The Relevance of Contemporary Islamic Finance

Ibrahim Warde

It is always a great pleasure to be back in Berkeley. I want to thank Khalil AbuGharbieh and Amy Coren for inviting me, and congratulate them for putting together such a great symposium.

Islamic finance is very much in the news these days, and the coverage has been both positive and negative. We often hear that Islamic finance has emerged unscathed from the current financial meltdown, and that it should become a model for the entire financial sector. You'll see later that my take on the subject is more nuanced than that. But the last few years have also witnessed — and not only on the lunatic fringe of the political spectrum— vicious attacks against Islamic finance.

I will discuss two aspects of Islamic finance, starting with politics and the question of terrorism, which as you all know has dominated foreign policy since September 11th, 2001. Later I assess the impact of the current financial meltdown on the Islamic sector, and discuss what Islamic finance can contribute to the debate on finance and financial regulation.

THE SEPTEMBER 11TH EFFECT

Following the attacks of September 11th, all things Islamic came under a cloud of suspicion. Islamic banks were certainly no exception, especially considering the widespread perception, as president George W. Bush put it, that "money is the lifeblood of terror." It was not

---

1. President Freezes Terrorists' Assets," Remarks by the President, Secretary of the
unusual to hear influential voices casually linking Islamic banks to terrorism. One such official was Sandy Berger, who was the National Security Adviser during Bill Clinton's second term, and was at the time the top official in charge of the surveillance of Bin Laden's networks. Following September 11th, he asserted that it would be difficult to track down Osama Bin Laden's money because it was hidden in "underground banking, Islamic banking facilities."²

Virtually every work in the abundant "secrets of terrorist financing" literature has alleged that the raison d'être of Islamic finance was to fund terrorism, and regulators, especially soon after the September 11th attacks, often acted as if this were the case. For example, the U.S. Treasury had asked foreign bank regulators, including the Saudi Arabian Monetary Authority, to place Islamic banks under close surveillance. The blow to the Islamic finance industry was considerable since it had been until then well-integrated into the global economy, and had been generally regarded as an effective way of countering Islamic extremism.

At a November 2001 Islamic Banking Conference in Bahrain, two of the most prominent figures in Islamic finance expressed dismay at what they saw as a smear campaigns against their institutions. Prince Muhammed Al-Faisal, founder of the Dar al-Maal al-Islami (DMI) Group and a pioneer of Islamic finance, declared: "We all condemn the September 11 attack on the World Trade Centre and Pentagon as a heinous crime, which has nothing to do with Islam or Muslims as a whole. The West is raising various questions. But these questions are not raised with us, but with 'experts' who do not know anything about this."³ Asked about the freezing of assets of some Islamic institutions, he said: "If they wanted to do it merely on the basis of suspicion let them do it. Of course, it is fair to freeze anyone's assets if there is proof and there should be remedy if they do so without any proof."⁴ As for Sheikh Saleh Kamel, founder of the Dallah al Baraka Group, and chairman of the General Council of Islamic Banks and Financial Institutions (CIBAFI), he declared: "The concept of Islamic banking is one of the

---

⁴ *Id.*
creative methods of Islam to serve the economic and social welfare of Muslims. But some circles tried to use the September 11 attacks to launch a campaign under the false pretext that these Islamic banks are the source for financing terrorism.  

Many top U.S. officials seemed to think so. In March 2002 Treasury Secretary Paul O'Neill, whose responsibilities included leading the U.S. financial war on terror, acknowledged that it took him six months to "learn," following meetings in Saudi Arabia, Kuwait and Bahrain, that Islamic banking is "a legitimate way of doing business." After this revelation, the U.S. Treasury created the position of "scholar-in-residence in Islamic finance" (which lasted about six months) and would occasionally organize "Islamic Finance 101" events designed to explain the industry to regulators.

Nevertheless, accusations against Islamic banks would periodically resurface. When on August 15, 2002, lawyers representing relatives of 600 victims of September 11 filed what one of them called "the lawsuit of the twenty-first century," leading figures of Islamic finance and major Islamic institutions – Prince Mohammed al-Faisal and his Dar al-Maal al-Islami, Sheikh Saleh Kamel and his Dallah al-Baraka group, the Al-Rajhi Banking and Investment Company, etc.—were among the dozens of defendants who stood accused of racketeering, wrongful death, negligence and conspiracy. The 15-count lawsuit aimed "to force the sponsors of terror into the light and subject them to the rule of law" by seeking "an amount in excess of $1 trillion." Other copycat suits followed.

The "global war on terror" had a paradoxical but significant impact on Islamic finance. Islamic institutions suffered a short-lived blow, but Islamic institutions were on the cusp of a period of unprecedented expansion. In the years following the September 11 attacks, the Islamic finance industry experienced dramatic growth and major transformations. Criticisms of Islamic banks were no doubt an important factor in the serious effort at rationalizing and streamlining Islamic finance. The perception that Islam was under siege resulted in greater religiosity, which in turn drove an increase in demand for Islamic products. The freezing of accounts of prominent Muslims resulted in substantial amounts of money leaving the United States and returning to the Islamic

5. Id.
world. Another very significant development was the steady rise in the price of oil between 2003 and 2008. Even outside the Islamic world, demand for Islamic products accelerated, and the number of conventional institutions offering Islamic products kept growing, both inside and outside the Islamic world.

Coming under attack had the effect of greatly concentrating the minds of Islamic bankers and their regulators. As a result, efforts at international coordination and standardization grew more serious and better focused. Notable developments include countless business and regulatory initiatives as well as the convergence of the Arab and the Malaysian models of Islamic banking. The year 2002 saw the creation of important coordination and standard-setting mechanisms such as the Islamic Finance Services Board (IFSB), the International Islamic Financial Market (IIFM), the Liquidity Management Center (LMC) and the International Islamic Rating Agency (IIRA). The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), though in existence since 1991, was greatly re-energized in its effort to harmonize accounting and auditing rules and create standard Islamic contracts. The year 2002 also saw the appearance of the first Malaysian sovereign ijara sukuk to which some Arab scholars were associated and which formed the template for future sukuk issues. In 2005, the International Islamic Centre for Reconciliation and Commercial Arbitration for Islamic Finance Industry was launched in Dubai in order to settle financial and commercial disputes.

These developments were part of a growing convergence of the Arab and Malaysian models, which is also an indirect consequence of the September 11 attacks. The freezing of the assets of prominent Saudis and the crackdown on Islamic financial institutions and charities led many Muslim investors to take a significant chunk of their assets out of the United States. Home markets could not absorb all those withdrawals (estimated at about $200 billion) and the quest for diversification led naturally to Malaysia, a Muslim country which had achieved an impressive level of economic development. Other forms of political and economic interaction also intensified. Malaysian Prime Minister Mahathir Mohammed’s stature grew in the Islamic world as he took a strong stand against those aspects of the global war on terror that he considered as unfairly targeting Muslims. There was also a significant increase in trade and tourism (many Gulf Arabs chose to vacation in Malaysia rather than in the United States or Europe). As a way of promoting its own viewpoint, Bank Negara Malaysia engaged in a massive “Shari’ah dialogue” program to promote dialogue with Arab
scholars. Malaysia started working closely with Arab regulators, especially those of Bahrain and the United Arab Emirates, on matters of Islamic finance. The Dubai Financial Services Authority (DFSA) entered into a memorandum of understanding with Bank Negara Malaysia, committing both parties to the further development of international Islamic finance markets. As a result of the joint initiative, DIFC (Dubai International Financial Center) domestic funds will be the first foreign funds permitted to be sold into Malaysia.

Most significantly, since 2006, three Arab Islamic banks have been authorized to operate in Malaysia: Kuwait Finance House, Saudi Arabia’s Al-Rajhi and the Asian Finance House. In Islamophobic circles, all this has created new anxieties. The cottage industry dedicated to exposing the dangers of Islamic finance greatly expanded in recent years. There are websites with names such as “Shariah Finance Watch” whose purpose it is to warn about the dangers of Islamic finance to democracy and indeed to Western civilization. Islamic finance is also now on the radar screen of right wing talk radio. The accusations can be summarized as follows: Islamic finance is a tool to finance terrorism; it is a backdoor way of introducing the Shari’ah in the United States; and it is a way of infiltrating American capitalism in order to destroy it from within. In the words of Frank Gaffney who has launched his own jihad against the industry, “Shariah-compliant finance... is a vehicle for effecting in America and in other Western capital markets, what its proponents have called ‘financial jihad’—a kind of soft jihad, but one arguably going after the lifeblood of our capitalist system and economy.”

There were also objections to government bailouts of AIG and Citigroup, on the grounds that these companies have Islamic subsidiaries. Last December, The Thomas More Law Center, a national, public interest law firm based in Ann Arbor, Michigan, filed a federal lawsuit in the U.S. District Court for the Eastern District of Michigan, challenging the AIG bailout on the grounds that taxpayer money is being used to fund and financially support a company which engages in Shari’ah-based Islamic religious activities that are anti-American, anti-Christian, anti-Jewish. According to the lawsuit, “The use of these taxpayer funds to approve, promote, endorse, support, and fund these Shari’ah-based Islamic religious activities violates the Establishment Clause of the First

7. Pete Winn, Shari'a-Compliant Financing Described as New Islamist Threat, CNSNEWS.COM, Apr. 21, 2008.
Amendment to the United States Constitution.” Richard Thompson, President and Chief Counsel of the Thomas More Law Center, explained, “Although widespread public anger has rightfully focused on bonuses AIG paid to top executives using taxpayers’ money, that anger would be at an even higher pitch if the public knew that our tax dollars were being used by AIG to promote Islam and Shariah law, which provides support for terrorist activities aimed at killing Americans and destroying America.”

A DIFFERENT KIND OF BUBBLE

Let me now turn to the impact of the financial meltdown on Islamic finance. It is true that Islamic finance has emerged relatively unscathed from the subprime crisis and from the credit default swaps debacle. Islamic law forbids many of the products and transactions related to those specific aspects of the meltdown—the securitization of debt, the bets inherent to credit default swaps, the excessive leverage, and more generally the sheer complexity and opacity of the derivatives and their distance and disconnection from real assets. But Islamic finance is not immune from bubble effects, and indeed it has started to feel the effects of a different kind of bubble, the one caused primarily by a fall in asset prices.

With the extension of the crisis from the financial realm to the real economy, a global economic slowdown has resulted in a sharp decrease in the demand for oil, and a fall in asset prices, in particular in real estate and stocks. This exposed the vulnerability of a sector that is generally asset-backed. I say generally because a couple of controversial Islamic products are not. I am referring here to “sales” contracts that are not really true and genuine sales, but rather pretexts to generate cash loans. One product is tawarruq, a cash loan backed up by a “synthetic” commodity transaction created by the bank on behalf of the client, which many scholars challenge but is nonetheless commonly practiced in the


Gulf region. Another is the bay' el 'Ina, where the bank sells an item on credit to a customer who then resells it to the bank for cash, which is only practiced in Malaysia.

Another source of losses is related to the broad interconnections between the Islamic sector and the conventional one. Consider the drop in sukuk (or "Islamic bonds") issuance in 2008. The market for sukuk had gone from close to zero in 2001 to $100 billion in 2007 in part because non-Islamic investors acquired a substantial percentage of the sukuk. To be sure, the controversies over certain Shari'ah rulings on the matter of sukuk were a factor, but I think the most significant cause is the global liquidity and confidence crisis.

The economic downturn is likely to expose problems that have been hidden by years of rapid growth. For decades, the growth of Islamic banks has been in the double digits, and in the last few years, growth has been spectacular (an increase of 26% in 2006 and an increase of 38% in 2007). To quote Warren Buffett, "You only learn who has been swimming naked when the tide goes out – and what we are witnessing at some of our largest financial institutions is an ugly sight."10 Another thing to keep in mind is that what is permissible is not necessarily advisable from a business standpoint. And Islamic banks are also not immune to incompetence, greed or outright fraud. On that subject, I should introduce the notion of Islamic moral hazard, when the presence of religion can foster reckless or unscrupulous behavior, and blind trust somehow "disables" controls and safeguards. Here, the recent financial scandals at Dubai Islamic Bank are instructive.11

Why is this bubble different? For one thing, and this is primarily because of the link to the real economy (in most cases at least, as I just explained), it is not likely to be nearly as bad as a financial crash caused by the open-ended creation of toxic assets. Also, after bubbles associated with a certain asset class burst, investors tend to leave those assets in droves. I don't think this will happen to the Islamic sector. My guess is that the sector will continue to grow, though Islamic institutions will be adjusting their practices and instruments.

Islamic Finance Between Innovation and Imitation

In order to understand the relation of Islamic finance and conventional banks, we need to trace the evolution of Islamic finance in terms of dynamics of innovation and imitation. A common mistake is to look at the Islamic sector as if it had always existed in its current state, or as if it had appeared fully-formed at some point in the 1970s. The reality is that it has gone through constant change, which can be explained in terms of changing political-economic context, dynamics of interaction with the conventional sector, and more broadly as the result of processes of trial and error.

When it first came into existence, Islamic finance purported to offer an alternative model, one based on partnership finance. The basic idea was that Islamic finance should not be based on interest-based finance, but rather on the double mudaraba principle. The mudaraba (or commenda partnership) is an association between the rabb-el-maal (financier) and the mudarib (entrepreneur) where profits and losses are shared based on an agreed-upon ratio. On the liabilities side of the balance sheet, the depositor is the rabb-el-maal and the bank is the mudarib. On the asset side of the balance sheet, the bank is the rabb-el-maal and the client is the mudarib. Another fundamental difference with the conventional sector was that Islamic banks had to take into account social and developmental goals. And of course, Islamic banks are different because their activities must be vetted by religious scholars. But more on this shortly.

The principle of partnership finance is certainly seductive since in theory there would be a harmony of interests among depositors, financial institutions and entrepreneurs. The bank would essentially be a venture capitalist financing promising entrepreneurs. In contrast to traditional lending, which favors already established businesses, venture capitalism favors new ventures. Islamic finance was supposed to bring a wide range of economic benefits to society, through mobilization of savings, productive investment and general economic development.

The first Islamic banks plunged into mudaraba with great enthusiasm and virtually no experience. The result was, to put it mildly, disappointing, and as a result, virtually all institutions decided to steer clear from profit-and-loss sharing, and focus instead on sale-based, or mark-up transactions.

A cornerstone of this form of finance is the Qur’anic verse which states: “Allah has allowed trading and forbidden riba” (2:275) and today, the overwhelming majority of transactions of Islamic financial
institutions are sale-based, primarily in the form of murabaha. What is murabaha? It is a cost-plus contract in which a client wishing to purchase equipment or goods asks the bank to purchase the items and sell them to him at cost plus a declared profit. In traditional fiqh, murabaha was a form of sale where a buyer would ask a seller to buy a good on his behalf and resell it to him after adding a pre-determined mark-up. The rationale was that merchants new to a market would prefer to negotiate the profit margin of the intermediary rather than the final price. Importantly however, traditional murabaha was a spot transaction.

The innovation of modern Islamic finance lies in the addition of an element of financing, since the bank will purchase the required goods directly from a supplier and sell them to the "borrower" for future payment. Proponents of murabaha stress its transparency, since the buyer is in a position to know exactly the cost of the goods (and associated expenses) as well as the profit made by the bank, which may be a lump sum or a percentage.

In the early years of modern Islamic finance, murabaha and other mark-up transactions were regarded as temporary modes of finance, used for reasons of ease and convenience when mudaraba and musharaka were not possible, and generating income while banks devised more authentically Islamic profit-and-loss sharing instruments. But over time, rather than disappearing, murabaha and comparable sale-based contracts grew significantly and today they constitute the bread-and-butter of Islamic banks.

The popularity of murabaha as a sale-cum-financing transaction could be attributed to its ability to replicate, in economic though not in religious, legal or regulatory terms, conventional loans. If a business needs $100 million to buy machinery, it could borrow money at 8% a year to purchase it, or it could have the bank buy the machinery on its behalf, and pay the bank $108 million a year later. Beyond the bottom line, parallels abound: in both cases, the prior due diligence consists in examining the client's creditworthiness; the purchased asset serves as collateral, and the bank can also require other guarantees from the client; after the deal is completed, the relationship of the client to the bank is that of debtor. Regulators as well as conventional bankers are thus usually comfortable with such transactions. But this is also precisely why murabaha and other mark-up schemes are criticized—on the grounds that such contracts simply disguise the interest through semantic games.

The overwhelming majority of Islamic transactions are of the
murabaha type, and usually for short-term financing. Because murabaha-type transactions do not bring significant social and economic benefits to the community, have a short-term orientation and tend to mirror conventional finance, Islamic scholars have accepted them grudgingly. Nevertheless, they have now become a dominant and permanent feature of the industry. Conversely, and this is one of the big disappointments of Islamic finance, true profit-and-loss sharing transactions (and here I am excluding fund management transactions where there is a profit-participation element) are almost insignificant.

It is also true that the ideal of partnership finance has not really materialized. But parenthetically it should be said that maybe a bank, any bank, cannot be a good venture capitalist. Banking and venture capitalism are completely different businesses; a good banker is not necessarily a good venture capitalist and vice versa. Most venture capitalists are entrepreneurs by background, concerned with the growth of a business rather than the repayment of loans. It is also questionable whether it is a good idea to use the money of small depositors to invest in new business ventures, which are risky by definition.

Despite all this, the profit-and-loss sharing and risk-sharing logics of Islamic finance have not disappeared entirely. On the liabilities side of the balance sheet, a mudaraba logic still prevails, since investment accounts are remunerated in proportion of the profits of the bank. Just as important, if you look at the specifics of Islamic contracts in general, or at how Islamic transactions work in practice, you find that the risk-sharing logic usually applies in situations where the debtor is unable to pay through no fault of its own. So where in conventional finance, you see a strong element of risk-shifting, where banks often take advantage of distressed borrowers, Islamic banks proceed differently. There are sharp limits on late fees and other penalties and Islamic institutions are expected to show forbearance when the customers acting in good faith are unable to fulfill their obligations for reasons beyond their control. Typically, the Islamic bank will extend a qard hasan (benevolent loan) to help the client.

Let us revisit now the question of originality versus imitation. It is true that the basic thrust of Islamic finance has been to mimic conventional finance. There is nothing inherently wrong with this since Muslims have the same needs as non-Muslims. We often hear in the wake of the current financial crisis that Islamic finance offers an alternative. There is some truth to that, but it is mostly by default, since for the past 30 years or so, there has been only a single model of finance, what could be called a Wall Street model, with its unshakable beliefs
about the self-regulating nature of finance, the need to deregulate and innovate, etc. It is precisely because of this unanimity (here we are reminded of Margaret Thatcher's assertion of TINA, which stands for There Is No Alternative) that the Islamic sector appeared as one of the few structured systems of finance that offer some differences.

In that respect, I want to return to Shari'ah Boards. They have been criticized on for being hopelessly old-fashioned, for being out of touch with the cutting edge of finance. But they also provide some badly needed checks and balances. In all walks of life, checks and balances are a good way of reining in excesses. By scrutinizing every innovation on the basis of criteria other than profitability, they have played a salutary role in preventing Islamic institutions from going too far in their imitation of the conventional sector.

So, the originality of Islamic finance lies not in offering an alternative model, but in reminding us of two things that have been forgotten: about the basics of finance, which is to channel credit to the real economy, and about the need to have safeguards. Islamic finance is conservative finance; it is also ethical finance. Thus Islamic banks are not allowed to invest in non-halal activities. When investing in stocks, numerous screens (based on the activity of the firm, on financial ratios, and on general ethical behavior) are used. Islam was born in the trading city of Mecca, that the Prophet Mohammed was a merchant (as were the four "rightly-guided Caliphs" who led the Islamic community after his death), that merchants played a central role in the expansion of Islam and that major trading routes were for centuries under Islamic control. Certain concepts created in relation with business practices – I think in particular of the Islamic concept of gharar, a broad concept encompassing deceptive ambiguity, risk shifting and excessive risk taking – reflect a long experience of business, and the constant reminder of its potential pitfalls.

When the question of the excesses of finance, and in particular on matters of executive compensation is evoked, there is a ready reference to Adam Smith, to the "greed is good" logic, to how the invisible hand of the market simply consists of the sum total of individual selfishness, etc. There are two things to keep in mind when Adam Smith is invoked. One is that in addition to writing An Inquiry into the Nature and Causes of the Wealth of Nations, he also wrote The Theory of Moral Sentiments. The other is that Adam Smith was a "moral philosopher." In other words, the field of political economy, which later came to be known as economics, came out of moral philosophy. For an academic specialization that likes to think of itself as a science, this is easy to forget, especially since the
concept of "financial engineering" swept the profession.

In the era of deregulation, finance came to be dominated by "quants." Indeed, since the 1980s investment banks and other financial institutions engaged in a massive effort to hire Ph.D. graduates in physics, mathematics and other such disciplines. The scientific pretenses seemed confirmed by the heavy use by financial engineers of mathematical formulas to create ever-more complicated (and ever more lucrative) products. Of course, engineering is value-neutral. So the whole notion of ethics and morality looked quaint, at least until the recent financial collapse. It is interesting that the long-forgotten concept of usury (in the sense of excessive and predatory rates of interest) has reappeared in the public debate in connection with sub-prime lending as well as such lucrative though morally questionable practices such as payday loans.

Islamic finance reminds us that all religions, and indeed even secular philosophies, always had a problem with the idea of making money with money. You may know about Aristotle's view that money is a barren commodity, or about medieval Christian theologians' problems with usury (which in those days meant all forms of interest), and which was punishable by excommunication. On a more political plane, you may also remember from college or high school history classes, the 1896 presidential election pitting William McKinley against William Jennings Bryan, when the gold versus silver standard debate took center stage. You may remember the powerful religious symbolism of Bryan's "Cross of Gold" speech. In studying the history of financial institutions we discover that many financial institutions appeared as a result of an ethical or religious impulse. In late 19th century Germany, Frederic Raiffesen, a Protestant, and in early 20th century Canada, Alphonse Desjardins, a Catholic, created mutual savings societies (neither of them was a banker) to save poor farmers from the clutches of predatory money-lenders.12

In conclusion, I want to say that we should not overstate the virtues of Islamic finance, which still in its formative stages. I happen to be suspicious of all panaceas, especially in finance where panaceas often prove recipes for disaster. The problem with panaceas is that when you start believing in them, you start being uncritical, and you stop asking questions. That was certainly part of the problem with the evolution of conventional finance where "Wall Street" played pied piper and analysts

and finance professors played cheerleaders. Look at what happened to the "Wall Street" model and to the five Wall Street giants in the past year: they either went under (like Lehman Brothers), or they got into a forced or at the very-least a government brokered absorption by a commercial bank (like Bear Stearns or Merrill Lynch), or they changed their status to that of commercial banks (like Morgan Stanley or Goldman Sachs). To repeat, I do not think that Islamic finance has all the answers. Here I would like to quote Professor Mahmoud El-Gamal of Rice University: "The claim that Islam has the perfect solution is questionable in economics, just as in politics."  

I do think however that the great merit of Islamic finance is to bring back age-old questions on the nature of money, on the dangers of making money with money, on the need to tether finance to the real economy, and more generally on the question of ethics and morality in finance. In my own experience I was always amazed at the general lack of intellectual curiosity of people in finance, perhaps because they were focusing too hard on finding new ways to make money. In seminars for bankers and MBA students, I would often ask questions such as "When were usury ceilings effectively removed in the US," and would get blank stares, yet I think it is a fundamental question if you want to put finance in some political-economic or ethical context. So in other words, Islamic finance may not have the right answers, but it helps ask the right questions—questions that conventional finance has, for about a generation, chosen not to ask.
