in which to examine the ongoing direction of ethical governance in modern Islamic finance and the role regulators, management, and Shari'a boards play therein.

With this backdrop, the overall objectives of this year's workshop were to (1) review the aims (maqasid) and ethical principles (qawa'id) that are central to any discussion of enhanced ethical governance in the Islamic financial services sector; (2) discuss specific practices in the Islamic finance sector in which the opportunity for expanded ethical consideration is particularly noteworthy; (3) discover the best practices associated with enhanced ethical governance in the Islamic finance sector and determine who should be responsible for establishing and applying such standards; and (4) evaluate the possible impact of religious and moral teachings on behavior and determine if better ethical behavior can be secured through moral education.

Sir Howard Davies, Director of the LSE, provided the opening remarks, commenting on the need for such timely discussions on ethics and governance in both the conventional and the Islamic finance sectors. Any discussion on ethics, even in Islamic finance, cannot but be framed by the global impact of the current financial crisis. This has been a financial crisis of considerable proportions. Though the exact impact on the Islamic finance industry is still unclear, most recognize that it too has been significantly affected. Issues of excessive debt, lack of liquidity, regulatory uncertainty, lack of proper risk management, and speculative transactions have all been raised as causes of this crisis. Understanding the ethical causes is one part, remedying those ethical lapses is another. He concluded by reminding the participants that the questions in regard to how institutions are made accountable and how boards think about the external influences on themselves are the same themes that are currently in discussion in the conventional field as well. Thanking Sir Howard and Dr. Nazim Ali for their efforts, Dr. Frank E. Vogel, moderator of the workshop then introduced the structure for the day.

In this year's workshop, participants analyzed three fictitious case-study scenarios in Islamic finance. Each scenario was devised to raise various contentious issues about ethics and governance in Islamic finance, while helping to inspire and focus the group's discussion about the topic at hand. In analyzing the three scenarios, participants were encouraged to comment on the impact at a systemic, institutional, and personal level. Participants also engaged in discussion on what Islamic ethical boundaries, if any, were crossed; what Islamic standards should subsequently be prescribed; and who should be responsible for prescribing those standards in the industry and how should they be enforced at all three levels. Using a simple medical analogy, Dr. Vogel summarized: 1) Is there a malady? 2) Diagnose this malady; and, 3) How should it be treated and who should treat it?

In the first scenario the group dealt with the bursting of a hypothetical regional economic bubble created by several over-leveraged and speculative real estate projects financed by a variety of Shari'a-compliant facilities and Sukuk from Islamic banks. This scenario in many ways paralleled the evolution of today's global financial crisis and, in particular, specific instances of failure by companies and Islamic financial institutions in the Gulf. The primary challenge for participants was of regulating markets and institutions without sacrificing efficiency.

The initial moral reaction to this scenario was that since speculation is forbidden, speculative projects should be impermissible. This was followed by a very lively debate on the definition of speculation, demonstrating the difficulty of identifying the threshold beyond which legitimate risk becomes impressible.

The group also debated the permissibility of debt-based modes of finance. While some argued for a check on debt-based modes of finance, others said that debt is sanctioned by the Qu'ran. And as long as contracts fulfill all the conditions of a contract, jurists cannot question the validity of such contracts on the basis of assumed intentions. However, there was some consensus around preventive measures to avoid excessive debt. One of the participants quoted Shaykh Justice Taqi Usmani in saying that when deals are done one must consider if value was created. As such 'value creation' could be one of the yardsticks to consider when evaluating the permissibility of a contract.

The group came to the conclusion that in the proposed scenario, the Islamic banks followed in the footsteps of the conventional banks and as a result were faced with similar risks. Participants also discussed that this situation was compounded by the fact that the regulatory system was not geared to deal with the nascent sector of Islamic finance. There was no clear consensus as to how to avoid this scenario. There was disagreement over whether Shari'a scholars and the board should be more active: some felt that it wasn't part of their job, others that it should be included. But, the general feeling among many participants was that the government and regulatory agencies need to step up their interaction with the Islamic financial industry to avoid such situations in the future.

The second scenario addressed Islamic ethical standards at the level of the individual Islamic finance institutions. In this hypothetical situation, participants together assumed the role of the board of directors of an Islamic bank who had been presented with demands from institutional investors that the bank immediately transform to become "strictly ethical." The shareholder's demands included changing the bank's internal structure, dealings, product lines, and marketing practices. Since the shareholders insisted on these demands, despite the risk of losing profitability, the group had to work to balance profitability with ethical considerations.

This ignited discussion in a very delicate area. Islamic banks historically have been run by dedicated Muslims who very strictly adhered to a code of ethics. The success of Islamic banks induced a short supply of adequately trained human resources. Correspondingly, Islamic banking was adopted by international banks to appeal to their respective client base. As a result, the self-imposed code of ethics, which it is argued had worked well initially, was not adequate. For Islamic finance to continue to succeed, Shari'a standards had to be institutionalized.

Participants recognized the contribution of industry bodies such as the Accounting and Auditing Organization for Islamic Finance (AAOIFI), but participants felt that more should be done. The real challenge, however, will be to strike a balance between prescribing ethical rules and growth.

The participants discussed the possible solutions that included developing a new, independent ethical rating agency or making Shari'a boards independent from banks. Participants agreed that if such steps must be taken, it must be in partnership with the central banks and the regulators.

The third scenario presented to the workshop's participants focused on Islamic ethical standards at the personal and consumer level. In the proposed scenario, the Islamic bank presents its customer with a variety of product offerings which have the effect of making the customer more indebted. At the same time, the consumer receives mixed signals from both the bank and his neighbors about whether or not Islamic banks are really different from conventional banks.

The participants as a group assumed the position of both the customer and the bank's relationship manager in order to debate the ethical issues of offering debt-based products to customers and justifying the higher cost for Islamic products.

The participants acknowledged that as Islamic finance has grown in tandem with conventional finance, it has become difficult to distinguish between Islamic and conventional products on the basis of economic outcome. As a result, customers are often very confused about which products are Shari'a-compliant and which are not. However, they are still committed to buying compliant products. Additionally, there is a problem with the rise of the debt culture. Participants discussed how this concept has taken root in a large number of communities worldwide, and many felt that this needs to be discouraged. Furthermore, some felt that it needs to be communicated to the banks that selling products to lure people into more debt is arguably against the Qu'ran because of the prohibition on squandering resources. Financial instruments are supposed to add value to the life of a customer and not trap him into debt.

The group concluded that education and training were essential for both bank employees and customers. Employees must understand the products that they are selling in order to explain them to their customers, so that the customer in turn can make informed decisions about these products and not rush headlong into debt. In further discussion, the participants agreed that while banks must implement this raining for employees and customers to educate them about debt and products, Shari'a boards must also be more proactive. The boards must insist that only approved products are used by Islamic banks. However, some participants mentioned that people who earn their living from Islamic banking are not the most suitable to decide on what is ethical due to the obvious conflict of interest. This brought the discussion back to the need for an independent body, such as national Shari'a boards, for the oversight of ethical standards.

During the second part of the workshop, a list of action points, including a code of ethics, was presented to the group of participants for discussion. It was hoped that the participants could reach a consensus on recommendations for future development in the industry and recommend issues for further research. From this discussion emerged an Islamic Code of Ethics where the participants recommended adopting pillars of transparency, authenticity, corporate governance, and social responsibility.

institutions need to clearly and explicitly explain profit rates to customers. Additionally, they should make decisions of Shari'a boards publicly available along with the underlying structure and reasoning of those decisions. universally applying AAOIFI Shari'a standards. Preferably, this would entail self-certification on up holding the letter and spirit of Islamic finance and by striving to avoid fueling consumerism. This could consist of mandatory reporting on the efforts to reduce the dependence on tawarruq transactions and other debt-based products. Subsequently, debt-based retail products should only be used for a customer's needs, as opposed to a customer's wants (i.e., prohibition of tawarruq for holidays overseas or extravagant, dream weddings, etc.).

procedures along with a mandatory comprehensive external audit. Shari'a boards should also be given a say in the compensation packages of senior management to create an incentive for them to take the recommendations of the Shari'a board more seriously.

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erful forces of change in their business and social communities. Internally, each institution should create its foundation for qard hasan and micro finance based on equity, possibly using proceeds from zakat and impure income. Furthermore, 5% of yearly financing targets should be committed to sustainable projects and the institution should have consideration for environmental issues as well. Consideration for the environment should be imbedded in the philosophy of Islamic financial institutions.

In addition to the code of ethics, the discussion of the participants produced several recommendations for the industry's consideration. Additional recommendations included the creation of Shari'a standards in marketing

would entail adopting regulations for marketing campaigns, and ensuring Shari'a approval to avoid fueling con-should include annual Shari'a certification of the bank's activities, an extensive Shari'a audit report to be submitted to the central bank in addition to an internal audit. To facilitate this, the SSB would nominate two directors: one SSB on their efforts to reduce consumer dependence on tawarruq and other debt-based products.

The closing discussion of the day focused on the next steps necessary to implement the ideas developed at the workshop and future workshop topics. It was decided that the existing committee would refine and then re-distribute the code of ethics and once 60% of the people have provided their consent, these recommendations would be shared with AAOIFI, IFSB and other regulatory bodies. To further the movement for standardization, it was also agreed that, as a first step, all Islamic financial institutions should adopt AAOIFI standards.

HARVARD LAW SCHOOL
Islamic Legal Studies Program

and

LONDON SCHOOL OF ECONOMICS

Workshop on

Reappraising the Islamic Financial Sector

Thursday, February 24, 2011

London School of Economics
Tower #3, 5th Floor (BOX)
London, United Kingdom

Harvard-LSE Workshop:
London School of Economics, London, UK - February 24, 2011

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 partici

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 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 Maqāsid Al-Sharī'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 ve 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 offering 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.

<u>Financing development while avoiding debt</u>

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.

<u>Moving from lawful to ethical finance</u>

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 partici

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 chan

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 Prospec

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.

Harvard-LSE Annual Workshops	
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

Acknowledgment: This report has been prepared by Usman Hayat of CFA institute of London with assistance from several Harvard Islamic Finance Project affiliates.

HARVARD LAW SCHOOL
Islamic Legal Studies Program

and

LONDON SCHOOL OF ECONOMICS

Workshop on

Islamic Financial Intermediation

Revisiting the Value Proposition

Thursday, February 23, 2012

London School of Economics
Tower #3, 5th Floor (BOX)
London, United Kingdom

Islamic Finance Project

Harvard Law School
Islamic Legal Studies Program

Harvard-LSE Workshop:
London School of Economics, London, UK - February 23, 2012

Islamic Financial Intermediation: Revisiting The Value Proposition: 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 sixth annual workshop on Islamic nance on 23 February 2012 at the LSE campus in London.

This year, participants chose "Islamic Financial Intermediation: Revisiting the Value Proposition" as the workshop topic. A diverse group of twenty-seven individuals attended the workshop, including distinguished Islamic legal experts (also referred to as shari'a scholars), academics, Islamic economists, bankers, lawyers, and representatives of standard setting bodies.

S. Nazim Ali, Director of IFP and Acting Executive Director of ILSP welcomed the participants to the workshop and thanked the participants, sponsors and the volunteers for their contributions in organizing it.

George Gaskell, Pro-director of the LSE (Resources and Planning) welcomed the participants to the workshop and assured the support of the LSE administration to this ongoing effort. David Kershaw, Professor of Law at the LSE played an important role in organizing the workshop, but was unable to attend due to unavoidable commitments.

Frank E. Vogel, Founding Director Islamic Legal Studies Program (ILSP) and moderator explained the rules of the house. e 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.

Objectives of the Workshop

The objectives of the workshop were: (i) reviewing the understanding of Islamic financial intermediation and narrowing down what is meant by its real value, (ii) testing this understanding of Islamic financial intermediation and its real value against the world's recent financial shortcomings and Islamic economic thinking about justice, equality, and wealth creation, (iii) discussing and applying Islamic financial intermediation with respect to each of: macro, institutional and consumer levels, (iv) discussing what immediate economic, legal, and regulatory reforms are needed to reposition the industry toward the value proposition on Islamic financial intermediation agreed earlier, and (v) exploring what Islamic financial principles are required to reposition the Islamic nance industry toward a more sustainable future.

Value Proposition of Islamic Financial Intermediation

The main issue addressed in the workshop was the value proposition of Islamic financial intermediation. It was pointed out that financial intermediation generally refers to moving funds from surplus to de cit units. ere is, however, disagreement about whether institutions offering Islamic financial services can be classiffied as financial intermediaries in the same sense as conventional financial institutions. However, there may be no harm in using the term financial intermediation in Islamic nance as long as the required shari'a conditions are met.

It was argued that morality is at the core of Islamic nance and its value proposition. ere- fore, morality should be expressed by things like s serving the real economy, reaching sections of population not served by the financial sector, discouraging debt, encouraging pro t sharing, promoting development, and reducing economic inequality.

An alternative view was that Islamic banking is only a part of Islamic nance which in turn is a part of the theoretical construct referred to as an Islamic economic system. Companies offering Islamic financial services are set up to earn a competitive return for their shareholders and other relevant stakeholders such as customers. It is unfair to demand that Islamic banks and Islamic nance try to deliver what is usually expected from governments and development financial institutions. Islamic banking cannot assume the moral responsibility that is meant for others and expectations of morality from Islamic nance should be consistent with the role of Islamic nance.

A counter argument was that some of the expectations from Islamic nance are partly a product of the vocabulary, symbolism, and rhetoric used by the sector and its proponents to promote its business to ordinary Muslims. Therefore, the sector should not disown these expectations of morality after having benefited from these expectations in profitability and growth. If the sector cannot deliver on the expectations that it creates by using the label "Islamic," it should perhaps scale down the expectations, explaining that it is merely trying to replicate conventional nance while comply- ing with form-oriented technical requirements of Islamic commercial jurisprudence.

It was highlighted that Islamic commercial banking is operating in a wider economic and financial system that creates obstacles to implementing the theory underlying Islamic nance. For instance, the Islamic economic theory relies heavily on risk sharing as part of its moral appeal but it is difficult to share risk in commercial banking, the largest segment in the sector. Those providing finance (e.g. depositors) are unwilling to accept a loss on their principal and those receiving nance (e.g. industrialists) are unwilling to share their profits. As a result, Islamic banking, like convention- al banking, also relies heavily on debt. Islamic economics and nance were conceived in the then newly independent Pakistan as pro t sharing arrangements, but later on these ideas were pasted onto commercial banking where they do not seem to t. Having said that, over the years the stance on debt in Islamic nance seems to have softened. While debt is not preferred over pro t-sharing arrangements, it is now more likely to be seen as a legitimate means of financing if the relevant conditions are met.

It was further explained that the unwillingness of parties providing and receiving nance to share business risk is due to the dominant conventional commercial banking with which all parties have become accustomed to. Commercial banking has little, if any, room for depositors and borrowers to share the risk of business outcomes. A wide range of factors—such as banking regulation, deposit protection insurance, tax deductibility of interest, higher capital adequacy charge for equity exposure—support the practice of conventional banking. For those working in the Islamic financial sector, it is a safe strategy to continue to replicate conventional nance because if they try to innovate more authentic solutions and fail, it could cost them their jobs.

It was contended that conventional commercial banking relies heavily on collateralized lend- ing and therefore it channels financing to those who can furnish the collateral and thus deepens economic inequality. Islamic nance was meant to channel financing to the entrepreneurs who may not be able to furnish the collateral. However, Islamic nance has not been able to move away from collateralized lending because the system designed for conventional nance does not let it do so. Until the playing eld is leveled, the niche of Islamic nance cannot o er the risk-sharing in financing which was meant to be a part of the moral value proposition.

A counter argument was that while there are important obstacles to realizing the moral value proposition of Islamic nance, Islamic financial institutions are not even doing what they can do within the current financial and economic system. For instance, conventional nancial institutions seem to be far ahead of Islamic financial institutions in corporate social responsibility even though morality is supposed to be at the core of the value proposition of Islamic nance. AAOIFI already has a standard on corporate social responsibility but that is not being widely followed in the sec- tor. Moral nance is the need of our times but despite its emphasis on morality, Islamic nance is conspicuous by its absence at the relevant forums, such as the World Economic Forum. Perhaps, by replicating conventional nance instead of offering something more consistent with its underlying theory, Islamic nance has created the perception that it has nothing new to offer.

It was also pointed out that if they want to, Islamic banks can use new methods, such as mobile banking, to include the financially excluded. Investors may seek protection of their principal but it is possible that they would be willing to sacrifice some economic return for social causes. e Islamic financial sector has not come up with the products to create opportunities for such impact investing whereas this is being done in conventional socially responsible investing. e dominance of conventional nance and a debt based system is no excuse for not doing what can be done within the current system to put into practice the morality in Islamic nance theory. Many agreed that this moral value proposition should go beyond technical compliance with Islamic commercial jurisprudence. Without this moral value proposition, the growth experienced by the Islamic financial sector will not be sustainable.

It was explained that the Arab Spring is both an opportunity and a challenge for Islamic nance. It is an opportunity because in the Arab Spring countries, the financial system focused on the economic and political elite while largely neglecting the entrepreneurial class. It is also a challenge because there is a risk that Islamic nance may fail to deliver and its reputation will be hurt. If Islamic nance offers the same sort of financing to the same class of people who are already well served by conventional nance, nothing will be gained and much will be lost.

Ideas for Making Progress on Value Proposition of Islamic Finance

During the course of discussion, different participants proposed a wide range of ideas that in their view would directly or indirectly help the Islamic financial sector o er the value proposition that is expected from it and further its progress. While there was no consensus on the desirability or feasibility of these ideas, they are being listed here in no particular order for the bene t of the readers of this report.

1. More emphasis on institutions other than commercial banks, such as investment companies, mutuals, cooperatives, social banks, and alternative methods such as peer-to-peer banking and mobile banking;
2. Greater engagement with stakeholders, particularly shareholders of Islamic financial institutions, to amend the charters of Islamic financial institutions to sacrifice some returns for social goals;
3. Establishment of an international association of shari‘a scholars to pursue objectives such as continuing education of shari‘a scholars, increasing transparency of juristic rulings (fatwas) and underlying rationale, implementing a code of ethics, and enhancing the reputation of this profession;
4. Introduction of investment products that o er both an economic and a social return reflecting the needs and priorities of the Muslim world, such as education and low-cost housing;
5. Greater engagement with regulators to bring about the regulatory changes needed for the growth and development of the Islamic financial sector as the global financial crisis has resulted in a loss of prestige for conventional nance and regulators may be more willing to consider Islamic nance as a morally superior alternative;
6. Revision of the AAOIFI standards that are in need of revision, their translation in relevant languages, and easier access to these standards;
7. More opportunities for training of shari‘a scholars in analyzing the macroeconomic implications of their legal rulings and more forums where shari‘a scholars and economists can engage in such discussions;
8. Effective mobilization and utilization of zakat funds through professional management and international institutions to promote economic fairness, justice, and wealth distribution;
9. More internships for students of Islamic nance in the Islamic financial sector to comprehend the practical issues encountered by the industry and to develop into a valuable human capital for the industry;
10. Building of bridges between Islamic nance and socially responsible investing whereby experts from socially responsible investing companies are invited to participate in Islamic nance events and Islamic nance experts can learn from the innovations in socially responsible investing, such as social impact bonds: and

11. Establishment of a think tank like structure for serious ongoing multidisciplinary dialogue to find solutions for the progress of Islamic nance which, among other ways, could be financed through the purification proceeds from the Islamic financial sector.

Harvard-LSE Annual Workshops on Islamic Finance	
2012	Islamic Financial Intermediation: Revisiting the Value Proposition
2011	Reappraising the Islamic Financial Sector
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HARVARD LAW SCHOOL
Islamic Legal Studies Program

and

LONDON SCHOOL OF ECONOMICS

Workshop on

Insolvency & Debt Restructuring in Islamic Finance

Thursday, February 28, 2013

London School of Economics
Tower #3, 5th Floor (BOX)
London, United Kingdom

7th Harvard-LSE Workshop:
LONDON SCHOOL OF ECONOMICS, LONDON, UK - FEBRUARY 28, 2013

Insolvency & debt restructuring in islamic finance: A SHORT REPORT

The global financial crisis that started in 2008 did not only affect mainstream finance but also niche segments such as Islamic finance. Many prominent institutions in the Islamic financial sector experienced difficulties meeting their obligations and some faced bankruptcy. In this context, the Islamic Finance Project (IFP) of the Islamic Legal Studies Program (ILSP) of Harvard Law School (HLS), along with the London School of Economics and Political Science (LSE), co-hosted their seventh annual workshop to discuss the issues of insolvency and bankruptcy under shari'a and their possible consequences on Islamic financial institutions working under different legal jurisdictions.

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 each workshop is chosen based on a survey of the participants. Participants are then provided background information on the topic and 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.

Shari'a scholars, legal experts, bankers, and economists from different countries first submitted written responses, then gathered at the LSE campus in London on February 28, 2013 to discuss various aspects of Islamic law related to insolvency and debt restructuring.

The theme of the workshop, "Insolvency & Debt Restructuring in Islamic Finance" was examined from the following angles:

a) Defaulting individuals;
b) Defaulting corporate transactions (insolvent corporate borrowers; sukuk issuers);
c) Distressed financial institutions;
d) National and cross-border bankruptcy and insolvency legislation, rules and regulation; and
e) Islamic finance industry bodies (e.g. standards, model laws).

Objectives

The objectives of the workshop were as follows:

1. Reviewing the understanding of the Islamic insolvency and debt restructuring with respect to creditors' and debtors' rights;
2. Understanding how modern regulatory regimes have handled financial defaults and how they have applied Islamic legal concepts and principles;
3. Discussing and applying Islamic financial insolvency concepts;
4. Discussing potential economic, legal, and regulatory reforms required to better deal with the complexities involved in defaults of contemporary Islamic finance products and institutions; and
5. Exploring any new guiding principles or processes that might help the Islamic finance industry in its quest for a more sustainable future.

Introduction

The workshop benefited from 25 written responses submitted before the in-person discussion. Later 29 experts (including some special invitees) participated in the day-long deliberations on February 28, 2013.

Dr. Nazim Ali, IFP Director and Acting Executive Director of ILSP, at Harvard Law School emphasized the importance of academic cooperation between Harvard and LSE and welcomed the participants who came from various countries to participate in the academic discourse.

Professor David Kershaw from LSE welcomed the participants on behalf of LSE and highlighted the importance of Harvard's and LSE's joint efforts in conducting programs on novel subjects like this. Prof. Kershaw termed this workshop as a capacity-building effort for LSE in the field of Islamic banking and finance. He also underscored the importance of ethics in the current financial world.

Professor Frank Vogel, while setting the ground rules for the workshop, reemphasized the importance of gathering thought leaders of the Islamic banking and finance industry and conducting off-the-record discussions for more frank and fruitful discussion. He noted that while in most respects modern bankruptcy and insolvency regimes seem compatible with the rules of the Islamic fiqh, there are a few spheres of challenge and potential conflict. These include issues of final discharge of the bankrupt without creditor consent, the liquidator's power to void any transaction prior to commencement of bankruptcy, bankruptcy requested by a debtor, acceleration of claims and discounting present value, inclusion of debts yet to mature, the shari'a status of goods that haven't been paid for, the possibility of assigning preference to government or workers, and the status of creditors who appear after the bankruptcy begins. On the implementation side, he highlighted questions of choosing the best means and resources available to deal with such issues.

Approach to Insolvency and Bankruptcy under Shari'a

The discussion formally started with the presentation of a summary of the comments received from the participants. Two distinct approaches could be gleaned from the summary:

1. Create a new model insolvency legal regime for the Islamic finance industry; or
2. Use the existing legal regimes with modifications for Islamic finance.

Challenges and benefits associated with the respective approaches were also highlighted. For example, the benefits highlighted in favor of a new model insolvency law included overcoming constraints of the current legal system, procedural flexibility, reducing legal arbitrage, stress rehabilitation (*sulh*) over liquidation or bankruptcy, avoiding strategic defaults, and uniform implementation of AAOIFI Shari'a Standard 43.

Islamic concepts of *ibra'* (cancellation of debt), hawala (transfer of debt liability to third party), and voluntary deferment of debt were the tools highlighted for achieving the new regime.

On the other hand, major challenges for the proposed new regime were found to be related to the cost of development, lack of enforceability powers and conflict with existing rules, regulations, and mechanisms.

Some of the pertinent shari'a issues related to a new regime concerned carrying of debt and whether the bankrupt could be finally discharged of his obligation. Should individuals and corporations be treated similarly? Is there possibility of nullifying certain transactions to protect the interest of creditors? It was also pointed out that acceleration of debt is another important issue where the shari'a and conventional points of view are quite different.

Continuing with the existing mechanism would have certain distinct advantages. Among them, the most important was lesser uncertainty and greater integration with the existing global financial system, leading to higher confidence of investors and institutions alike. It was further argued that shari'a-compliant products have already become a part of secular jurisdictions and are providing good interface with secular courts of law. The most important challenge found in this case was lack of infrastructure to deal with Islamic finance and the opportunity of legal arbitrage. Enforceability of shari'a guidance and lack of alternative mechanisms to resolve bankruptcy related matters faced by Islamic finance were other important issues associated with the existing mechanism. It was observed that Chapter 11 is too lenient and biased in favor of debtors, which conflicts with the Islamic ethos of debt.

Bankruptcy in Shari'a: Nature and Scope

Participants had a long discussion regarding what constitutes insolvency (iflas) and bankruptcy (al-i`sar al-madani). It was concluded that insolvency is a debtor's inability to clear his debt at the time of maturity but without necessarily implicating his ability to clear his debt. Bankruptcy was described as a situation in which the liability of the borrower exceeds his assets. It was noted that shari'a has a provision only for insolvency.

Another notable aspect on this topic was related to the mudaraba (investment management) deposit of Islamic banks. It was highlighted that an Islamic bank may become insolvent on mudaraba accounts but remains a going concern with regard to its other activities. Some participants highlighted a new term (ta'athur, i.e., financial distress) being used for restructuring on the principle of sulh waqi min al-iflas (a settlement that prevents insolvency) though many others believed that rescheduling and debt restructuring could attract serious shari'a objections.

Some participants pointed out that the rules of the game are clearly different today from what might be envisaged in an ideal shari'a environment. For example, debt in shari'a-compliant business is not a policy decision, but in today's business environment it has become a matter of conscious policy. In this context it was also suggested that it is important to look at legal and real personalities where an individual may be averse to borrowing but a legal entity may not have the same reservation. Some participants also sought to draw the link between economic and legal perspectives. They referred to the exploitation of existing bankruptcy laws by corporations to their advantage. Issues of fairness and justice and economic expediency which weigh heavily in the current bankruptcy regulations were also discussed in the light of shari'a, and it was found that there are certain points of conflict with shari'a. For example, what is fair to a debtor may not be in the best interest of the business enterprise and consequently may affect economic development and poverty alleviation efforts of government. Many participants agreed that a flexible bankruptcy regime is good for the economy but comes at the cost of moral values. The main concern in this regard is how to strike a balance between disciplining debtors, protecting creditors, and encouraging entrepreneurship.

Major Challenges Confronting Insolvency and Restructuring

A great number of the transactions in Islamic finance are actually based on sale and lease-back types of contracts; according to many participants this leads to confusion among parties with regard to their rights. For instance, what are the options available when a bank goes bankrupt and has financed or leased out an asset to a customer? Can the asset be taken back because the bank has yet to receive its full payment or holds the title? Or will the asset remain with the customer and he will continue to make payment as per his agreement with the bank? Or will renegotiation happen to close the deal earlier than its original schedule?

Another related issue in the case of an early closing is whether the customer is required to pay as per the original agreement or if he is entitled to a rebate for making early payment? What is the shari'a view on these issues and how much discretion do judges have to enforce a settlement? Most importantly, how can these types of situations be resolved keeping in view justice and fairness and without prejudice to other claimants' rights and status?

According to participants, the AAOIFI Shari'a Standard is clear on this subject: the bank has the right to a full claim. On the other hand, it was pointed out that claiming full profit (as against accrued) will be unfair to the customer in case of early termination and may prejudice other unsecured creditors—which the court will not accept. It was submitted that Malaysian courts have not yet resolved this issue. It was also brought to the attention of the participants that the Saudi Central Bank has made it obligatory for banks to accept early termination by charging a maximum of 1% of the remaining profit.

Participants elaborated the shari'a view on this by stating that in iflas, all deferred payment will be accelerated. All four major schools of Sunni thought are of the view that rebate is not allowed—though OIC has permitted this practice by the banks. On practical side, it was highlighted that judges should use their discretion on this matter rather than making rebate statutory, which may harm the creditor.

Participants then moved on to discuss following possible scenarios:

insolvency law to make it better for Islamic insolvencies?

and insolvencies of sukuk and insolvency of customers?

pari passu when a combination of conventional and Islamic finance is used to finance a project?

During the discussion on the above, AAOIFI's Shari'a Standard on sukuk underwent critical scrutiny of some of the participants. One participant noted that the AAOIFI standard defines sukuk such that holders have ownership; however, in practice, the dominant majority of sukuk are not structured that way. He called it a contradiction between theory and practice. Another participant clarified that AAOIFI's standards are minimal in nature as far shari'a compliance is concerned and that scholars have allowed some liberty to achieve tax efficiency in the transaction. He further explained that there is no shari'a issue if the sukuk holders (being owners) agree to forego their rights and become pari passu with other creditors. Another scholar contended that any condition which violates the spirit of the contract is unacceptable; it is only post-closing that one may agree to such conditions but not at the time of signing the agreement.

Future Course

Considering the enormity of challenges in both the options (creating a new model or working with the existing legal system), another path was discussed among participants as a better alternative. This called for educating stakeholders by clarifying to them shari'a principles, making specific recommendations to Islamic finance institutions on how to manage within existing laws, preparing a master agreement on bankruptcy (like that of tahawwut), and preplanning insolvency. To avoid instances of bankruptcy it was suggested that preparing model guidelines based on work done by the International Association of Restructuring, Insolvency & Bankruptcy Professionals (INSOL) would help and guide legislators, practitioners, and possibly courts.

It was noted that some Muslim states are in the process of revising their insolvency laws, so this may be an opportune time to work with them. But the major challenge in this connection was the actual shari'a-related changes required for existing regimes and whether fiqh level issues can be overcome through government legislation as has been the case in recent past. How far legislative compulsion can be justified under shari'a? For example, can creditors be forced to accept reorganization? Can a stay be imposed on secured creditors? How can the rehabilitation option be strengthened? How can the handling of ta`aththur be strengthened? How can one jurisdiction or arbitration entity be developed into a recourse for insolvencies?

With regard to the above, major challenges discussed among participants focused on the following: the differences among scholars on fiqh issues; the different philosophical approaches (pro-debtor, pro-creditor); the complexity of fact situations; and the divergent treatment of these issues across laws and jurisdictions. Some complex issues like the limits of fiqh, what is subject to pre-agreement, what is subject to the discretion of financial institutions as a grace, what is up to the discretion of judges, and what is achievable only through regulation were also discussed among participants to identify and set priorities among institutions, markets, and participants.

Suggestions

It was suggested to conduct a review of the rules and institutions existing world-wide insolvency and bankruptcy systems as to their susceptibility to harmonization or not with shari‘a—a "World-Wide Legislative Review" (WWLR)—and then recommend which solutions would be best from the viewpoint of shari‘a compliance, along with any further ideas. It was thought to have the following benefits: it would be worthwhile even for revisions of a general insolvency law (Islamic and not); it would be useful for legislative bodies with a significant Islamic sector; legislation could then be adjusted to local historical, legislative, and cultural contexts; and it could be useful to judges and insolvency practitioners, as well as stakeholders.

Participants also discussed the possibility of producing a tool-kit of restructuring methods and approaches that will be acceptable in shari‘a. These would be designed primarily to prevent bankruptcy through voluntary workouts and amicable settlements among parties. And in the event of the involvement of courts, these tools would guide in matters of reorganization, rescue, and liquidation.

At the end of the workshop, participants provided specific suggestions on how to deal with the issue. Some of the key suggestions are: first, look at preventive measures to help avoid insolvency and bankruptcy; review the existing fiqh literature on the subject in the light of current experiences; conduct a survey of Western jurisdictions with a focus on the issues of importance to shari‘a; produce a model law of insolvency using international best practices; and improve AAOIFI's current Shari‘a Standard 43 to bring it up to requirements of the time.

HARVARD LAW SCHOOL
Islamic Legal Studies Program

and

LONDON SCHOOL OF ECONOMICS

Workshop on

Use & Abuse of Limited Liability

Thursday, February 13, 2014

London School of Economics
Tower #3, 5th Floor (BOX)
London, United Kingdom

USE AND ABUSE OF LIMITED LIABILITIES

Harvard - LSE Workshop Report, Feb 13, 2014, held at London School of Economics, London.

The 7th London School of Economics (LSE) Islamic Finance workshop was organized (2013) in the backdrop of the global financial crisis that had impacted all and sundry. The workshop had focused on "Insolvency and Debt Restructuring in Islamic Finance". At the conclusion of the workshop many of the participants shared their feeling that the issue of debt and restructuring is closely linked to the concept of limited liability for corporates. Hence the majority of the participants decided to vote in favor of "Use and Abuse of Limited Liability" for the 8th LSE Workshop.

The topic of the workshop, „Use and Abuse of Limited Liability' was examined from the following angles:

- Juridical person and limited liability: separate concepts or interdependent. What is the extent of justification for them under Islamic law?
- Similarities, differences and implications of a „juridical person" in shari„ah. Does the concept violate Islamic principle of *al-kharaj bi al-daman*?
- Can examples of „juridical person" be emulated in and extended to other areas?
- Islamic view on one juridical person creating another juridical person.
- Benefits and costs of a Limited Liability Company to investors, shareholders, managers and the society at large.
- Various possible models under Islamic Laws.

Objectives

The main purpose of the workshop was to envisage various models or structures of organizing business that retain the beneficial aspects of limited liability while avoiding the misuse of the concept. Accordingly the objectives set for the workshop were as follows:

1. Revisiting the debate on the shari„ah viewpoint of juridical person and limited liability;
2. Understanding advantages and benefits of limited liability to economy and business (public) in general and to promoters, shareholders, and employees in particular;
3. Discussing disadvantages and misuses: causes and extent;
4. Exploring remedies and options.

Professor Frank Vogel, the moderator of the workshop, re-emphasized the importance of gathering five key stakeholder groups at the workshop, namely: shari„ah scholars, economists, practitioners, lawyers and industry organizations. He said that every time we pick a worthwhile and substantive issue the real purpose is to use the issue to debate how the industry itself makes decisions – how it weighs considerations that are ethical, religious, legal, economic, financial, professional, political, reputational, and purely pragmatic to come to a conclusion on a specific issue.

Professor Vogel divided the agenda of the day-long workshop into three parts.

1. The shari„ah issues and positions on juridical person and limited liability;
2. The economic issues and consequences of the use (*maslaha*) and abuse (*mafsada*) of the limited liability concept and how to manage the costs and benefits;
3. Shari„ah compliant optimal organizational forms in the context of the benefits and misuses of limited liability.

Limited Liability and Legal Personality: Benefits, Costs and Concerns

The workshop began by listing several benefits of limited liability such as ability to bring together large groups of investors as one body, providing continuity for the enterprise regardless of the changing circumstances of shareholders and shielding the shareholders from unanticipated liabilities arising from the running of the business. It also provides investors an opportunity to diversify their investments across various projects rather than just in projects that they can manage themselves. Limited liability also enables small savers to invest in businesses that otherwise may be confined to wealthier investors.

These benefits, however, come with certain disadvantages. For example; it allows business managers to sometimes indulge in excessive risk taking by borrowing huge amounts of money to increase profits and hide behind the corporate veil if the venture fails, which results in the privatization of gains and socialization of losses. Many of the ills in today‟s financial system, such as short-termism in the financial markets, excessive indebtedness and speculative risk-taking can be attributed to the concept of limited liability as those responsible are able to protect their personal wealth regardless of what happens to the venture for which they are responsible. The presenter also posed certain questions to the participants. For example:

When can the corporate veil be pierced? And should it be automatic or should it be looked at on a case-by-case basis?

What are the implications for bankruptcy and defaults within limited liability? Should we go for a regulated limited liability regime or should it be limited liability as a rule?

Whether limited liability and legal person can be separated in shari„ah or it has to be combined for a shari„ah ruling.

How to deal with different shades of limited liability company (LLC)? In different countries and at different times the limited liability concept can be applied differently.

Can an LLC by itself create other LLCs and what are the parameters for it? Where to put a stop to this process and on what basis?

What are the different shades of legal personality?

Scope of Limited Liability and Legal Personality in Shari‘ah

The participants agreed that interpretations of shari„ah have allowed the concept of juridical person and limited liability and their use is widespread in Islamic finance and in Muslim countries in general. More importantly the concept has been accepted across the world including by the Islamic standards setting bodies such as AAOIFI and *Majma Fiqh al-Islami*, etc.

One participant highlighted the concept of separation between ownership and management. Referring to the *mudaraba* contract it was pointed out that any liability incurred by the *mudarib* without the express permission of the *rabbal maal* is the responsibility of the *mudarib*. Therefore, to shift the responsibility onto the *rabbal maal* (beyond his capital), it has to be proved that all the actions of the *mudarib* were conducted keeping the *maslahah* of the *rabbal maal*. For example, if an Islamic bank fails, its creditors cannot have any recourse to the *mudaraba* fund (or investments accounts) managed by the Islamic bank as the fund does not belong to the bank. The debate on this issue concluded that overall there are many more benefits in limited liability that serve *maqasid al shari'ah* than causes for disquiet. A hadith related to Saeed ibn Mohal was also quoted in this context where the Prophet Muhammad allowed his creditors to take recourse to the garden that he had and beyond which they had no claim. Taking a cue from this ruling it was argued that creditors have no claim over the future earnings of the bankrupt, let alone having any claim in the Hereafter.

A participant then questioned what stopped classical *fuqaha* from not starting a joint partnership with limited liability? This was clarified: since the concept of juridical personality was not established at that time, any business was actually a personal company owned by its partners, who were liable for the responsibilities through their personal wealth. After the concept of juridical personality was introduced and developed, however, it was adopted under shari„ah.

A participant noted that taking a historical perspective, the idea of a limited liability corporate as a separate legal entity was developed in the time of European expansion to fund the exploration and exploitation of global resources. It provided a successful corporate structure for that purpose and has since been adapted to suit contemporary commerce. The emergence and development of the limited liability corporate structure proceeded without any serious engagement by Muslim jurists and scholars. The association of the limited liability corporate with colonial forerunners such as the East India Company led to the development of many negative connotations about this emerging structure to facilitate commerce. This is very similar to negative sentiments about capitalism due to its close association in Muslim minds with colonialism. There is, therefore, a need to separate these negative sentiments from the arguments based on the usefulness or otherwise of the underlying substance of the limited liability corporate.

It was also suggested that profit sharing is the opposite of lending money at interest or the prohibited *riba*. Profit sharing requires business partnerships and it is these business partnerships, which early on did not have limited liability, that have evolved into limited liability companies.

Managing Abuses in Limited Liability

The discussion then veered toward managing abuses. The moderator posed the question: what is required from an Islamic point of view to rectify abuses and whether it is sufficient to just rely on western legal systems, which focus more on managers and majority shareholders when it comes to managing abuses?

A participant pointed out that the real question in this regard is who controls decisions and who is responsible for abuses. In a small private company shareholders make decisions and should be liable. In a large company, however, it is managers and not shareholders who run the business. The moderator then asked, if you are in a position to control the actions of your company, does Shari‟ah say you should also face the consequences even beyond limited liability? Two of the Shari‟ah scholars answered that if the shareholders are represented by a board of directors then the directors shall be responsible for any act of omission or commission as per the corporate governance code, which covers potential misuse of limited liability. If, however, the board of directors has been acting according to the articles of association and terms and conditions of their appointment then the responsibility for their actions will fall on the shareholders.

It was also highlighted that economic development requires risk-taking. If there is too onerous a burden imposed on those running limited liability corporations, putting their personal wealth and by implication the well-being of their families at risk, it may dissuade risk-taking to the detriment of economic development.

Piercing the Corporate Veil: When and How

This session began with issues related to piercing the corporate veil and under what conditions it may be pierced in the United Kingdom. It was suggested that the only possibility of piercing the veil is in a situation where the corporate form is used to avoid an existing liability. As far as future obligations are concerned it is acceptable to use the form to limit your liability, even in cases which appear unacceptable. For example, a pharmaceutical company that has a product that they think will hurt people, yet they develop it in a subsidiary, the corporate veil will not be pierced. When asked about the possibility of managers/directors being held responsible for their actions, it was clarified that, save in the situation where the company is already in insolvency, the directors have an obligation to use the powers they have to promote shareholder value. As long as the company is a going concern, those directors are not burdened with the interests of creditors.

The moderator then asked the scholars if they would be satisfied with the corporate governance rules as practiced in the United Kingdom. One shari„ah scholar suggested that rules for piercing the veil should be made clear and objective rather than left to the sole interpretation of judges. Another participant noted that limited liability companies did not grow organically in Islamic culture. The SPV (special purpose vehicle) model is also imported from the West. Instead of trying to find Islamically unique solutions to those problems, therefore, we should accept the solutions that are applicable in those countries. Another participant refuted this assertion on the ground that shari„ah allows borrowing outside the realm of rituals. He argued, „You can use a tool you have not developed, but it must conform to the rules of shari„ah. It is important to develop necessary sensors to detect specific pitfalls and dangers to be able to protect yourself".

The Role of SPV's and Limited Liability in Sukuk

Many participants raised the question of the growing use of SPVs in issuing *sukuk* (Islamic debt securities). Some of them were very critical of the miniscule capital base of these SPVs and called for restrictive use of these structures. One participant suggested AAOIFI should come up with a Shari‟ah standard on SPVs. Another participant noted that the demand for restrictive use of SPVs is not because of its limited liability feature nor are SPVs invented on the advice of Shari‟ah scholars, but lawyers need them for various reasons including tax benefits and bankruptcy remoteness. He cautioned that the concern should actually be how these SPVs are

used as a tool and whether they are used for private gains or for the benefit of society at large. If these vehicles are used to defraud people then they should be dealt with accordingly.
Another participant pointed out that the issue of transfer of ownership of assets into SPVs is not clear and therefore the ultimate responsibility still lies with the corporate (originator). It was also noted that many *sukuk* holders instead of claiming assets go for recourse to the originator.

A practitioner who has been part of many landmark *sukuk* stressed that the SPVs are created for nothing but logistic purposes. Since there are thousands of *sukuk* holders, a vehicle is needed to represent them. Since at the time of issuance the investors are not there, the documents are signed saying it is on behalf of beneficiaries who will come later. The SPV is needed to buy the assets on behalf of future investors and then to lease the same on behalf of the *sukuk*. The trust structure facilitates the transferability and allows the documents to be signed in advance of issuance itself. SPVs own the assets on behalf of the investors. From an accounting perspective also legal ownership rests with the lessee.

The SPV structure also plays an important role in acquiring high-risk assets, where the financiers want to ring fence the liability by creating an orphan SPV, where the shares are held in trust for some charity. A charity is brought into the picture because it cannot be sued. In case of something going wrong the banks have a first priority charge over the asset and if a third party claim is enforced, you say the ultimate owner is a charity which cannot be sued. It was argued that in the absence of limited liability, nobody would finance aircraft. The SPV, therefore, is a standalone entity without any ulterior motive or purpose.

Summary and Conclusion

The last session of the workshop was devoted to summarizing the day-long discussions and drawing some conclusions from it.

The moderator invited responses to the idea of imposing liability on the shareholders and managers for the misuse of limited liability. He also suggested the institution of non-legally-binding but ethical standards or industry standards under the corporate governance rules. He wanted to know if the discussion could be enlarged to include trusts and mutuals as they too are reported to have been used inappropriately. He asked participants to highlight whether there is any Shari‟ah-specific suggestion and criteria or it is acceptable to work with the existing system. He further asked participants their views on whether transparency in disclosure is a sufficient requirement to justify limited liability or whether the existence of a separate legal person underlying the concept of *dhimmah* is also required as a basis and what is the logic behind the shari„ah acceptance of these notions. What is the possibility under Islamic law of imposing additional obligations of disclosure? Who will enforce them and in what context will they be enforceable?

Participants reacted to these queries in different manners. One noted that any new structure that is developed is for a purpose, but over a period it starts getting misused. The message is to remain vigilant, therefore, as the issue is more of a regulatory than statutory nature. Some others tried to cite real life examples. For instance, Malaysians have a statutory provision for piercing the veil in case of tax evasion. One participant highlighted the role of credit bureaus in providing disclosures and making available the necessary information about the creditworthiness of the borrower. On the other hand some contended that a credit history is not available for all transactions and more importantly it is not accessible to all. One participant highlighting the shari„ah aspect referred to a hadith describing delayed payment as an injustice punishable by exposing the delinquent.

A suggestion was made to put some sort of restrictions on limited liability. One participant tried to highlight the difference between natural factors leading to failure and fraudulent behavior. Another suggested providing incentives to those who are cautious in incurring obligations or taking too much risk. To control the misdemeanor, especially in the context of overleveraged banks it was suggested that a look should be taken at the German mutual and cooperative bank model, where shareholders could be made liable beyond their share capital. The moderator highlighted Saudi corporate practices where shareholders are required to provide guarantees if their company‟s capital drops to one quarter of its total obligation. One participant drew attention to the new Malaysian Companies Act imposing higher duties on managers and increasing shareholders‟ responsibility.

One participant argued that the business known as the John Lewis Partnership in the United Kingdom could be a model for Islamic enterprises. John Lewis is owned on trust for the benefit of its members. Every employee of John Lewis becomes a member on the day they join. The trustee of the settlements is the John Lewis Partnership Trust Limited. Its chairman is the partnership chairman and its other directors are the deputy chairmen. The Partnership is governed according to a written constitution, which is subordinate to and must not conflict with the settlements. Power in the partnership is shared between three governing authorities: the Partnership Council, the Partnership Board and the Chairman. Profits are used to sustain commercial vitality and distribute to the members. Each year every employee receives a percentage of their salary as a bonus. The company also provides benefits such as holiday houses that the partnership maintains. Employees who have worked at the company for 10 years or more also continue to receive benefits after they retire such as 20% off John Lewis products. The John Lewis partnership with its happy customers, employees and management may be what we would want shari„ah businesses to consider as a model.

Looking from another perspective it was observed by participants that the current financial system has a deep influence on the capital structure used by companies. Since debt is made cheaper than equity, it is unlikely that reliance on debt will change unless equity and debt are brought to a level playing field. The systematic preference of debt over equity runs like an underlying theme behind abuse of limited liability.

(This report is published in New Horizon, Issue No. 191, 2015, pp.43-46)

LONDON SCHOOL OF ECONOMICS
AND POLITICAL SCIENCE

and

HAMAD BIN KHALIFA UNIVERSITY
QATAR FACULTY OF ISLAMIC STUDIES

Workshop on

REVISITING ISLAMIC SECURITIZATION AND STRUCTURED PRODUCTS

An economic and legal analysis

FRIDAY FEBRUARY 13, 2015

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HAMAD BIN KHALIFA UNIVERSITY
College of Islamic Studies

LSE–HBKU Workshop | February 13, 2015

Revisiting Islamic Securitization and Structured Products an Economic, Shari'ah and Legal Analysis

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Cite this report as: Tariq, W. (2018), Summary report of the 'Revisiting Islamic Securitization and Structured Products An Economic, Shari'ah and Legal Analysis' hosted by the Center for Islamic Economics and Finance (CIEF), College of Islamic Studies, Hamad Bin Khalifa University at the London School of Economics on February 13, 2015.

Introduction[1]

The Center for Islamic Economics and Finance at the Qatar Faculty of Islamic Studies (QFIS), a college of Hamad bin Khalifa University (HBKU), organized a workshop on Islamic finance at the London School of Economics (LSE) on Friday, February 13, 2015. The workshop was on the theme of "Revisiting Islamic Securitization and Structured Products." This report is a summary of the workshop deliberations.

There is confusion in the *sukuk* markets about whether *sukuk* are securitizations.

The workshop began with participants claiming that the definitions of *sukuk* that the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) have put forward are causing confusion in the markets.

AAOIFI defines *sukuk* as follows:

> "Investment sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity…" (AAOIFI, 2010, p. 307). [2]

IFSB describes the process of issuing *sukuk* as follows:

> "Securitisation in *sukuk* is broadly referred to as a process of issuing *sukuk* involving the following steps:
>
> (a) origination of assets…
> (b) transfer of the assets to a special purpose entity (SPE) which acts as the issuer by packaging them into securities (*sukuk*); and
> (c) issuing the securities to investors." (IFSB, 2009, p. 3).

Some participants were of the view that the prevailing definitions and descriptions of *sukuk* given by AAOIFI and IFSB inaccurately represent *sukuk* as an asset-backed securitization. It was argued that the majority of *sukuk* are not true securitizations. From an English law perspective, most *sukuk* are unsecured bonds[3]. In the event of default, there is only the Purchase Undertaking Deed (PUD) whereby the originator promises to purchase back the assets at an agreed upon exercise price. Investors usually do not have recourse to the *sukuk* assets. In a true asset-backed securitization, the security-holders would have recourse to the underlying assets and not to the originator of the *sukuk*. In the vast majority of cases, s*ukuk*-holders do not have recourse to the *sukuk* assets—they have recourse to the originator. This raises many important concerns in the market especially with respect to the actual risks involved in investing in such products.

1 Acknowledgements**:** This roundtable was convened by S. Nazim Ali and moderated by Frank Vogel. The roundtable was organized by S. Nazim Ali, Hussam El-Khatib, Shariq Nisar, and Wijdan Tariq. This report is based on the excellent notes of Jennifer Schwalbenberg. The comments of Frank Vogel and other participants were also instrumental in preparing this report. The usual disclaimer applies. All errors that remain are the author's own.

2 The standard definition continues "…however, this is true after receipt of the value of the sukuk, the closing of subscription and the employment of funds received for the purpose for which the sukuk were issued. Furthermore, AAOIFI also defines securitization as follows: "Securitisation is known in Arabic terminology as Taskeek (issues) and Tasneed (securities). Securitisation is a process of dividing ownership of tangible assets, usufructs or both into units of equal value and issue securities as per their value." (AAOIFI, 2010, p. 322)

3 The Bank of England statement on sukuk supports this view.

The sale of underlying assets in most *sukuk* issuances is not a true sale. Deviations from true sale are primarily due to the purchase undertaking and the absence of legal transfer of ownership of the assets sold from the buyer to the purchaser. This view is problematic—if there is no true sale then there is no genuine ownership. In the absence of ownership of the assets, on what basis are the *sukuk*-holders generating their returns? If one accepts that there is no ownership of the assets by the *sukuk*-holders and/or there is no true sale, the *shariah*-compliancy of the product comes under serious doubt in the eyes of many of the participants.

It was suggested that the IFSB definition creates confusion especially if it were to go to an English court. A party could argue in court that this definition by IFSB meant that they had a legitimate expectation to have recourse to the assets. Widely accepted terms such as "securitization" have specific meanings, so the Islamic finance industry should not associate its own preferred definitions to the word "securitization". For instance, one participant stated that in Saudi Arabia, the term "securitization" is being used specifically to describe the discounting of receivables. Some participants were of the view to separate the word *sukuk* from the word "securitization" and accept that they are not the same thing—this would reduce legal uncertainties to an extent.

When questioned further to clarify the source of the confusion in the *sukuk* definitions, a participant stated that the definitions do not say where the recourse. To further elaborate on the concern, one practitioner described the practice of issuing *sukuk* in the Middle East and North Africa (MENA) region. Many transactions in MENA do not complete the registrations and lawyers in the Gulf Cooperation Council (GCC) countries—civil law jurisdictions—will issue the term "beneficial right" even though it is a common law concept. With beneficial rights, if the seller goes and sells that same asset to someone who perfects those assets, the first buyer will lose that beneficial claim on the asset. However, Western securitization is based on the true sale concept and the total transfer of assets. The investor relies on the fact that that asset cannot go back to the originator thereby securing the investors rights to enforce debt claims. The participant suggested that *sukuk* got off to a wrong start because it was poorly defined and the asset came into existence only to give the structure *shariah* credibility. The reality is that it is a temporary lending of the asset or temporary transfer of title and the asset will eventually go back to the originator. Very few issuers in Asia and the Middle East want to relinquish their assets. They do not want to diminish their balance sheets—they want the assets back. The participant argued that we need to redefine *sukuk* to show what it actually is.

One participant had a different opinion on the source of the confusion. The confusion does not stem from the definitions—the confusion comes from the fact that very few people actually read the *sukuk* prospectuses. The reality is that we have many different types of *sukuk*, and there is a degree of overlap between securitization and *sukuk*. Asset-backed *sukuk* involve true sale with recourse to the *sukuk* assets[4]. We also have subordinated securitizations and subordinated *sukuk*. The AAOIFI and IFSB standards do describe some of these alternative *sukuk* structures, although the basic descriptions provided by AAOIFI and IFSB do appear to describe the less common asset-backed structures. Nonetheless, the more pressing problem according to this view is that investors do not read the prospectuses. There are some people who claim that they do have a right to the underlying asset. But if you look at prospectuses, the documents are clear that you have no right to that asset and no right to enforce against the asset. Your only right as a *sukuk*-holder (in the vast majority of cases) is against the purchase undertaking. Therefore, you join other groups of unsecured creditors if you take that claim for payment to court. This is clearly detailed in prospectuses, so the key is to encourage stakeholders to read the prospectuses and allow them the time to understand the key aspects of these documents before making investment decisions.

One participant spoke briefly about the historical evolution of the *sukuk* markets as well as the *sukuk* standards from firsthand experience. The participant acknowledged that the confusion in the *sukuk* markets exists among all stakeholders, even the *sharia* scholars. The historical view may shed light on why *sukuk* in practice have not

[4] However, the participant agreed that we do not have many of these and there may be an opportunity for them to develop.

been asset-backed and how the AAOIFI standards came into being. *Sukuk* were initially issued because of idle assets of state-owned corporations. The state-owned corporations used to borrow conventionally through interest-based loans and bonds. Over time, pressure grew from the general public and from Islamic institutions that governments should not borrow using interest-based transactions because it was deemed *haram* (prohibited by *shariah*). The corporations were left with two options: either to continue to borrow on an interest-basis and obtain *fatwas* (legal opinions) on their permissibility due to lack of alternatives, or to issue "Islamicisized" versions of the conventional debt-based products in the form of *sukuk*. The corporations took the latter option. The *sukuk* market started small but proliferated quickly and the market was not ready for the tax, legal and regulatory implications. There was no real preparation for this market. Over time, many different professionals including lawyers became actively involved with the markets. When issues arose, AAOIFI was asked to prepare *sukuk* standards. The *sukuk* standard was one of the earliest AAOIFI standards. They attempted to control some of the issues that were occurring. In the view of this participant, the IFSB/AAOIFI standards should not be viewed as perfect and do need to be refined.

On the issue of securitization and *sukuk*, the participant went on to state that in the Middle East it was not known what the term "securitization" meant in practice. Islamic finance, he argued, should be credited for bringing some sort of securitization to the region through *sukuk*. Islamic banks introduced securitization to the Muslim world and this is their invention and contribution. *Sukuk* should be viewed as a hybrid between conventional bonds and conventional securitizations. In the *Shariah*, purchase and sale undertakings within a sales contract is a matter of debate. Some scholars are of the view that such a sale is a true sale with certain obligations that come into effect under certain conditions such as default. These purchase and sales undertakings have a history as well. Lawyers have always demanded for Islamic finance to be *pari-passu* with conventional finance. It is in the interest of *sukuk*-holders to be *pari-passu* with other creditors otherwise all other creditors will want to be secured as well. In a nutshell, this is the historical background on the complications of the *sukuk* market and its relationship to securitization.

It was disclosed during the discussions that AAOIFI in their last *shariah* board meeting decided that they plan to re-visit the *sukuk* standards and to include recent issues such as asset-backed, asset-based, tier 1, tier 2, perpetual *sukuk*, etc., in the revised standards[5]. A team of seven experts has been formed that includes four shariah scholars, an expert from Malaysia, an accountant and a lawyer working in the field. The *shariah*, tax, and legal aspects of *sukuk* will be considered when drafting the new standard. Roundtable workshops similar to this one are being planned by AAOIFI and all the comments (including from this workshop) would be beneficial for AAOIFI. It appears that one of the additional objectives of the new standard would be to encourage moving beyond *shariah*-compliance and to consider the *maqasid-al-shariah* as well. In other words, the standard may address questions about the use of *sukuk* proceeds and about the overall objectives and aims of financing. Accordingly, the assumption according to this view is that the problem with *sukuk* structures does not stem from a lack of disclosures or from people not reading prospectuses; the main source of problems in the first place is the motivation for issuing *sukuk*—this is what results in controversial structures. For example, do issuers want to create these instruments to get rid of assets permanently, or is it just for a temporary period by informing investors that they do not have claim to the assets? The new AAOIFI standard might attempt to address such questions relating to incentives.

Another important source of confusion according to a participant is the gap between the interpretation of sale from a *shariah* perspective and from a legal perspective. In the *shariah* point of view, the participant claimed that there is no difference between true and beneficial ownership. In *shariah*, there is offer and acceptance, and the contract is valid as long as risk and liability are transferred and as long as the subject of sale is free from *shariah* prohibitions (e.g. *gharar*, banned goods, *riba*, etc.). There are instances where the *shariah* scholars have

5 This was also reported in a Reuters article dated 19 November 2014 titled "Islamic finance body AAOIFI to revise four standards, eyes sukuk".

regarded transactions as true sales, but the court of law does not recognize it as a true sale. Definitions of true sale vary between common law and civil law jurisdictions. Thus, this is an important source of uncertainty and confusion: the difference in secular legal interpretations and the *shariah* interpretation of a true sale.

At the same time, within the *shariah* differences of opinions do occur on issues related to *sukuk*, structured products and true sales. One must acknowledge this as a source of confusion as well[6]. For instance, how does the non-recourse condition in *sukuk* affect its compliance with the *shariah*? Is the contract void? Is the condition void? There are instances in *sukuk* issuances where buyers (investors) have no right to conduct due diligence on the underlying assets. Would this be considered as a true transfer of ownership from a *shariah* perspective? These questions were posed a number of times throughout the discussion without a conclusion or a clear consensus reached. With such differences of opinions among *shariah* experts, confusion in the markets is inevitable.

According to a lawyer, there is a gap between the expectations of some *shariah* scholars in the industry and the effective legal regime in those jurisdictions. In addition, the products were placed in the market before the availability of an appropriate legal and regulatory environment. This is a problem of *sequencing*. How can we issue *sukuk*—regardless of whether it is asset-backed or asset-based—in countries that do not recognize any securities other than a conventional bond? We need to create the enabling environment in order to reduce the significant gap between what we want these instruments to be and what the jurisdiction enables.

One participant argued that in a market economy, it is supply and demand that determines which products are offered and available. No one is preventing industry players to undertake full-fledged asset-backed securitizations. However, this is not what is being demand by industry, government, and large enterprises. In addition, under the new Basel committee rules, asset-backed instruments have higher capital requirements than before. So the market demand for securitization is just not there, according to this participant.

The capital markets view of *sukuk* instruments is to assess what recourse is available in the event of a default. With the prevalent asset-based *sukuk*, the rating agencies treat them in the exact same way as bonds. For bonds, the rating is based on the entity responsible for repayment and in *sukuk* the rating is based on the entity that has the obligation under the purchase undertaking. A true asset-backed *sukuk* can achieve a better rating than the entity obliged under the purchase undertaking—usually the originator itself—if the quality of underlying assets is higher than the quality of the originator. This is one of the key motivations for issuing true asset-backed securities. If *sukuk* issuers understand these benefits more fully, the markets might move towards asset-backed structures.

The discussion then moved on to discuss the content of the *sukuk* prospectus. Some participants suggested that the legal regime governing the prospectus should be clarified and that *sukuk*-holders are not told what the law of the land is in the countries where the underlying assets are located. In particular, recent experiences with *sukuk* prospectuses have shown the difficulties of having two legal regimes (e.g. *shariah* and English law) in the same contract. In fact, from an English law perspective, you cannot introduce two competing regimes within the contract. Some participants made normative claims that if a party to a contract is "Islamically-minded", then they should abide by the contract of the *sukuk* irrespective of the law of the land that gives them recourse to the assets of the originator. The fact remains, however, that such normative opinions are difficult to enforce without the appropriate legal incentives and framework. One potential solution to these problems is that *sukuk* prospectuses can specify that disputes will be resolved by arbitration. Each party selects an arbitrator and both parties select a third arbitrator. One *shariah* scholar agreed that if the parties do not go to court and instead appoint arbitrators that will uphold *shariah* law, then most of the concerns raised in this discussion could be

6 Statements on *sukuk* by a board member of AAOIFI in 2007 and the OIC Fiqh Academy in 2012 (published in English in 2014 in IRTI's *Islamic Economic Studies*) are examples of ongoing debates from within the *shariah* on some of these issues.

solved. Arbitration tribunal could potentially solve some of the issues because it could recognize the *fiqh* nuances where an English court would not. However, another participant questioned the relevancy of arbitration—when a contract says that you have no recourse, this is a serious issue. *Sukuk* documents do increasingly contain arbitration provisions. In bilateral contracts, you would have more flexibility. In the case of *sukuk* where an offer is being made to anonymous group of investors and who are trading all the time, you may still have arbitration; however, it needs to be clarified whether there is recourse to the assets or not because the ratings agencies, the exchanges and the investors need to know the rights of the parties. Simply having an arbitration provision does not satisfy the needs of these stakeholders.

The discussion went back towards whether a real sale is intended in the first place. Lawyers are saying that there is no true sale in most *sukuk*. Both parties do not want a real sale, so the intention to sell does not exist. *Sukuk*-holders do not have full ownership rights, but only the right to take value from the assets. In many jurisdictions, the parties do not want to pay sales taxes. Governments and companies do not want to give up their assets for economic, political, or strategic reasons. If there is no intention to sell, then perhaps we need to find a new solution.

One of the *shariah* scholars criticized what he called the "anti-*sukuk* school" and he described the views of critics as a minority view. He claims that true asset-backed securitizations are difficult and highly risky due to their volatile characteristics. These kinds of structures need a much higher level of due diligence and other factors also mean more complications—especially in the developing markets where there are no standards. Leaving *sukuk* and moving towards securitization will not happen according to this *shariah* scholar. He is critical of those that demand full ownership. According to him, ownership has two sides: full ownership and full liability. For example, imagine an oil & gas company issues a true asset-backed *sukuk* and subsequently there is a large oil spill involving the company—in the case of true sale, all the *sukuk* investors (as owners of the assets) may be liable. The *shariah* scholar claims that the critics do not realize both these sides of ownership, and that once they do realize this, they will appreciate the difficulty and unattractiveness of true asset-backed *sukuk* for the market.

Participants did not agree with the assessment of the *shariah* scholar that the critical view of *sukuk* is a minority view. Many participants agreed that it is in fact the *majority* view both inside and outside of the roundtable discussion. Many technical and non-technical people argue that Islamic finance uses legal devices to give veneer of compliance. They are suspicious of Islamic finance, and they see it as nothing more than a series of legal devices. Some participants agreed that securitization is a gradual process and that we cannot switch overnight, but we cannot ignore the critical views because this is in fact the majority view.

One of the participants was critical of finance lawyers. He claimed that lawyers are not making it clear to the *shariah* scholars that there are different set up of basis on which you can form *sukuk*. Lawyers are advising clients to go for beneficial ownership only. It is upon the lawyers to advise what can be done to have recourse to the asset and to be in line with the existing legal system. At the same time, *shariah* scholars need to emphasize more during their interactions with lawyers on what needs to be developed. Another participant added that while this is true, we must keep in mind that the sector is dominated by conventional players who are not as concerned with the *shariah* issues as much.

The question was asked whether the issue of sale in AAOIFI resolution is clear. Most of the discussants agreed. One *shariah* practitioner suggested that AAOIFI needs to review the standards and make the true sale part of the standards itself. Lawyers cautioned against this because there is no jurisdiction in the Middle East where you can do that—where you can perfect the transfer of title. There are no insolvency laws in some of these countries. If the jurisdiction does not guarantee recourse to the assets, no one will give a legal opinion without major qualifications. And you cannot just say this to retail investors. It would be disastrous if it goes wrong.

One London-based participant commented that assets (to be the basis of securitization) are available but no one wants to buy or sell them. Pre-2008, *sukuk al-mudharaba* with fixed price undertaking was available to the market—this gave the market the benefit of having a product that is a credit claim without the need for assets. This kind of structure was acceptable for a long time. After the well-known AAOIFI pronouncement in 2008 prohibiting any structure which implies the guarantee of principal in a profit-sharing structure such as *sukuk al-mudharaba*, those types of structures witnessed a marked decline. However, the structures that we have now are still economically similar; returns are not really linked to the asset—they are predetermined. According to this participant, the market still demands a product which allows *sukuk* holders to invest in a business and to get a return fixed up-front and have a right to get principal back in a debt-like way. Is there any way to recreate the economic reality of a debt claim and a minimal return without the need for assets? The market demands instruments that look like conventional bonds but have a *shariah* justification and analysis applied to them. They can then be easily explained to the different stakeholders such as the exchanges and ratings agency which will allow the investors to easily conduct their risk analysis. Essentially, the market wants to reverse engineer a conventional bond to make it *shariah*-compliant.

In response to the above comment, another London-based participant gave the example of a German insurance company that issued a *wakala sukuk* that was backed by insurance policies. It acted more like a covered bond.[7] He said that although the assets were ring-fenced, they remained on the balance sheet of the originator and did not need to be transferred across. The previous commenter remarked that assets were still needed for that structure and that this would not meet the demand for structures that do not require for there to be underlying assets.

Other *shariah* experts warned that without having underlying assets, the link to the real economy is broken. They also acknowledged, however, that many companies are coming forward with these requests. The only way this can be permissible is to make it similar to *mudaraba*, *musharaka*, or *wakala*—share the profits that are generated and follow the guidelines of the perpetual *sukuk*. The market is already moving towards such structures with the introduction of perpetual *sukuk*. More innovation would be required and it was recognized as an area of ongoing concern.

Perpetual *sukuk*, however, do not meet the market demand for bond equivalents. The reason is that perpetual *sukuk* are highly subordinated debt and they are priced that way. There is a strong market demand for Islamic debt instruments that are pari passu with conventional debt and with a similar pricing. We need to acknowledge that *sukuk* are treated—in the wider financial system outside of the realm of *shariah*—as a loan with interest. If you look at pricing from the investor's perspective, the pricing is similar in good conditions. In other words, the presence of underlying assets is irrelevant when it comes down to the final economic/financial analysis.

The *shariah* scholars took strong objection to the desire of the industry to create bond-like instruments with no underlying asset and to try to pass them off as Islamic. The desire to create the risk profile of a bond with no underlying asset and to make it Islamic is, according to one participant, like "trying to sell milk in the wine market." The scholars expressed strong disapproval of the conventional finance market to solely insist on the one contract—that is, the interest-based loan. This unidimensional reliance of mainstream financial players on the interest-based loan contract stifles innovation in finance, according to the Islamic finance scholars.

The question was asked whether it would be ok to relax the *shariah* rules for a period of time to allow the industry to reach a degree of economies of scale. The benefit of this could potentially be a larger, deeper market with an avenue to finance the necessary innovative (and more genuinely Islamic) structures in the future. This

7 Although the participant did not mention the name of the issuer, it is likely that he was referring to the $US 100m *sukuk* programme that the European insurance group, FWU issued in October 2013. The European Islamic Investment Bank was one of the arrangers of this deal.

may sound something similar to the Malaysian model where the trading of debt (*bay' al-dayn*) was allowed which helped the market to grow very large and become efficient over time. Should we encourage this approach? One *shariah* scholar admitted that there are glaring *shariah* issues ("violations") in the way that many aspects of Islamic finance are practiced, not just *sukuk*[8]. At the same time, he said, we have to be fair regarding the reality of being able to address these issues and solving them in the real market. We must recognize that we do not have any sovereign sponsor or patron and that we are operating at the periphery and "swimming against the current". The size of the industry is too small and costs of addressing the *shariah* violations will be much higher proportionally. The fact that we are not addressing the issues head on—the *ulema*, the *fiqh* and regulatory bodies are turning a blind eye because of the necessities of the market—does not make all of this right; they are just postponing the issues for another time. What remains to be seen is whether this postponement would be for the benefit or the detriment of the industry. It is not being addressed because it is working and the issues have not yet rocked the boat. Just because we have not been able to address these concerns does not make them acceptable. But at the same time our hands are tied. There is a big gaping hole in the Islamic compliance requirement, but it is beyond our means to control it at this point in time.

Others commented that relaxing the rules even further would be detrimental. The public—and especially the youth—are already losing trust in Islamic finance, it was claimed. So these kinds of proposed plans would have to be considered with extreme caution, carefully assessing the costs and benefits of such a strategic approach. At the same time, another participant argued that the main attraction of Islamic finance for the wider audience—including conventional mainstream economists—is the emphasis on risk-sharing and equity-like financing arrangements. According to this view, there is a need for Islamic finance to reconsider this approach and emphasize risk-sharing and equity-financing more than debt. This is where Islamic finance can potentially add value. If Islamic finance cannot add value, it will continue to face questions about its existence. The problem, commented another participant, is that it is not attractive to engage in equity financing due to the favorable tax benefits that debt arrangements receive. Furthermore, the risk weighting that Basel attributes to equity financing makes it very unattractive for the financier. There needs to be top-down strategic thinking to enable the shift from debt to equity-like arrangements.

A *shariah* scholar commented that sometimes when scholars declare an instrument as non-compliant with *shariah*, innovation follows. For instance, when conventional insurance was declared non-compliant over many years, we saw the development of cooperative insurance.

The Basel approach to regulation is relevant for the regulation of *shariah* in the Islamic finance market as well. The Basel Committee on Banking Supervision changes their standards and imposes them on the industry and the industry is compelled to comply, even if it is not binding. However, in Islamic finance we observe that standard-setting boards do not want to revise standards in order not to hurt the market. This defensive approach to standard-setting must change. At the same time, participants expressed concern that pronouncements from AAOIFI members in the past have negatively affected the industry, and there was a worry that if AAOIFI came out and suddenly announced that, for example, hybrid *sukuk* are wrong, that it would damage the industry. Other participants assured that in the future, AAOIFI will not make statements and will only issue standards. However, there is a need for the industry to adopt the standards just as banks adopt Basel standards.

A discussion ensued about the means through which innovation in *sukuk* can be achieved. It was suggested that for innovation to occur, we need to look at the business model of the issuing firms—what is their business all about? Based on this, we can create constructs that have enough tangibility and assets that are defined in a legally certain way. For instance, with an airline company we can identify that the right of passengers to fly is

[8] The *shariah* scholar went on to mention that there are problems in the other practices of Islamic banking, such as the treatment of *mudaraba* investment accounts. In response to this, the participants were notified that on 28 December 2014, AAOIFI had issued new standards on investment accounts.

something that can potentially be securitized. Ironically, airline industries are asset-intensive, yet you can innovate to create a *sukuk* based on an underlying intangible concept. The same principle, therefore, can be applied to industries that are asset-light. If we can find ways of looking at different industries and find out what they do, and create guidance around how from a *Shariah* perspective you should look at how to do it[9], this may be the way forward towards innovative Islamic financial engineering. The challenge is that some entity has to pay for this extra work. If you innovate and bring a new instrument to the market, it might not be accepted and issuers are not willing to take the risk.

One participant lamented at the fact that no one has collected and documented all the innovative *sukuk* that have been structured over the years. He stated that there are many examples of innovations in *sukuk*, such as in the airlines industry, the SABIC *sukuk*, and the UAE national bond program[10].

It was suggested that some *sukuk* structures were justified and allowed by *shariah* scholars as exceptional cases, in which case the *shariah* scholars usually will qualify it by, say, allowing it for one year and then reviewing the situation thereafter to see if the same circumstances exist. Another *shariah* scholar provided an alternative view to this. When *shariah* scholars decided that asset-based *sukuk* were permissible, they were not saying it was exceptional. Based on the advice from the lawyers, the understanding was that it is not exceptional. If from the beginning it was made clear to the scholars that *sukuk*-holders have no rights to the asset, i.e., that there is no link to the asset, asset, no link with asset. If this was made clear to the scholars at the onset, they would at least have made it exceptional. But this was not done, maybe because of the lawyers were not clear enough or maybe because the scholars could have done more due diligence. But today, we are clear that this condition is wrong. The scholar asked whether we going to continue to declare asset-based *sukuk* as *shariah*-compliant or not? One way to clarify this issue is for AAOIFI to discuss with lawyers what are criteria for the beneficial ownership existing now. Without settling this, we will have so many opinions from scholars saying that beneficial ownership is right or wrong.

One *shariah* expert took the view that there is a problem in the way that *fatwas* are reached, even at the level of *fiqh* academies. He argued that there should be a broader kind of consultation. Particularly, practitioners need to be involved in the process in order to provide the informative role of explaining how products are structured in practice, the considerations of the different parties to the financing, and the challenges on the ground. *Shariah* scholars need to ensure that they have developed the correct perception of the ground realities. These practical issues on the ground are sometimes neglected by the *fiqh* academies and *shariah* scholars. It is important to have this broader consultation with practitioners without compromising the *shariah*-compliancy aspect.

Conclusions and unanswered questions

One thing that was striking was the disconnect between the scholars and the lawyers. The scholars showed a certain amount of disagreement on asset-based sukuk. There seemed to be two perspectives on the purchase undertaking. One view from shariah scholars is that this is a true sale with two purchase undertakings on each side, but others are saying—with a degree of surprise—that if this is what the prospectuses really say, with all those exceptions to the rights of an actual owner, how can we say this is a sale? In 2008 with the resolution clarifying AAOIFI's standard on sukuk, it is clear some kind of true sale is expected, and a view was expressed during the roundtable that if scholars knew what prospectuses now would be saying, they would not have approved sukuk at the time.

But now the sukuk are out of the bag and are a huge part of the Islamic finance industry and reputationally we are committed. So should this be an exception or accepted? If this is an exception, then it was expressed that

9 The concept of a *salam* sale may be relevant here.
10 The participant referred to the UAE national bond program as a kind of an "Islamic lottery".

there should be a time limit or some kind of future state when it will stop. Why is this disagreement amongst the scholars, that there are some who support the existing sukuk apparently and some who do not, not better understood? How many people are labouring under the idea that this is a sale, but with the purchase undertaking cloaking it? How far is this obscurity experienced? Is it only amongst the scholars?

On the disconnect between the scholars and the lawyers, the lawyers claim that they have been making it totally clear that if this is a sale it is a very shaky, uncertain kind of a sale. You cannot sell the assets and cannot do due diligence. How can the industry continue without some kind of property? And some lawyers say that even if you wanted to do true sales, you cannot do it in a MENA jurisdiction, not without such heavily caveated opinions that only the bold will willingly dare to tread. Some specialised asset-backed securities have been issued, but with people closing their eyes to the risks. And practically speaking there was no sense of what shariah has been calling for all along, and now there is reputational risk. Participants felt that there is a need to look at how the industry has reached this state of affairs.

There are some scholars who do know the situation and accept it, their views have perhaps evolved, and they have considered other interpretations of these contracts and feel they are justified. Now this particular thing is valid as to the purchase undertaking—maybe beneficial ownership is what makes it valid, perhaps there is some confusion there, but they have accepted it. But how can these sukuk keep being issued if scholars are not approving them? Are the lawyers intimidated by the scholars, or maybe the scholars do not want to hear? What can be done to improve this exchange of views? To understand what the law actually means and what are the complexities of ratings—should the scholars be engaging on all those levels? It has impact on what Muslims are doing. One scholar did accept that they need to know more about this and take it into account. Perhaps there is a lack of follow-up, even though the scholars have always said they have an obligation to follow-up after they have given the fatwa.

Outside of fiqh, is there another explanation for how this disconnect happened? Maybe the market is not taking its cue from the scholars anyway and goes where it wants—the prevalence of the commodity murabaha in hybrid sukuk suggests that this may be the case. Then the question is, what other measures does this fact call for? First, that asset-based sukuk should explicitly be declared an exception, accepted by some scholars but an exception to most. These asset-based sukuk are out there in the market—this view suggests that let us keep them but impose a time limit. The other view is simply to stop sukuk issuances. This view suggests that such a strict measure of declaring the asset-based sukuk as noncompliant with shariah would foster and simulate the desired innovation. In either case whether it is an exception or halted, there should be an urgent effort to develop in the Gulf and elsewhere the infrastructure that is needed to do asset-backed *sukuk*, and there should be innovation to create new assets that can be securitized. The market needs this supporting infrastructure and innovation.

What alternative structures are there for Islamic structured products? And where do the incentives come from? The market appears to want bonds. In Islamic finance, the struggle typically is to go against the corporate market's demand (for bond-like instruments) and to create a new financial structure for the Muslim world and other markets. For this, the industry needs an entity to drive that effort, create the incentives and provide the institutions that will allow it to happen. Are there institutions now that will push for greater compliance rather than less?

One of the objectives of such roundtables is to uncover questions that remain to be answered with the hope of motivating researchers to undertake research projects in these areas. In addition to the preceding discussion, questions uncovered by this workshop included:

- What are the different types of transfer of assets and how do the different types of asset transfers affect the condition of recourse to assets?

- What are the different legal refinements of ownership and does the *shariah* recognize these different types of legal ownership?
- Is there a difference between the *shariah* definition of a true sale as compared to the legal definition?
- Is there a need to accept that *sukuk* are not securitizations and accept that they are not the same? Or do *sukuk* structures have to be reformed to be in line with definitions of AAOIFI and IFSB and hence meet the definition of a true asset-backed securitization?
- What are the different analogies that come to mind when thinking about *sukuk*? Are they similar to shares in terms of legal right vs ownership perspective? Is consistency of AAOIFI in question when we think about similar structures such as *ijarah muntahia bittamleek*—why allow one and discourage the other if they are similar?
- Should *shariah* scholars reach a consensus on these issues? If so, how?
- Markets normally dictate the *shariah* standards. How can *shariah* scholars ensure that markets abide by their principles, rather than the other way around?
- What would happen if AAOIFI declares most *sukuk* as non-compliant? How do similar resolutions such as the 2012 OIC Fiqh Academy resolution affect *sukuk* markets? Can they ever be binding? How can we reduce these related tensions?
- What does the future hold? Is there a need to move towards asset-backed securitizations (ABS)? How can we foster more innovative structures? Do fees of registration, title transfer, etc., need to be reduced—is this main obstacle to ABS? Does the entire approach to Islamic securitization and Islamic financial engineering need to be re-considered? And finally, how do we address the prevailing market needs for bonds without assets?[11]

[11] Readers would find more questions related to *sukuk* from economic and legal perspectives in Mahmoud El-Gamal's *Islamic Finance: Law, Economics and Practice* (2006, p. 22, e-book version). The questions that he poses on the economics of *sukuk* are still relevant today.

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LSE–HBKU Workshop | February 12, 2016

Islamic Infrastructure Finance and the Sustainable Development Goals

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Cite this report as: Rehman, A. (2016), Summary report of the 'Islamic Infrastructure Finance and the Sustainable Development Goals' hosted by the Center for Islamic Economics and Finance (CIEF), College of Islamic Studies, Hamad Bin Khalifa University at the London School of Economics on February 12, 2016.

BACKGROUND[1]

In 2016, the London School of Economics and Political Science and Hamad Bin Khalifa University (LSE-HBKU) organized a workshop on the topic of "Islamic Infrastructure Finance and Sustainable Development Goals." The event built on a tradition of similar workshops on Islamic finance held regularly at the LSE since 2007.

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 each workshop is chosen based on a survey of the participants. Participants are then provided background information on the topic and 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.

Following our workshop tradition, Sharia scholars, legal experts, bankers, professionals, and economists from different countries first submitted written responses, then gathered at the LSE campus in London on February 12, 2016, to discuss various aspects of Islamic infrastructure finance and sustainable development goals in detail. Thirteen written comments were received in advance of the event, providing a rich basis for the discussion in advance of the event.

The current document offers a short report from the event, conveying key themes and discussion points. The event was held under strict Chatham House Rules, enabling candid discussion and fostering debate. Remarks are thus not attributed to specific individuals.

OPENING

Role of the workshop

The organizers of the workshop opened the event with background on the forum and its place in the study of Islamic finance. It was noted that the workshop was initiated in 2007, and the current event thus marked the tenth convocation of the gathering.

It was also observed that the event plays a unique role both in the academy and in the industry. The sustained and committed leadership of the workshop organizers and moderator were noted, with appreciation, by the attendees.

Consistent features

Participants commented on the workshop's unique role in bringing together practitioners, Sharia scholars, legal experts, and economists for rich and candid discussion of critical issues. Attendees praised the candor of the event, which, under Chatham House rules, has allowed experts from a full range of disciplines to probe deeply and challenge one another's views in service of rigorous discussion.

Another consistent feature of the workshop noted was the public lecture that precedes it and is open to the general public. The public lecture has been seen to foster enthusiasm and interest among a range of attendees and especially among students and young professionals.

[1] Acknowledgements: This roundtable was moderated by Frank Vogel. The roundtable was organized by S. Nazim Ali, Hussam El-Khatib, Shariq Nisar, and Wijdan Tariq. This report is based on the excellent notes of Jennifer Schwalbenberg. The comments of Frank Vogel and other participants were also instrumental in preparing this report. The usual disclaimer applies. All errors that remain are the author's own.

Recurring issues

The organizers identified a set of five recurring issues that had been present in the workshop over the past decade irrespective of the discussion theme for that year. One such issue is what the very meaning and purpose of the Islamic finance industry are. Another is the matter of identifying (and balancing) short- and long-term objectives in advancing the industry. A third is the question of how the industry links to broader macroeconomic environments in which it operates. Fourth, the workshop has consistently considered pragmatic and commercial considerations facing the industry. Fifth, it has addressed questions of religion and ethics each year over the past decade.

ROUNDTABLE DISCUSSION

The roundtable discussion, over the course of a full day, explored three core themes: (1) infrastructure funding and the role of Islamic finance, (2) supporting the Sustainable Development Goals (SDGs) adopted at the United Nations in 2015, and (3) addressing practical impediments to applying Islamic finance for infrastructure funding and supporting the SDGs. The workshop closed with concluding remarks from participants on the path forward.

I) Infrastructure Funding and the Role of Islamic Finance

Defining "infrastructure"

The discussion began with an attempt to reach a shared working definition of "infrastructure" in the current context. Key features of infrastructure were cited as (1) being used for capital-intensive public works that bring social benefit, (2) adopting a project finance model, with recourse mainly to the project, and (3) often involving governments or public-private partnerships (PPPs).

The challenge of scale

Several participants stressed that infrastructure projects tend to be large-scale in nature, whereas the Islamic finance industry is relatively small. Further, the funding sources of the industry are short-term in nature—it was observed that 70% of the industry stems from retail banking, principally in the form of demand or short-term deposits. This situation creates a challenge in the form of mismatching assets and liabilities: infrastructure assets are long-term in nature; bank deposits are short-term liabilities.

A further challenge associated with scale is the matter of risk management: Islamic financial institutions rightly need to diversify their exposure and limit their concentration to a single project or sector. This impairs their ability to lead major infrastructure projects.

Participants considered ways in which Islamic finance has played—and can continue to play—an important role in infrastructure projects. The Islamic Development Bank, with its extensive portfolio of infrastructure financing, was cited as an example. Participants also cited examples of Islamic banks collaborating with one another and with other financial institutions, with such collaboration dating back over twenty years.

Interaction with conventional finance

A question posed to the forum was how Islamic finance is differentiated from conventional finance in the context of infrastructure. Numerous attendees emphasized that Islamic finance in fact collaborates with and complements conventional finance on infrastructure projects.

An example was cited of a project in which the Islamic finance tranche comprised 2% of the total transaction. In such settings, Islamic finance can require additional documentation and add complexity to the transaction despite being a small share of the total funding.

Attendees noted, nonetheless, that Islamic finance has been able to demonstrate both applicability to infrastructure funding (for example, the 100% Islamic financing of Madinah Airport) and the ability to effectively collaborate with conventional finance.

Sharia considerations

A Sharia scholar stressed that Islamic finance has developed a wide range of innovative structures to meet the needs of infrastructure projects while complying with Islamic law. He noted early innovations that have allowed Islamic finance to participate in common terms agreements with conventional finance—a major requirement to make viable a role for Islamic finance.

Another scholar questioned whether the industry might be trying to "run before it can walk" and thus risk ethical compromises. He noted that a great bulk of rulings allowing contemporary Islamic finance structures are based on minority ("dissenting") opinions of jurists, and that some structures that were meant to be exceptions have often become the norm. A participant later observed that we were "trying to build the plane while flying it."

In the same discussion, it was noted that the industry relies on "asset-based" rather than "asset-backed" sukuk, with only 2% of sukuk being asset-backed. Participants noted that the reason for this is commercial and demand-driven: such structures are being used because that is what the market wants. It was commented that developing even a sub-optimal (but nonetheless Sharia-compliant) structure is an important contribution because it allows Islamic finance to participate.

Participants questioned whether greater ethical differentiation could spark demand. A practitioner noted that clients don't always know what they want until they see it—innovations like the iPhone required vision beyond what customers immediately demand.

Modes and instruments

A practitioner asserted that equity participation in infrastructure offered a substantial opportunity, as (1) it offers attractive financial returns, and (2) it allows Islamic financiers to drive the decision-making on a project's capital structure and its use of Sharia-compliant debt.

Continuing the discussion on sukuk, participants stressed the importance of private sector issuances to broaden and deepen the market. It was noted that the legal environment for sukuk is not equally favorable in every jurisdiction, but progress is being made.

The role of takaful was mentioned by multiple attendees. Using takaful mechanisms for infrastructure projects can be important in reducing the risk of investing in infrastructure. It was further noted that takaful companies are natural investors in long-term assets like infrastructure, although their scale today is very small.

Emerging opportunities

Participants raised a number of emerging opportunities for consideration. One is the rise of green and ESG (environmental, social, and governance) bonds, which have grown to $80 billion and are attracting the attention of institutional investors in emerging markets. If these can be made Sharia-compliant, they can grow the Islamic finance industry.

Innovative initiatives in a range of countries—including Malaysia, the UAE, and Iran—were cited as noteworthy and as potential examples that could be grown and replicated.

II) The Sustainable Development Goals

Maqasid: need for precision

Several participants linked the SDGs with the *maqasid* (objectives) of the Sharia. A view voiced by multiple participants was that the maqasid need to be not only broad concepts, but also be applied concretely to specific goals. A migration was needed from "very vague concepts" to "faith-based economic concepts." Without application, the maqasid might be only a "distraction."

A participant noted that the SDGs were not developed by the religious sector—they were developed by civil society. It is thus not the province of religious scholars alone to develop concrete goals based on the *maqasid*—it is the work of multiple stakeholders. Another participant commented that a "bottom-up" approach to standards is needed, and that governments should not be expected to take the lead. A third participant noted that the Pope has been vocal on financial matters, and has been willing to publicly criticize banks for their ethical shortcomings. Whether Islamic scholars would do the same is a "political" question.

It was noted that the SDGs have provided a robust and concrete framework. The applicability of Islamic finance to the SDGs is (1) a way of articulating its social impact and (2) connecting Islamic finance more clearly to mainstream development finance. This was seen by some participants as an important step to advance the industry.

Importance of pragmatism

Participants commented on the importance of a pragmatic approach to ethical and ESG goals. One practitioner discussed a data-driven approach that analyzes social impact and demonstrates the long-term financial benefits of such investments. Such data could persuade investors to participate in Sharia-complaint ESG funds.

Another participant offered a series of questions to guide a pragmatic approach: "Is it affordable? Is this practical? Can it be scaled?"

Embracing the ESG approach

Participants expressed enthusiasm for the SDGs and for attention to ESG metrics. One benefit cited was linking Islamic finance more concretely to the global development agenda being pursued by multilateral financial institutions including the World Bank, the EBRD, and others.

Participants noted the importance of incorporating elements of the ESG approach that are not customarily considered in Islamic finance. Labor rights and a "living wage" were cited as crucial social concerns that should be incorporated when considering ethical acceptability. A participant commented that environmental and social issues are both important, and "there is a big risk of not thinking about these issues."

II) Addressing Practical Impediments

Project-level constraints

In identifying impediments to applying Islamic finance to infrastructure and to the SDGs more broadly, participants began with impediments at the project level. These can include lack of familiarity with Islamic contracts, challenges generating cash flow, and execution challenges for financiers and for project operators. A participant noted that such constraints, while meaningful, can be surmounted. He noted that parties to infrastructure transactions are sophisticated and that creative structures and solutions can be formulated to address their needs.

Enabling environment

It was observed that macro and environmental factors play a crucial role. One participant detailed his collaboration with a multilateral development bank regarding Islamic finance regulations in a North African country. In addition to issues specific to Islamic finance, there exist broader issues of commercial law such as the bankruptcy regime and rules for SPV formation.

In-depth research

Several participants commented on the need for high-quality, in-depth research. One of the topics highlighted for research was bankruptcy regimes and Sharia compliance. Another topic was the introduction of Islamic finance regulations in civil law jurisdictions. A third was the area of tax. Participants underscored the challenges of research; one noted "when you get down into the dirt, it's really hard work."

Participants specifically referenced initiatives in Saudi Arabia that are engaging large numbers of young scholars and researchers in Sharia and commercial law. A Sharia scholar related his own experience of working under a senior scholar who "taught me in a year in a bank more than I learned in all my time in formal education in Sharia."

Academics noted the significant volume of interest in Islamic finance among doctoral students. A key challenge observed in this respect was a scarcity of properly qualified supervisors for such students' dissertations. It was noted that the inconsistent quality of supervision was a risk to the quality of research. A participant suggested that doctoral candidates be engaged in field projects with practitioners, which would enhance their capacity to conduct research on critical issues.

CONCLUSION

In concluding remarks, workshop participants were asked to comment on what needs to be done and who should take responsibility for undertaking the actions discussed.

Participant responses underscored the issues cited previously, with three additional themes emerging:

1. The opportunities and challenges pertaining to Islamic finance, infrastructure funding, and addressing the SDGs are complex and nuanced;
2. Advancing these opportunities and addressing the challenges is the collective responsibility of the industry's stakeholders (practitioners, legal experts, Sharia scholars, academics, industry organizations, etc.); and
3. The workshop attendees remain enthusiastic about directly participating in advancing research and practice on the issues discussed

APPENDIX I: LSE WORKSHOP THEMES

The LSE Workshops on Islamic Finance have been organized in conjunction with Harvard Law School (2007-2014) and HBKU (since 2015), with themes as follows:

2007	Tawarruq: A Methodological Issue in Shari'a -Compliant Finance
2008	Sukuk: Economic and Jurisprudential Perspective
2009	Islamic Economic and Islamic Ethico-Legal Perspectives on the Current Financial Crisis
2009	Microfinance: Toward a Sustainable Islamic Finance Model
2010	Islamic Financial Ethics and Ethical Governance
2011	Reappraising the Islamic Financial Sector
2012	Islamic Financial Intermediation: Revisiting the Value Proposition
2013	Insolvency & Debt Restructuring in Islamic Finance
2014	Use and Abuse of Limited Liabilities
2015	Revisiting Islamic Securitization and Structured Products
2016	Islamic Infrastructure Finance and the Sustainable Development Goals

APPENDIX II: WORKSHOP ATTENDEES

MODERATOR
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Shariq Nisar, *Adjunct Professor*, ITM, Mumbai, India
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THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

جامعة حمد بن خليفة
HAMAD BIN KHALIFA UNIVERSITY
كلية الدراسات الإسلامية
College of Islamic Studies

Workshop on

FINTECH AND ISLAMIC FINANCE:
Applying Hiyal & Makharij and other Islamic Principles

Thursday, February 23, 2017
8:30a.m--5:00p.m.

London School of Economics
Box Room, 5th Floor, Tower #3
London, United Kingdom WC2A 2AE
Directions: http://www.lse.ac.uk/mapsAndDirections/campusMap.pdf

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كلية الدراسات الإسلامية
College of Islamic Studies

LSE–HBKU Workshop | February 23, 2017

FINTECH AND ISLAMIC FINANCE

Applying Hiyal & Makharij and other Islamic Principles

Edited & Compiled by
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Cite this report as: Djafri, F. (2017), Summary report of the 'LSE-HBKU Workshop on Fintech and Islamic Finances' hosted by the Center for Islamic Economics and Finance (CIEF), College of Islamic Studies, Hamad Bin Khalifa University at the London School of Economics on February 23, 2017.

INTRODUCTION[1]

On February 23, 2017, the London School of Economics and Political Science (LSE) and Hamad Bin Khalifa University (HBKU) organized a workshop on "**FINTECH AND ISLAMIC FINANCE: APPLYING *HIYAL* & *MAKHARIJ* AND OTHER ISLAMIC PRINCIPLES**". The workshop theme was selected by the participants who had attended the previous workshop on Islamic Infrastructure Finance and the Sustainable Development Goals on February 12, 2016.

The emphasis of the workshop was not meant to review contemporary Fintech technology, products and processes, but rather focus on the Shariah related challenges Islamic finance must address to ensure their compliance. Therefore, the main purpose of this workshop was to explore whether to use and apply the A*hkam Fiqhiyya,* and/or, *Hiyal, Makharij* or other exception based Islamic principles, to achieve a specific *Masalah* or *Masalih*, within this chosen contemporary area of Islamic finance, i.e., Fintech. More specifically, the objective of the workshop was to examine the proposed theme from the following angles:

1. To understand and to review Fintech as currently practised and applied to Islamic finance, the relevance of achieving Shariah compliance.

2. Shariah Compliance - What are some of the current Shariah issues in Fintech and what needs to be looked into to ensure continued or even improved Shariah compliance and the evolution of Islamic finance.

3. *Fiqh* & *Ijtihad* – How to apply the best use of Islamic *Fiqhi* tools (*Hiyal* & *Makharij* and *Dhara'i*) to Fintech driven products, services and contracts. The question is should we wait for issues to emerge and mature or should we be proactive and be prepared with a suitable and timely response.

4. *Maslahah* Determination – How can we continue to apply *Maqaṣid al-Shariah* and agree on the ideal *Maslahah* for new technologies, especially those that challenge existing structures and methods? How to determine and deal with disagreements on *Maslahah*?

This document is a summary/report of the event, conveying key themes and discussion points of the workshop. Annotations are therefore not assigned to a specific individual.

OPENING

The workshop began with an opening remark on behalf of the London School of Economics (LSE) and Hamad Bin Khalifa University (HBKU) by Professor Syed Nazim Ali. This was followed by an introduction by Professor Frank E. Vogel who thanked the organizer of the conference for making it happen, and he commented on the event's unique role in bringing together Shariah scholars, activists, lawyers, economists, practitioners and academicians for candid and rich discussion on critical issues in the industry. After that, the roundtable discussion, over the course of a full day, examined four core themes, namely:

[1]**Acknowledgements:** This roundtable was moderated by Frank Vogel and organized by S. Nazim Ali and Hussam El-Khatib. This report is based on the excellent notes of Stephania Prashad. The comments of Frank Vogel and other participants were also instrumental in preparing this report. The usual disclaimer applies. All errors that remain are the author's own.

- Islamic Fintech - differentiating it from conventional;
- Applying the *Ahkam* or *Hiyal* & *Makharij* in the context of Islamic Fintech;
- Determination of *Maslahah* in Fintech; and
- Exploring the way forward for Islamic Fintech.

1. Islamic Fintech - Differentiating it from Conventional

The first session began with a presentation of 15 minutes on the overview of Fintech in Islamic finance and the key issues faced. This was presented by Professor Volker Nienhaus. The speaker highlighted that there is an interest in Fintech but the people who run this are usually not experts in finance or Shariah. He added that many Fintech products and procedures seem to be not in full harmony (compliance) with formal requirements of Islamic contract law in general and Shariah nominate contracts in particular. He argued that the fundamental issue is the reliability of information on a fund seeking project in general and on its Shariah qualities in particular. For Instance, a Muslim investor has to be sure that the contracts of"Islamic" P2P equity or financingfinancing platform, as well as the use of the funds by the recipient(s), are Shariah compliant. The speaker mentioned that, to ensure the Shariah compliance of contracts and projects, the platform operators would have to play a more active role than operators in the conventional finance industry. The consumer protection regulations for conventional crowdfunding, for instance, will not be sufficient for Islamic schemes where the Shariah compliance of contracts and of the of use of funds are essential for the financer/investor. To this extent also Blockchain allows new tools to enhance Sharia Governance and ensure the implementation of the required steps.

The speaker then moved to talk about whether Islamic finance is reactive or proactive. He stated that Fintech products and structures are not an alternative to Islamic finance but new phenomena within Islamic finance. Islamic finance, by definition, is proactive but the question could be narrowed down to Islamic banking. Fintech start-ups such as equity crowdfunding or Islamic P2P financing platforms begin to challenge Islamic banks that have to react. He concluded that the determination of *Maslahah* in the Fintech world is a very risky issue. It is not even clear whether and how Fintech innovations such as cryptocurrencies, smart contracts, robo-advisors or matchmaking platforms relate to the public good. As such, the regulatory framework that covers Islamic Fintech should be there in addressing consumer protection and market conduct issues.

After that, the floor was opened for the participants to share their views on the difference between conventional Fintech and Islamic Fintech, and the impact of Fintech on the compliance of the products. Several participants stressed that Fintech is an enable and it is considered as the application of technology within the financial industry. It refers to the innovative use of technology in the design and delivery of financial services and products. From the Shariah point of view, the adaptation of any supporting services in Islamic finance is much encouraged and is within the permissible areas of development in Islam. Besides, some Participants revealed that there is no real difference in either substance or outcomes between conventional Fintech and Islamic Fintech and they are simply facilitating tools.

One of the participants suggested that we need to understand what the status of Islamic finance industry is in current digital finance era to get to the root of compliance. He added that Bitcoin relies on the blockchain technology, but how does it work and how are these things governed? Where does it stand? What are the challenges faced by Islamic finance industry? What are specific Shariah issues in the light of emerging new technology and contracts? And how will Shariah scholars respond to all these issues?

In response to the above questions, one participant informed that Bitcoin is just an example of cryptocurrency and Fintech goes beyond just cryptocurrencies, as it covers a wide spectrum of application of innovative technology in financial services. So in lieu of limiting the discussion to cryptocurrencies, other potential applications such as online crowdfunding platforms, smart contracts through the use of blockchain technology, and online dispute resolution platforms for Islamic finance may raise new solutions as well as challenges. By emphasizing on blockchain technology and the significance of smart contracts, Islamic banks may leverage on this for Islamic finance agreements.

Another participant noted that Bitcoin may constitute an effective instrument for the further development of Islamic finance. Islamic finance imposes different requirements compared to conventional financial policies on a monetary instrument concerning its use as a tool for achieving social and economic justice. He added, most eminent Shariah scholars are keeping their minds and hearts open and maintain a close look at developments in the wider cryptocurrency world.

The discussion then moved on to discuss the importance of having Shariah space for people to bring ideas. One participant noted that there is an interest in setting up safe spaces where people can regulate. However, the innovators are not following regulators and the regulators are sitting back and seeing what is happening. Another Shariah scholar stresses that Shariah compliance in Fintech operations and practices should be taken into consideration by the regulator or authority so that Muslims consumers are not sceptical to utilize its services.

In the same discussion, it was noted that, out of the 53 notation platforms and 13 equity platforms available, only 3 equity and 2 loans based are Shariah compliant. The equity-based are mostly in real estate finance in Singapore and US. The rapid growth of the Fintech sector is expected to change the financial landscape in the future and potentially disrupt the traditional models of banks and financial institutions

It was revealed during the discussion that the developments in the Fintech sector can be classified into two spacious categories:

- The first one relates to innovations in operations and infrastructure which includes blockchain, application programming interface ecosystems, payment infrastructure, artificial intelligence, etc. and
- Second, relates to providing different products and services. The trends of recent Fintech products include retail services (e.g., digital, peer-to-peer financing), wealth management (robo-advisory, crowdfunding, social investment), insurance, capital markets and investment banking, small and medium enterprises (e.g. peer-to-peer and next generation financing) and payments (e.g. mobile payments and international remittances).

After all, the participants agreed that Islamic Fintech has no additional distinction or enhancements of any kind over conventional Fintech forms of financing. The participants agreed that there is no real difference and they are simply facilitating tools. Most of them stressed that technology is just a means.

2. Applying the *Ahkam* or *Hiyal* and *Makharij* in the context of Islamic Fintech

The discussion began with an attempt to reach a shared practical definition of ***"Hiyal"*** and ***"Dhara'i"*** *in the current context. Key features of these terms were cited as:*

Hiyal means legal loopholes or artifices; and
Dhara'i (plural: *Dharai*) means pretence or instrument or means.

Hilah and *Dhara'i* are among the two common terms often discussed with relevance to *Sadd-al- Dhara'i* in the *Usul al-Fiqh* discourses. Both are similar in the sense that these act as determinants of legal rulings, whether or not an act is permissible or otherwise.

One of the participants conferred that many jurists have rejected all *Hiyal* with an invalid means, however, Ibn *Qaiyyim al-Jauziyyah* argued for accepting all *Hiyal* which uphold justice and establish the *Maqasid al-Shariah*. Likewise, the *Dhara'i* also play vital roles in accomplishing the *Maqasid*. The relationship between the two is so interconnected that the M*aqasid* would not be fulfilled without the means. Therefore, the impacts of the *Dhara'i* on the *Maqasid al-Shariah* in general, and on the *Maqasid al-Muamalat,* in particular, is immense. In other words, Islamic jurists have accepted the use of many *Hiyal* depending on their compliance with the *Shariah* and fulfilling their objectives (*Maqasid al-Shariah*), establishing justice, or preventing injustices.

The discussion then moved on to discuss the applications of *Hiyal*, *Makharij* and *Dhara'i* to Islamic Fintech. Most of the participants were of the view that Fintech is an innovative service, which is no doubt expected to contribute to the expansion and growth of the Islamic Finance Institutions (IFIs). Such an innovative tool, however, could be considered as a *Dhara'i* (means) leading to a service or benefit (*Maslahah*), and not necessarily a *Hilah* or *Makhraj (*artifices), since the application of Fintech is not intended to divert any legal rulings (*Aḥkam*) of a transaction. Rather it is used as a smart tool in facilitating the regular financial services of the IFIs.

According to a Shariah scholar, *Hiyal, Makharij* and *Dhara'i* are necessary and in fact are inevitable. Shariah contracts should not be restricted to the replication approach to suit the feature of conventional finance products. Innovation through Fintech shall be explored to emphasise the value proposition of Islamic finance such as how to use technology to manage risk in *Musharakah* and *Mudarabah* model of financing or how *Istisna* and *Salam* can be operated using Fintech.

Another participant stated that Bitcoins are digital currencies, which could be easily created (or minted) by solving cryptographic equations; however, these are extremely volatile, with high chances of speculation, and there is lack of control due to decentralization of its creation. There is also a risk of hacking and criminal misuse of technology. The intrinsic value of the Bitcoins may also be questionable, as it needs to be backed by tangible assets under Shariah parlance. He raised several questions about what would be the *Nisab* for *Zakah* to be obligatory upon the owner of the Bitcoins, or if the *Zakah* itself could be paid with the Bitcoins?

In response to the above questions, one participant mentioned that Bitcoin is still in its infancy phase, thus it requires further development to provide any concrete Shariah answer. However, the Shariah scholars should endeavour to determine the Shariah perspectives of Fintech and its relevant services, and guide the IFIs towards incorporating the digital technologies. Fintech is a global trend, and a reactive approach towards it could render IFIs to lag behind their global competitors. Thus, the roles of the Shariah scholars along with IFIs are vital for a proactive approach towards Fintech and its related services.

After that, the discussion went back towards how to make the best use of Islamic *Fiqh* tools (*Hiyal and Makharij* and *Dhara'i*) to new Fintech driven products, services and contracts. Participants agreed that we cannot ensure the elimination of *Hiyal, Makharij* and *Dhara'i* in dealing with Fintech, it is important to note that the evolution of Fintech should trigger Islamic finance industry players for innovations and creativity by supplying new perspective and practice in financial transactions. Shariah scholars and industry players in this regard must work together to produce innovative Shariah compliant products that fulfil the needs of society and realize the *Maqasid al-Shariah*.

3. Fintech – Determination of *Maslahah* in Fintech

The discussion on this began with a recap of the importance of Fintech to Islamic finance and how it can contribute positively to the development of the Islamic financial products and services offering. Among the questions that have been raised during the discussion were about how to determine *Maslahah* for new technologies and how to deal with disagreements on *Maslahah*?

Participants spoke briefly about introducing Fintech in the financial sectors will result in shorter transaction chain, reduced operational cost, the enhanced resilience of operational processes, ability to access new customer segments to increase revenue and improved capital efficiency. Besides, Fintech innovations and high penetration of mobile technology promise to enhance financial inclusiveness by bringing in a larger segment of society. All these benefits can be considered as *Maslahah* to the customer and whole practice of financial operations.

One participant asserted that Fintech in the Islamic finance space can contribute positively to the evolution of Islamic financial products and services offering. Through the elimination of intermediaries, operating costs are lowered whilst the potential returns are higher. Crowdfunding and Peer-to-Peer financing provides the platform for alternative techniques such as *Musharakah* and *Mudarabah*-based financing, which have struggled to settle in the space occupied by traditional Islamic institutions, as well as their conventional counterparts.

According to an academician, the impact of technology on Islamic finance is considered as a real opportunity to enhance research and education in Islamic Finance. More multidisciplinary research could be created and encouraged such as IT, finance and Shariah. The industry should support conferences and workshops in these new multidisciplinary of fields. Universities also are encouraged to reflect these technological changes and developments in its textbooks, classes and students.

In contrast, one participant had a different view on the determination of *Maslahah* in Fintech. He raised several questions about how do we consider the *Maslahah* in robo-advisors for portfolio management? More importantly, what is the value of Shariah robo-advisors or robo-advisors for Shariah-compliant products? This might pose a significant legal, operational, reputational and Shariah risks to Islamic finance transactions. He added, can investors trust robots to render better investment advice in Shariah-compliant transactions? Can we replace Shariah Officers in financial institutions with robots? This would have some implications for consumer protection laws and agencies. Therefore, *Maslahah* determination of Fintech should consider the imperativeness of legal and regulatory framework to avoid market abuse which is currently being experienced in some cryptocurrency applications.

A Shariah scholar remarked that Shariah aims at establishing *Maslahah* that would contribute to the wellbeing and welfare of the people in this life and the life hereafter. As such, the practice of transactions in Fintech application should follow the rule of contract used in the transaction by observing the pillars and conditions of the contract. In addition, Fintech application should also aim at achieving the objective of Shariah (*Maqasid al-Shariah*), namely to realize the benefits (*Maslahah*) and avoiding the harms or difficulties (*Mafsadah* and *Mashaqqah*).

After that, it was concluded that Fintech is impermissible only if there is clear evidence that it is in conflict with Shariah principles, such as presence of prohibited elements in a transaction – *riba*, *maysir*, *gharar*, etc. The transaction must also be transparent with no hidden costs, irresponsible or unethical financing. On the issue of the regulatory framework, participants suggest that a firm that operates within the framework must commit to observing reasonable standards of service, transparency to customers and appropriate funding and reporting requirements. A proper Shariah governance framework would also ensure that the operations of Fintech are in compliance with the Shariah to minimize Shariah non-compliance risk to firms who utilize Fintech, thus reducing dispute and conflict. To an increasing degree such governance can be embedded part of the FinTech solution, akin to RegTech.

CONCLUSION _ EXPLORING THE WAY FORWARD FOR ISLAMIC FINTECH

In concluding remarks, participants were asked to comment on what needs to be done to contribute positively to the evolution of the Islamic finance. Most of the participants expressed the view that Fintech enables innovative and flexible organizational structures and business models to enhance financial inclusion. It has the flexibility to adopt business models that can provide various financial services in a more efficient way. Besides, Islamic finance has an opportunity to use this new trend to reorient itself by introducing innovative business models that will help fulfil its broader goals of *Maqasid al-Shariah* and reflect its values and principles.

In addition, participants noted that the deployment of Fintech applications for Islamic financial services and products should not only be properly regulated under the laws of different jurisdictions but the emphasis should also be placed on Shariah governance. Regardless of the numerous advantages inherent in Fintech applications, its significant regulatory challenges remain a major concern in the global Islamic finance industry. Therefore, proper Shariah governance framework would ensure that the operations of Fintech are in compliance with the principles and precepts of Shariah. Further, developing Shariah standards that is related to Fintech by international standards-setting bodies such as AAOIFI and IFSB.

In addition to the preceding discussion, questions uncovered by this workshop and proposed for future discussion included:

- Further study of peer-to-peer banking model that Fintech companies can facilitate and how could that benefit the development of the Islamic Banking and Finance industry;
- Address the concerns attached to the Fintech sector, particularly the concerns of regulators and consumer groups;
- Assessing current Islamic social finance projects (WAQAF/ZAKAT);
- Regulations of Islamic social finance products.

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