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Contemporary Islamic Law and Finance: The Tradeoff Between Brand-Name Distinctiveness and Convergence

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Thank you very much for your kind introduction. I assume that you have invited me to speak at this Symposium because of the great potential for lawyers to engage in Islamic finance. Indeed, most of the benefits of Islamic finance to-date have gone to lawyers, as the bankers here will attest to. In the meantime, the customers may not be getting all the value that they're hoping for. This is a young industry that is still reinventing the wheel, which is still a little square-ish. Eventually we'll get to a round wheel, I hope.

One thing, for those who've never heard about Islamic Finance, that comes as a surprise to them is that Islamic Finance is a very, very recent phenomenon. It is a brainchild of the Islamists' Identity Politics of the mid 20th Century and it grows with petrol-dollar flows. The biggest surge in Islamic Finance started in the 1970s, with the first and the second oil shocks of '73 and '79. There was another surge after 9/11 with some of the money that got repatriated to the region, and then there is another surge now because of the new wave of petrol-dollar flows, with oil selling well above $100 a barrel.

The theory behind Islamic Finance, as it was born in the 1970s, was that Islamic Law emphasizes issues of equity even over issues of efficiency and growth, at times. Therefore, there was a theory that if you had an Islamic Finance then your economy would be more equitable, more fair, et cetera. However, when people examined the nitty-gritty legal details, and started hiring lawyers and Islamic jurists, the issue of Islamic finance became a much more formalistic exercise. Instead of thinking, what are the objectives, why do we need an Islamic Finance rather than a regular finance, it became, well, how do we make this permissible?

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So you examine the list of rules for financial transactions, as codified in medieval texts, and you treat them the same way you treat, say, dietary rules. It also so happens that in the 1980s there was a revolution in the UK and the U.S., in the area of regulatory arbitrage, where lawyers went into finance and basically revolutionized it. It was very easy to take these same tools right off the shelf and just like a corporation, Enron or another, would want to take debt and interest paid off its balance sheet, restructuring the debt instead in terms of an operating lease off balance sheet (by selling its assets to a special purpose vehicle and leasing them back). It was easy to recognize those structures as "interest-free finance" and therefore to repackage the same instruments as "Islamic Finance", and that introduced a new financial revolution in the Middle East.

Some may think that I am being too critical of Islamic Finance sometimes, but I am simply doing my job as an academic. To be charitable to the industry, I have to say, as an economist, that one definition of a great entrepreneur is one who can create a market for which they are the only supplier. I think that the Islamic Finance industry has grown primarily because the *Shari'a* advisors, who serve to certify something as Islamic or otherwise, also serve as promoters of the brand name and as creators of the market. Essentially, they tell the potential customers and other Muslims around the world that engaging in conventional finance is impermissible, that it's one of the gravest sins, and now they have to buy the synthetic financial products that the jurists have manufactured.

If you can create your own demand, that's great entrepreneurship. Early on, it's all about legal arbitrage. You hope, eventually, that there will be value created for the customers. Think about a simple mortgage - this is a debate I've had multiple times and some of you have seen this version of it before. When I was saying this five, six-years ago, when all real estate prices were going nowhere but up, people were laughing at me. But you think today, if I have a mortgage, and I have the bulk of my net worth in my home, I would have hoped that whoever I financed with would share some of my equity losses, as the bubble in the real estate market starts to deflate. Wouldn't that have been nice?

But that is not what the bulk of Islamic Finance has been about, although I do admit that some initiatives in Islamic finance did attempt to provide equity-based models. Islamic Finance as generally practiced takes a mortgage, declares it to be forbidden and warns of great punishment for those who use it to finance their home purchases. Then the industry manages to sell the same product for a little bit more, after characterizing it as something different from a simple mortgage.

Consider a typical mortgage, something that we all understand. In my case, I first decided who was going to build my house. Then, I went to a bank, and the banker agreed that they will pay for 80% of the house, and I will pay for 20%. We went to the title company, I wrote my check for 20%, they brought the check for 80%, and both checks were consolidated by the title company, and paid to the one who built the house for me. The title for this property was split in two, I got the equitable title, my mortgagee got the legal title, and I pay for it over 15-years until I fully own the house and the title is reunited in my possession.

The way Islamic Finance proceeds, typically, is to come to this transaction and say that the contract that was written with the mortgagee was called a loan. Take the word "loan" and translate it back into medieval Arabic as *qard*, and that's money for money. It is thus assumed that the mortgagor is paying interest on money, which is forbidden usury or *riba*.

To reach this conclusion, one must characterize my mortgage transaction in a manner that is excessively simple, and patently false. Under that characterization, I am assumed to have received a check for 80% of the price of the house and to be paying that money back, plus interest. In other words, the assumption is that I consolidated that money with the money that I had saved to buy the property, and ultimately to have borrowed money for interest, which is a forbidden transaction. That's a completely false characterization of my transaction.

When one actually studies Islamic Law, one finds that in a loan of money, the borrower owns whatever is lent and can do whatever they want with it. There is an obligation now to pay back that money, whatever amount it is, but the borrower owns the money. This means that our prospective mortgagor could have taken that money and bought a Bentley instead of the house. In fact, however this is not the case in a modern secured transaction, where the borrower never owns the lent money. Of course, the industry survives by picking and choosing words from the medieval law (e.g. equating a mortgage "loan" to medieval monetary loans) to create the illusion that this was a usurious loan that is forbidden.

A number of medieval legal devices are available to restructure the "loan" in a manner that makes it appear different. One of the oldest workhorses of the industry, from its earliest days in the 1970s, was invented by the late Dr. Sami Homoud, a Jordanian Central Banker who studied in Egypt. In that model, known as *murabaha* financing, the mortgagee has to buy the property first, outright, and then sell it on credit. Instead of just buying basically the legal title part and selling it on installments, the mortgagee thus buys the property outright, takes ownership of the title, and then sells the title to the mortgagor. This introduces various legal problems, depending on the jurisdiction. In the UK, the Financial Services Authority [FSA], decided that for the purpose of home financing, based on HSBC lobbying, they will allow this property flipping to be conducted with only one property tax being paid, even though there are two transactions and the title gets transferred twice.

That, of course, creates another host of legal-arbitrage opportunities, especially during a housing bubble, when arbitrageurs may wish to conduct property flipping for another reason.

Returning to our main theme, let's ask if there is any value added by this type of Islamic Finance? The answer has to be a resounding no, unless there were customers who were locked out of that market by their own religious choice, and now the industry has created some alternative for them. Somebody who had no access to credit, according to this argument, may now have a more expensive alternative to credit. Well, maybe that's better than nothing. Then again, because this is supply creating its own demand, it's not quite clear that there is value being added there.

In addition, there's a host of potential protections against predatory lending that may be violated by the industry. One of the main customer-protection measures in the U.S. are truth in lending provisions. According to regulation Z, Islamic financiers still have to report the interest rate whether the transaction is characterized as a credit sale, a lease, or anything else.

But you can imagine that other countries do not have similar truth-in-lending regulations. Professor Al-Misri at King Abdulaziz University in Jeddah explicitly asked industry practitioners to call their financing charges "interest," because we have usury laws that put a ceiling on interest. But if we call it profit in a sale, he argued, then the problem is that we have no rules about the limits on profits in a sale. So this will be ripe for predatory lending. Needless to say, we know that mortgage financing is indeed an area where there has been a record of predatory subprime lending to minorities in the U.S., despite regulatory protections. You can imagine what may happen in the Islamic world where there are much weaker regulations and customer protections.

Now the legal arbitrage path in Islamic Finance is made possible because of the legal fixation on contract forms in medieval Islamic jurisprudence. The industry thus follows a purely formalistic approach. There are certain contracts that are allowed and certain contracts that are not allowed. This dichotomy is grossly inadequate in today's age of financial engineering. Naturally, in a primitive society where there was no efficient way to document debts and titles to property, and so on, it was reasonable to resort to simple rules that permit or forbid certain types of transactions.

But even in the ancient times, at the time that Islamic scripture was codified, people knew that there were ways to get around these transactions. If I wanted to engage in a usurious loan at 100%, well, instead of giving you $1 now demanding $2 later, I sell you a pen that's worth $1 for a credit price of $2, knowing that you'll sell this pen to obtain $1 in cash. You get the $1 now, and you owe $2 later, it's the exact same transaction. Indeed, you go back to the 14th century and you find scholars who are writing about this type of transaction and wondering if usury on the ground is better, or usury atop a tall ladder where you can fall and break your neck, especially if it's also costlier, because one adds all these spurious trades just to make the transaction fit into a mold.

A lawyer-turned-banker friend of mine once told me that the problem with Islamic Finance is like trying to fit a square peg in a round hole. My response was, that must be why they're cutting so many corners. It's clear that the objective of the law was protection of the customer. However, the end result of

"Islamic finance" is to provide the customer equal or more risk and a higher cost. Then, by definition, that's not what the law has intended.

Indeed, in the area of transactions it is a matter of Islamic legal theory that the objective of the law is always the benefit of the customer. Therefore, if one's reading, even of the canonical text, suggests something that is provably detrimental to the financial health of the customer, then one must have read the text wrongly. One then has to re-read the text and try to understand what it means. It is impossible for the law to have the intention of enriching people at the customer's expense.

Now the history of religious-legal restrictions on commerce has always had a built-in arbitrage opportunity. Even if one were to go back to the Code of Hammurabi, one would find that there are two different interest rates for in-kind loans and monetary loans. That's an immediate arbitrage opportunity if there ever was one. If I can lend at one interest rate in money, and I can lend at a different interest rate if I'm lending wheat, then this will turn into a money pump by doing a series of loan transactions (borrowing at the lower rate and lending at the higher, with trades in between).

We may look at the prohibitions of usury (*ribit*, *riba*) in the Bible and in the *Qur'an*, and attempts to explain what was the purpose of all these prohibitions. One of the best economic explanations of course, is the one by Glaeser and Scheinkman in the *Journal of Law and Economics*, where they suggested that in ancient poor societies, usury laws were a great form of social insurance. Most people were going to be very poor; very few people were going to have wealth, which justifies the rule that the wealthy have to lend to the poor at zero interest, as a form of social insurance.

To avoid the prohibition of usury, rabbinical tradition introduced the *Heter Isqa* contract, which basically is a silent partnership. In Islamic Finance it would be called a *mudaraba*. In some variations on this contract, principals fixed the interest rate while calling it a profit share. There is an incident in the appellate court in New York, 1960, which looked at this attempt to avoid usury and said that the transaction complied only in form with the rules against interest, but in substance, the transaction was an interest-bearing loan.

In Islamic Finance, similarly, there have been a couple of cases that were brought before British Courts and there, too, the Islamic banks eventually got their interest. The plaintiffs in those cases were claiming that the contract should be voided because it claimed to be in adherence to the *Shari'a*, but was really interest based. English courts saw it differently, voiding the Islamic-*Shari'a* provisions and awarding interest payments.

Under the Catholic ban on interest the Medici proto-bankers found effective ways of bundling interest rates with exchange rates in bills of exchange. You'd pay money in Florence, in one currency and then you collected in another country and another currency, where the effective exchange rate has the interest rate built into it.

In Islamic Finance, the issuance of *sukuk*, or Islamic bonds, has become one of the success stories. *Sukuk* is the plural of *sakk*, the Arabic precursor of the word "check." It just means documentation of debt. Until recently, when it resurfaced in Islamic Finance, I had only heard the term *sukuk* within the context of indulgences, which the Eastern Church called "certificates of absolution," or *sukuk al-ghufran*. Islamic finance now refinances or issues new bonds by selling properties to special purpose vehicles and leasing them back, paying principal plus interest in the form of "rent." This looks just like the typical structured-lending operations that were used in the 1980s and '90s, and that led to some legal problems in the case of Enron, for example.

What enables this industry to prosper is that lawyers are doing exactly what they should. It is for this reason that I and others publish analyses that make the tricks of Islamic-finance legal arbitrage transparent to all, thus expediting the arbitrage process to make markets more efficient. In this regard, the lawyers are in fact providing a valuable service, as they collect their fees.

The other component that enables this industry, however, is much more problematic, and that is the "bait and switch" by the religious scholars associated with this industry. Those scholars appeal to rulings that are immutable and that don't necessarily have to make sense, like dietary laws. Then they transfer the frame of mind of formalistic adherence to dietary rules to the area of finance, where the legal tradition has never been that formalistically pietistic. The Islamic legal tradition in financial transactions has always been adaptive.

For instance, the *Shari'a* board of HSBC Amanah finance answered a question about the similarity between their financial methods and rates on the one hand, and the conventional instruments on the other, by appealing to dietary rules. They argued that if you have a butcher that obeys the kosher laws and one that doesn't, the meat would be essentially the same but you can't argue that the kosher meat is not kosher just because it's sold for the same price as the non-kosher meat. This is a non sequitur, because the object of finance is not meat, but also because one conducts a sale or lease with the ultimate objective of financing, which is exactly how the lawyers present the structures to regulators.

Industry lawyers need to characterize each financial instrument in two ways. The first characterization is meant to satisfy the *Shari'a* scholars, by showing there is no interest-bearing loan. Then, the second characterization shows the regulators that there is no material difference between this transaction and the standard interest-bearing lending conducted by banks.

There are three steps, then, for an Islamic Financial transaction. The first is prohibition. You inspect some instruments that produce a desired financial outcome and declare that this transaction is severely forbidden in Islam. The way this may be accomplished, as explained earlier, is by drawing false analogies, to dietary laws, or methods of prayer, et cetera. Another method described earlier is to use a bit of mistranslation. For instance, you take the word "*riba*" and you claim that all *riba* is interest and all interest is *riba*, when this is demonstrably false from the canonical text as well as Islamic jurisprudence.

This first step, prohibition, creates a market niche, a cornered market. The next step is to provide a product for that cornered market. This requires more false analogy in order to synthesize the exact same ostensibly-forbidden product from medieval contracts. One need not try too hard because one may take a contract that's already in a 10th century book, and use its name only, retaining only some of its attributes but transforming the mechanics and objectives completely.

For instance, the workhorse I mentioned earlier, the buy-sellback, is often called *murabaha*. When one inspects the classic books of jurisprudence, one finds that *murabaha* is simply cost-plus sale. For example, one may go to the car dealership and negotiate the mark-up over invoice, trusting the seller to reveal their cost of acquiring the car. This allowed Bedouins who don't know local prices to conduct commerce with minimal potential for exploitation.

Combining this simple cost-plus structure with a credit sale produces the modern form of *murabaha* financing. The interest is now characterized as a margin of profit that is collected over time. Of course, that time component is justification for the entire profit, and the credit rating of the debtor determines whether the "profit" should be high or low. Then, of course, that "profit" is nothing but the price of credit, which we conventionally call interest.

The end result has very little in common with traditional *murabaha*. However, the simpleton customer will find the name *murabaha* approved by various classical scholars in traditional books of jurisprudence, and thus feel confident that the transaction is permissible. Thus, the modern scholars derive their authority from the old scholars' opinion.

The final brand-name of the product is thus a combination of the Arabic names of classical contracts (which bear only slight resemblance to the modern transactions using their names) and the names of modern scholars who are vigorously marketed by the industry's bankers. Thus, the bankers are essentially codifying Islamic law, because they get to choose whom to hire, and if they don't get the *fatwa* they like, if they don't get the opinion they like, they can hire somebody else. In addition, if the bankers receive many different opinions, they can show only the ones that they like.

If the bankers' questions do not produce the desired answers, they can modify their questions. There are examples, even in the gulf, where a solicited *fatwa* on trading gold on credit deemed the practice forbidden. When asked subsequently if it is permissible to trade platinum on credit, the desired *fatwa* was obtained, allowing interest-based lending through such credit sales.

The danger, of course, is that many of the new financial instruments, for example, the bonds marketed as *sukuk*, contain mammoth risks that we do not understand fully. We pretend that we understand the risks associated with those structures through bankruptcy-remote special purpose vehicles, but unless and until there's a bankruptcy proceeding, nobody knows how much risk there is. There are currently many billions of dollars in such structures.

Another area that leaves a lot to be desired are the so-called *Shari'a* compliant mutual funds. Some of the rules followed by those funds, for example refusing to invest in breweries, make perfect sense. However, those funds also have strange financial rules that are pulled out of thin air. In order for companies to qualify for *Shari'a*-compatible investment, those rules suggest, the debt to market capitalization ratio must be less than one-third. That's a rule that says implicitly that as market capitalization rises, one may buy a company's stock, but as it goes down one must sell the stock. That is a buy high, sell low, strategy. Obviously the purpose of the *Shari'a* was not to impose such guaranteed-loss trading strategies.

Returning to ostensibly forbidden products, from interest-bearing loans to various derivative securities, one can synthesize them easily from a small set of contracts that were sanctioned in medieval times: sales, leases, prepaid forward sale, credit sale. That's a theorem. I do not have time in this brief overview to discuss all of those possibilities, but I hope that I have given you a taste of how such synthesis is done.

I have discussed some of those possibilities in a recent paper entitled "Incoherence of Contract-Based Islamic Jurisprudence in the Age of Financial Engineering." I have argued there that it made sense in a primitive society to legislate by forbidding or permitting a short list of contracts. This was possible because the transaction costs of synthesizing one contract from others were reasonably high. However, in today's age of financial engineering and structured finance, such synthesis has become relatively cheap. This suggests that we should follow a substance-over-form approach to regulation, as regulators who have permitted various forms of Islamic finance have done. The net result of contract-based Islamic regulation and substance-based secular regulation is that Muslim customers get less for more, as legal arbitrageurs collect arbitrage profits and pass unnecessary transaction costs to their customers.

In fact, as the great Islamic legal theorist Abdul-Wahhab Khallaf has written, in the area of financial transactions, there are different means of reaching a legal conclusion. One can use benefit analysis, in Arabic we call it *fiqh al-maslaha*, and then you have the various other legalistic methods—analogical reasoning is of course the strongest. Different methods may lead to different legal conclusions. Khallaf then argued that the objective of the law is to maximize benefit. Therefore, if purely legal methods do not produce the most beneficial outcome, then we may overrule them. Indeed, that's what the great scholars have done throughout history, at times by saying that they abandon a more apparent but weaker analogy for a hidden but superior analogy. Great legal scholars were thus able to codify the most beneficial opinions using whichever legal technology was favored during their time.

Please do not misunderstand me: I think it's a good idea to try to do finance from an Islamic perspective, understood as ethical value-creating finance. But you can do that within conventional finance as easily as you can do it through something Islamic, and you wouldn't have the stigma of marketing using religious labels, which, I think, is always a dubious thing to do. Why don't we have that, so far? Because the low-hanging fruit have been the pursuit of simple legal-arbitrage opportunities.

Let me just go back to asking where these ancient and medieval Islamic legal rules come from, anyway. People pretend like restrictions on financial transactions, and various approved nominate contracts, are part of the revealed canon. That is grossly inaccurate. The bulk of the prophetic tradition on financial transactions was just agreeing with common practices during the Prophet's time, regulating it a little bit. So for instance, for the prepaid forward contracts, the prophet merely ordered the buyer and seller to specify the object of sale, the time of delivery, and the price, as precisely as possible. Well, that's developing a market; that's going towards eventually having the "futures" market that we have today.

Similarly, classical Islamic trusts, known as *awqaf* were just copied lock, stock, and barrel from Persian Sassanid law. So the way Islamic societies developed early on was by adopting what the other advanced cultures—much more advanced at the time—had already developed, and regulating them at the margins if necessary. And that's what we should be doing today as well. We should study financial instruments that are already available. If we can synthesize those contracts, then maybe that's an exercise that we need to do for legal sanity checks, but in the end of the day if we can show that this can be justified, then we should pursue the most efficient implementation, because that's what's in the customer's best interest, which is the objective of the law. Of course as long as arbitrage opportunities are available, there will be people who will go after them first. To expedite this process, we can continue to reveal all these tricks to hasten market efficiency through convergence to conventional financial practice. Once we outgrow this phase of reinventing the conventional financial wheel, we may begin to focus on Islamic finance as a distinctive ethical set of business rules.