

# Soul Searching and Profit Seeking: Reconciling the Competing Goals of Islamic Finance\*

## I. Introduction

The worldwide growth of the Islamic financial industry over the past decade has been steady.<sup>1</sup> Increasingly, the ethical principles that underlie the Islamic financial system have been a popular topic of debate.<sup>2</sup> While Islamic finance has much to offer with regard to financial management, ethical investing, and project finance, there are fundamental tensions within the system that may work to stifle its growth and foreclose opportunities to reach a broader and more diverse investor group.

Chief among these difficulties is the fact that the Islamic financial industry lacks what some consider a necessary cohesive and overarching governance structure. Different countries, and the various sects of Islam within those countries, each have their own interpretations of both the religious and financial teachings of Islam. This has caused the related problems of inconsistent enforcement, inaccurate risk estimation, and the generalized hesitancy among even Muslim investors to pursue Islamic financing options.

This Note, in Part II, provides a brief overview of the Islamic financial system's development, its current status, and its primary methods for financing and investing in compliance with Shari'a law. Part III then outlines several of the problems and issues that have prevented more widespread acceptance of Islamic finance as an alternative to conventional, Western financing techniques. These central issues are (1) a fragmented regulatory structure; (2) the regional differences among Muslim countries' interpretations of Shari'a law; (3) the heightened level of risk involved in anticipating future trends in the Shari'a compliance requirements; and (4) the lack of scholars specializing in Islamic finance.

In Part IV, I outline three general proposals aimed to address these problems. The proposals seek to prevent and manage the risks these problems create for the Islamic financial system. The proposals include (1) streamlining the educational system for Islamic financial experts; (2) creating new methods for avoiding conflicts of interests among the field's

---

\* I would like to thank Professor Henry T.C. Hu for his guidance and advice during the preparation of this Note.

1. See Andreas Junius, *Islamic Finance: Issues Surrounding Islamic Law as a Choice of Law Under German Conflict of Laws Principles*, 7 CHI. J. INT'L L. 537, 538 (2007) (discussing the increasing number of Islamic financial institutions worldwide); Theodore Karasik et al., *Islamic Finance in a Global Context: Opportunities and Challenges*, 7 CHI. J. INT'L L. 379, 379 (2007) (noting, as of 2006, growth rates nearing 15% per year).

2. See Anita Hawser, *Back to Basics: Islamic Financing*, GLOBAL FIN., Nov. 2008, at 31, 31 (finding that Islamic financial institutions fare better than their conventional counterparts during times of economic distress due in large part to the system's emphasis on ethics).

influential scholars; and (3) changing how Shari'a compliance ratings are computed for Islamic financial institutions and companies.

Lastly, in Part V, I employ case studies of a recently developed and somewhat controversial Islamic financial product, the *tawarruq*, to illustrate the identified problems that have been associated with the Islamic financial system. Additionally, this study of *tawarruq* demonstrates how the implementation of even limited versions of the proposed modifications may help popularize the Islamic approach to investing and finance. Addressing this issue and exploring Islamic investing trends is particularly relevant given the system's short history, recently increasing popularity, and arguable viability as an alternative to the risky methods of conventional banking that have recently caused such severe economic turmoil.

## II. A Brief Introduction to Islamic Finance

### A. *Shari'a Law*

Islamic finance can be broadly described as a financial system that is intended to function in compliance with Shari'a law. For Muslims, Shari'a law serves as the principle source of guidance for all areas of their lives.<sup>3</sup> The term "Shari'a" can be roughly translated as "Islamic law" and is often interpreted by Muslims as "the totality of divine categorizations of human acts."<sup>4</sup> Shari'a law is thus an umbrella term that refers to four distinct sources of religious and legal tradition.<sup>5</sup> The primary materials from which Islamic law is derived include, in order of significance, (1) the Holy Qur'an, (2) the *hadith*, (3) *ijm'a*, and (4) *qiyas*.<sup>6</sup> Muslims believe the Qur'an contains the literal words of Allah as revealed to Muhammad.<sup>7</sup> The *hadith* are the recordings of the Prophet Muhammad's actions and words as documented by his contemporaries and later followers via oral tradition.<sup>8</sup> These examples set by Muhammad are clarified, expanded, and made applicable to present conditions primarily through a form of analogical reasoning known as *qiyas*.<sup>9</sup> And finally, when Islamic jurists reach a consensus on the proper application of *qiyas*, it results in a per se valid and binding religious law known as *ijm'a*,<sup>10</sup> popularly translated to mean "consensus of jurists."<sup>11</sup>

---

3. Gohar Bilal, *Islamic Finance: Alternatives to the Western Model*, FLETCHER F. WORLD AFF., Winter/Spring 1999, at 145, 146.

4. *Glossary*, in STRUCTURING ISLAMIC FINANCE TRANSACTIONS 226, 232 (Abdulkader Thomas et al. eds., 2005).

5. Haider Ala Hamoudi, *Jurisprudential Schizophrenia: On Form and Function in Islamic Finance*, 7 CHI. J. INT'L L. 605, 608 (2007).

6. Irshad Abdal-Haqq, *Islamic Law: An Overview of Its Origin and Elements*, 7 J. ISLAMIC L. & CULTURE 27, 36 (2002).

7. *Glossary*, *supra* note 4, at 231.

8. Bilal, *supra* note 3, at 146.

9. Hamoudi, *supra* note 5, at 608.

10. *Id.*

### B. *The Importance of Islamic Finance Today*

Islamic finance is a relatively new brand of finance. Its roots are traced to a bank in Cairo, Egypt, founded in 1963.<sup>12</sup> Since then, Shari'a law has become increasingly popular and has become a player in both Muslim and Western countries' financial markets.<sup>13</sup> As of the close of 2007, there were \$500 billion invested in Shari'a-compliant assets,<sup>14</sup> which reflects a growth rate greater than 10% per year for each of the past ten years.<sup>15</sup> In recent months, Islamic finance has received increased attention in mainstream media outlets in the context of the recent and worsening worldwide financial crisis.<sup>16</sup>

### C. *Departure from Conventional Banking*

One of the world's foremost scholars in Islamic finance, Sheikh Muhammad Taqi Usmani, has written: "[T]he basic difference between capitalist and Islamic economy is that in secular capitalism, the profit motive or private ownership are given unbridled power to make economic decisions."<sup>17</sup> This idea may best be characterized as a distinction between a financial system driven purely by profits and one that contains the dual goals of religious piety and profit maximization.<sup>18</sup>

The most central practical differences between Shari'a and conventional finance revolve around the various restrictions on the types and methods of investments allowable under an Islamic approach. Muslims rely on Shari'a law for the proposition that investment in the following things, among others, are *haram* (forbidden): the charging of *riba* (interest), engagement in excessively speculative ventures, contractual uncertainty or ambiguity, traditional insurance protection, and industries that deal in gambling, pornography, alcohol, tobacco, pork products, and even those that produce media products

11. *Glossary*, *supra* note 4, at 228.

12. SAYED KHATAB & GARY D. BOUMA, *DEMOCRACY IN ISLAM* 110 (2007).

13. *See* Karasik et al., *supra* note 1, at 379 ("[T]here are over 300 Islamic financial institutions in more than 75 countries . . .").

14. Oliver Agha, *Islamic Finance in the Gulf: A Practitioner's Perspective*, 1 *BERKELEY J. MIDDLE E. & ISLAMIC L.* 179, 179 (2008).

15. *See* Juan Solé, *Islamic Banking Makes Headway*, *IMF SURV. MAG.*, Sept. 19, 2007, <http://www.imf.org/external/pubs/ft/survey/so/2007/RES0919A.htm> (asserting that the Islamic banking industry has grown 10%–15% per year over the last ten years).

16. *See, e.g.*, Hawser, *supra* note 2, at 31 (reporting on Islamic finance's resilience during the credit crunch).

17. MUHAMMAD TAQI USMANI, *AN INTRODUCTION TO ISLAMIC FINANCE*, at xiv (2002).

18. *See id.* (discussing the attempt of Islamic finance to protect societal interests and divine restrictions within a market-based economy); *see also* Umar F. Moghul & Arshad A. Ahmed, *Contractual Forms in Islamic Finance Law and Islamic Inv. Co. of the Gulf (Bahamas) Ltd. v. Symphony Gems N.V. & Ors.: A First Impression of Islamic Finance*, 27 *FORDHAM INT'L L.J.* 150, 152 (2004) (recounting that Islamic finance is closely tied to Islamic religious principles).

such as gossip magazines.<sup>19</sup> Many scholars believe that in no instance should any of the forbidden products comprise more than 5% of the total revenues of any Shari'a-compliant business.<sup>20</sup>

The prohibition of interest is often considered the centerpiece of the Islamic banking system. The insistence on adherence to this rule is derived both from passages from the Qur'an and teachings of Muhammad.<sup>21</sup> The central Qur'anic passage on which Islamic finance is based reads:

Those who devour usury will not stand except as stands one whom Satan by his touch hath driven to madness. That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are Companions of the Fire: they will abide therein (for ever).<sup>22</sup>

In addition to the widely accepted prohibition of interest, it is often necessary for Shari'a-compliant companies to appoint and maintain a Shari'a board that provides guidance to the company's leadership on matters of Shari'a law and compliance.<sup>23</sup> Each board should technically contain at least three Islamic scholars,<sup>24</sup> though there are various interpretations as to what this means, creating a problem that will be addressed later in Part III.

#### D. Islamic Financial Products

Islamic finance has demonstrated an ability to innovate and adapt to changing economic times, and it has experienced a wave of innovation over the past two decades. The most common forms of financing in Shari'a-compliant industries are addressed below. While the following list of financial products is in no way exhaustive, these are collectively considered

---

19. Shahzad Q. Qadri, *Islamic Banking: An Introduction*, BUS. L. TODAY, July–Aug. 2008, at 59, 59; see also Angela Jameson, *Conventional Insurance in Conflict with Islam*, TIMES ONLINE, Mar. 1, 2008, [http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article3463702.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article3463702.ece) ("Conventional insurance products are in conflict with Islamic beliefs for three reasons. Insurance involves an element of uncertainty, gambling and the charging of interest, which are prohibited by the Koran."). This is not intended to be a complete list of all prohibited items in the Islamic financial system. However, these remain the most central and visible restrictions on Islamic investment as it currently exists. Cf. Qadri, *supra*, at 59 (noting that "a consensus among Muslim scholars" confirms the existence of the religious prohibitions on these economic activities).

20. See Zaineb Sefiani, *Inside View: Islamic Finance*, FUNDS EUR., July 2009, <http://www.funds-europe.com/July-2009/INSIDE-VIEW-Islamic-finance/menu-id-228.html> (describing the first step in screening investments for Shari'a compliance as filtering out companies that derive more than 5% per year from forbidden business sectors).

21. Agha, *supra* note 14, at 180.

22. HOLY QUR'AN 2:275 (Abdullah Yusuf Ali trans., 2000).

23. Neil Miller & David Baylis, *Sharia-Reliant*, LAWYER, May 28, 2007, <http://www.thelawyer.com/sharia-reliant/126147.article>.

24. *Id.*

the most widely used.<sup>25</sup> The descriptions of these products illustrate the methods that have been employed to avoid formalized interest payments.

1. *Mudharabah*.—*Mudharabah* refers to a profit-sharing contractual agreement typically between a financial institution or investor and an entrepreneur who is seeking funding for a project or endeavor.<sup>26</sup> The investor or institution gives money to engage in the entrepreneur's business activity, and the entrepreneur provides the labor and expertise.<sup>27</sup> Prior to the beginning of the business activity, the two parties determine a ratio at which they will share profits, and all profits that are made in the venture are shared according to that ratio.<sup>28</sup> Likewise, losses from the business venture are also shared, and because the investor or bank is exposed to this risk, this justifies the party's claim to part of the profits in the event of a gain.<sup>29</sup>

2. *Musharakah*.—Along with the *mudharabah*, joint-venture financing, or *musharakah*, is among the more common methods used to engage in project finance, real-estate purchases, letters of credit, and other investment projects in primarily Muslim countries.<sup>30</sup> *Musharakah* is literally translated as "sharing."<sup>31</sup> Each partner in a *musharakah* arrangement inherently has the right to equal management authority over the venture, even though their respective investments may be unequal.<sup>32</sup> However, much like in Western business law, the parties are able to deviate from this presumption via express written contract.<sup>33</sup>

3. *Murabaha*.—The *murabaha* form of Islamic finance has many variations, but at its root it consists of a bank or financial institution buying an asset and selling it back to the customer, who will make either a single

---

25. See, e.g., Qadri, *supra* note 19, at 59–60 (describing *mudharabah*, *wadiah*, *musharakah*, *murabaha*, and *ijarah* as key basic concepts in Islamic banking); Abdulkader Thomas, *Introduction: The Origins and Nature of the Islamic Financial Market*, in STRUCTURING ISLAMIC FINANCING TRANSACTIONS, *supra* note 4, at 1, 7–8 (naming *mudharabah*, *musharakah*, *ijarah*, and *sukuk* as core financing mechanisms); Ahmad Lutfi Abdull Mutalip & Mohd Herwan Sukri Mohammad Hussin, *The Emergence of Islamic Financing Based on the Syariah Concept of Tawarruq 1* (2008) (unpublished manuscript, on file at [http://www.azmilaw.com.my/Article/Article\\_8\\_&\\_9/Article\\_9\\_Tawarruq\\_00093603\\_.pdf](http://www.azmilaw.com.my/Article/Article_8_&_9/Article_9_Tawarruq_00093603_.pdf)) (naming *bai' bithaman ajil* as a traditional type of sale and *tawarruq* as a newer type of sale that is gaining popularity). See generally USMANI, *supra* note 17 (discussing *musharakah*, *murabaha*, and *ijarah* as principal parts of the Islamic financial system).

26. Qadri, *supra* note 19, at 59.

27. *Id.* at 59–60.

28. Bilal, *supra* note 3, at 156.

29. Qadri, *supra* note 19, at 59.

30. *Id.* at 60.

31. Muhammad Taqi Usmani, *The Concept of Musharakah and Its Application as an Islamic Method of Financing*, 14 ARAB L.Q. 203, 203 (1999).

32. Husam Hourani, *The Three Principles of Islamic Finance Explained*, INT'L FIN. L. REV., May 2004, at 46, 47.

33. Qadri, *supra* note 19, at 60.

deferred payment or multiple deferred payments over time.<sup>34</sup> The purchase and sale price, along with the explicit profit margin, are agreed upon up-front at the time of the original sales agreement. The profit margin in this sense is acceptable because the bank is viewed as being compensated for the time value of the money.<sup>35</sup>

4. *Ijarah*.—Literally translated as “compensation,” “substitute,” “consideration,” “return,” or “counter value,”<sup>36</sup> *ijarah* is a contract that involves the lease or transfer of ownership of a service for a specified period in exchange for prearranged consideration.<sup>37</sup> *Ijarah* is best likened to a simple lease form, and it is almost uniformly accepted as Shari’a-compliant as “a convenient means for people to acquire the right to use any asset that they do not own, as all people might not be able to own the tangible assets for use.”<sup>38</sup> Islamic finance views dealing in assets or other intangibles that one does not own harshly,<sup>39</sup> but due to its structure, *ijarah* avoids this pitfall.

5. *Bai’ Bithaman Ajil (BBA)*.—A contract of *bai’ bithaman ajil* involves a deferred-payment sale or a “credit sale.”<sup>40</sup> This product differs from a concurrent purchase and delivery of an asset (such as in a *murabaha* agreement) because it allows for a deferred delivery or payment of existing assets.<sup>41</sup> Interestingly, a BBA does not typically require the lender, or lessor, to disclose a specific profit margin up-front, which differentiates this from many Shari’a-compliant arrangements.<sup>42</sup> This is because the vast majority of BBAs involve significantly long-term ventures.<sup>43</sup>

6. *Wadiah*.—Arabic for “custody,” a *wadiah* is a contract between an account holder and a bank where the account holder places his funds in trust with the bank, and the bank, in return, keeps and invests the funds,

34. *Id.*

35. *Id.*

36. *Ijarah*, <http://nurhisyammuhasabah.blogspot.com/2009/02/ijarah.html> (Feb. 5, 2009, 13:31 EST).

37. *Glossary*, *supra* note 4, at 228.

38. MUHAMMAD AYUB, UNDERSTANDING ISLAMIC FINANCE 279 (2007).

39. See generally Mohammad Nejatullah Siddiqi, Economics of *Tawarruq*: How Its *Mafasid* Overwhelm the *Masalih* (Mar. 10, 2008) (unpublished manuscript, on file at [http://konsulta.simuamalat.com/home/index.php?view=article&catid=1%3Alatest-news&id=45%3Aeconomics-of-tawarruq-how-its-mafasid-overwhelm-the-masalih&format=pdf&option=com\\_content](http://konsulta.simuamalat.com/home/index.php?view=article&catid=1%3Alatest-news&id=45%3Aeconomics-of-tawarruq-how-its-mafasid-overwhelm-the-masalih&format=pdf&option=com_content)) (arguing that *tawarruq*, a tool to make purchases on deferred payment, is not Shari’a compliant because the macroeconomic harms it causes outweigh the benefits).

40. Abdulkader Thomas, *Changes and Challenges*, in STRUCTURING ISLAMIC FINANCE TRANSACTIONS, *supra* note 4, at 222, 225.

41. Andreas A. Jobst, *Derivatives in Islamic Finance*, in THE CREDIT DERIVATIVES HANDBOOK 16, 19–20 (Greg N. Gregoriou & Paul Ali eds., 2008).

42. *Id.* at 19 n.8.

43. *Id.*

guaranteeing repayment of any part of the funds on request.<sup>44</sup> While this may sound much like a traditional bank account, the major difference is that depositors are not entitled to any rewards or interest payments for entrusting their money to the bank or financial institution.<sup>45</sup> This allows the parties to the contract to avoid committing the forbidden act of interest charging and payment. In lieu of interest payment, most financial institutions engaging in *wadiah* contracts will pay “gifts” to their depositors periodically, and many depositors expect this payment, though there is no formal requirement for the bank to do so.<sup>46</sup>

7. *Sukuk*.—Frequently referred to as “Islamic bonds,” *sukuk* is more accurately translated as “Islamic investment certificates.”<sup>47</sup> This is a more precise definition, considering that the primary difference between *sukuk* and bonds is that *sukuk* do not draw traditional interest.<sup>48</sup> The legal structure of *sukuk* is most analogous to U.S. trust certificates.<sup>49</sup> A traditional bond is a contractual debt obligation, and the bond issuer is obligated to pay bondholders both interest and principal at agreed-upon intervals.<sup>50</sup> With a *sukuk* issuance, the holders each hold “an undivided beneficial ownership interest in the underlying assets” and are thus entitled to share both in the *sukuk* revenues as well as the proceeds of the realization of the *sukuk* assets.<sup>51</sup> However, as the *sukuk* system has progressed and grown, borrowers would usually promise to buy back the assets irrespective of whether the assets made money.<sup>52</sup> This has led to some controversy surrounding *sukuk* issuances, to be addressed below.<sup>53</sup>

8. *Tawarruq*.—Because not all funding endeavors can actually be supported by physical assets, the *tawarruq* financing method has grown in popularity.<sup>54</sup> The basic structure of this transaction type occurs where an

---

44. HOLGER TIMM, THE CULTURAL AND DEMOGRAPHIC ASPECTS OF THE ISLAMIC FINANCIAL SYSTEM AND THE POTENTIAL FOR ISLAMIC FINANCIAL PRODUCTS IN THE GERMAN MARKET 40 (2004).

45. *Id.*

46. Qadri, *supra* note 19, at 60.

47. Abdulkader Thomas, *Opportunities with Sukuk and Securitizations*, in STRUCTURING ISLAMIC FINANCE TRANSACTIONS, *supra* note 4, at 154, 154.

48. Jeff Black, *An Unhealthy Interest?*, MIDDLE E., July 2008, at 44, 44.

49. Thomas, *supra* note 47, at 154.

50. Tamara Box & Mohammed Asaria, *Islamic Finance Market Turns to Securitization*, INT’L FIN. L. REV., July 2005, at 21, 21.

51. *Id.* at 21–22.

52. See Kit R. Roane, *Fatally Flawed Bonds*, PORTFOLIO.COM, Sept. 23, 2008, <http://www.portfolio.com/news-markets/top-5/2008/09/23/Changes-in-Islamic-Finance> (noting Usmani’s assessment that some 85% of *sukuk* issuances at the time guaranteed return of the principal regardless of default); see also *infra* notes 86–87 and accompanying text.

53. See *infra* notes 82–91 and accompanying text.

54. MAHMOUD A. EL-GAMAL, ISLAMIC FINANCE: LAW, ECONOMICS, AND PRACTICE 69 (2006); see also Salah Al-Shalhoob, Organised *Tawarruq* in Islamic Law 3 (unpublished

individual or company buys a commodity from a financial institution and then resells the commodity to a third party for cash.<sup>55</sup> Like the other above-mentioned instruments, in a *tawarruq* the bank is repaid over a fixed period of time with an inbuilt profit for the use of that commodity.<sup>56</sup> A case study of *tawarruq* development is included in Part V below.

The Islamic financial products discussed above each have numerous variations that have developed in response to changes in investor needs and conventional financial products. Many of the hybrid products incorporate elements of multiple financing methods, often achieving a result that parallels conventional investments.

### III. Mixing Business and Religion: Recipe for Conflict

The restrictions placed on Shari'a-compliant investment funds cause rifts and various points of contention when applied within the framework of conventional banking and finance. Scholars and commentators, Muslim and non-Muslim alike, have pointed to numerous issues with the current way Islamic finance is structured.<sup>57</sup> The nature of a religiously based financial system that crosses geographic, ethnic, cultural, and doctrinal lines creates problems of consistency and levels of risk that have scared away some potential investors.<sup>58</sup>

#### A. *Fragmented Regulatory Structure*

There are numerous bodies that oversee the Islamic financial system, interpret Shari'a law, and issue recommendations, *fatwas*, and other forms of guidance on how to invest in accordance with the will of Allah. Some commentators have argued that this system has hindered the success and advancement of Islamic finance and its adaptation to modern conventions.<sup>59</sup>

---

manuscript, on file at [https://eprints.kfupm.edu.sa/14894/1/organised\\_tawarruq\\_in\\_Islamic\\_law\\_\(Conf\\_23\\_Apr\\_2007\).pdf](https://eprints.kfupm.edu.sa/14894/1/organised_tawarruq_in_Islamic_law_(Conf_23_Apr_2007).pdf)) (reporting that the Saudi Arabia British Bank introduced *tawarruq* in 2000 to facilitate trading on the international commodities market by Islamic investors); Mutalip & Hussin, *supra* note 25, at 1 (reporting that many Malaysian institutions offer *tawarruq* in order to avoid scholarly criticism of other forms of financing).

55. Stella Cox & Abdulkader Thomas, *Liquidity Management: Developing the Islamic Capital Market and Creating Liquidity*, in STRUCTURING ISLAMIC FINANCE TRANSACTIONS, *supra* note 4, at 171, 174–75.

56. *Id.*

57. See, e.g., Agha, *supra* note 14, at 182 (“[U]ncertainty is considered a problem under Islamic Finance.”); Kilian Bälz, *Islamic Finance for European Muslims: The Diversity Management of Shari’ah-Compliant Transactions*, 7 CHI. J. INT’L L. 551, 556 (2007) (“[F]or centuries, the Islamic Shari’ah has been a discursive legal system with a fair degree of pluralism (or uncertainty) in terms of black letter rules.”); Rodney Wilson, *Capital Flight Through Islamic Managed Funds*, in THE POLITICS OF ISLAMIC FINANCE 129, 129–31 (Clement M. Henry & Rodney Wilson eds., 2004) (discussing the capital flight from Islamic countries due to the structure of Islamic finance).

58. See, e.g., *infra* notes 80–92 and accompanying text (discussing a drop in issuances of *sukuk* following a speech by Sheikh Muhammad Taqi Usmani).

59. See, e.g., sources cited *supra* note 57.

1. *Accounting and Auditing Organization for Islamic Financial Institutions.*—Among the several agencies that pass guidelines and regulate Islamic financial systems internationally, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is arguably the most important. Founded in 1991, the AAOIFI describes its role as “an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shari’a standards for Islamic financial institutions and the industry.”<sup>60</sup> While it is located in Bahrain, the AAOIFI has two-hundred members from forty-five countries, and these members primarily include central banks and Islamic financial institutions.<sup>61</sup> Seven countries have adopted and implemented the AAOIFI’s standards, and six others have issued guidelines and laws based on the AAOIFI’s standards.<sup>62</sup>

Some commentators have noted that the AAOIFI has focused more on the “big ticket” market and given less attention to the retail market of Islamic finance.<sup>63</sup>

In addition, the AAOIFI does not develop products; it simply establishes a framework within which products can be developed. Furthermore, even institutions that heavily rely on the AAOIFI will normally also retain an internal or external Shari’ah board that supervises compliance with these principles. As a result, standardization in the fashion carried out by the AAOIFI may help provide some orientation, but it will not solve the problems encountered when structuring a concrete product.<sup>64</sup>

2. *Islamic Financial Services Board.*—The Islamic Financial Services Board (IFSB) in Malaysia describes itself as “an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors.”<sup>65</sup> The IFSB has published standards and other documents to help guide institutions and countries in developing standards for Shari’a compliance.<sup>66</sup>

---

60. Accounting & Auditing Org. for Islamic Fin. Insts., AAOIFI Overview, <http://www.aaofi.com/overview.html>.

61. *Id.*

62. *See id.* (noting implementation of AAOIFI standards in Bahrain, Jordan, Lebanon, Qatar, Sudan, Syria, and Dubai International Financial Centre, and of AAOIFI-based guidelines in Australia, Indonesia, Malaysia, Pakistan, Saudi Arabia, and South Africa).

63. *E.g.*, Bälz, *supra* note 57, at 556.

64. *Id.*

65. Islamic Fin. Servs. Bd., <http://www.ifsb.org>.

66. Islamic Fin. Servs. Bd., Standards Development, <http://www.ifsb.org/standard.php>.

3. *Islamic International Rating Agency.*—The Islamic International Rating Agency (IIRA) is the only ratings agency that provides a rating system that encompasses the “full array of capital instruments and specialty Islamic financial products.”<sup>67</sup> The IIRA provides traditional ratings of Shari’a-compliant institutions, similar to more commonly used ratings agencies like Moody’s and Standard & Poor’s. However, in 2005 the IIRA became the first agency to also offer a Shari’a Quality Rating<sup>68</sup> (and currently remains the only one to do so). The Quality Rating gives investors a sense of the level of Shari’a compliance of certain Islamic financial institutions.<sup>69</sup>

4. *International Islamic Financial Market.*—The International Islamic Financial Market (IIFM), located in Bahrain, was created out of the efforts of a number of central banks and government agencies, including Bahrain, Brunei, Dubai, Indonesia, Malaysia, Pakistan, Sudan, and Saudi Arabia, among others.<sup>70</sup> Among the IIFM’s primary objectives is to “encourage self-regulation for the development and promotion of the Islamic Capital and Money Market segment.”<sup>71</sup> The IIFM issues trade guidelines, best-practice procedures, and standardized financial contracts in its efforts to promote Islamic financial innovation.<sup>72</sup>

5. *International Islamic Fiqh Academy.*—The International Islamic Fiqh Academy, located in Saudi Arabia, is an organ of the Organisation of the Islamic Conference.<sup>73</sup> Among its stated objectives is to “study contemporary problems from the Sharia point of view and to try to find the solutions in conformity with the Sharia through an authentic interpretation of its content.”<sup>74</sup> Rulings of the Fiqh Academy have been considered generally decisive on a number of recent Islamic finance issues.

This structure of various regulatory bodies based in different countries, with different membership requirements and methods for evaluating financial products, poses some difficulties in advancing a cohesive message. First, most of these organizations have been formed in the past ten to fifteen years

---

67. Islamic Int’l Rating Agency, Corporate Profile, <http://www.iirating.com/profile.asp>.

68. *See id.* (emphasizing that the IIRA “is the sole rating agency established to provide capital markets and the banking sector in predominantly Islamic countries with a rating spectrum that encompasses the full array of capital instruments and specialty Islamic financial products, and to enhance the level of analytical expertise in those markets”).

69. Islamic Int’l Rating Agency, Products & Services, <http://www.iirating.com/service.asp>.

70. Int’l Islamic Fin. Mkt., <http://www.iifm.net>.

71. Int’l Islamic Fin. Mkt., Objectives, <http://www.iifm.net/AboutUs/CorporateProfile/Objectives/tabid/61/Default.aspx>.

72. *Id.*

73. USMANI, *supra* note 17, at xi.

74. Organisation of the Islamic Conference, Subsidiary Organs, [http://www.oic-oci.org/page\\_detail.asp?p\\_id=64#FIQH](http://www.oic-oci.org/page_detail.asp?p_id=64#FIQH).

and are still evolving.<sup>75</sup> There are regular instances when the notion of Shari'a-compliance is defined differently by these organizations or is overbroad, leaving other scholars and financial officials unsure of where the lines are drawn. Second, because these organizations are international in nature and largely advance guidelines rather than binding laws, it has proven difficult in some instances to reconcile their directives with the disparate bodies of national law among different countries.<sup>76</sup>

### *B. Regional Differences*

In addition to the structural and organizational gaps of the Islamic financial system, conflicting issues arise when national norms and interests are advanced and given precedence over international standards and guidelines on Islamic financial methods. One example of how differently various countries, even Muslim countries, can interpret Shari'a compliance can be found in the respective cases of Malaysia and Saudi Arabia. As one well-known Islamic finance practitioner casually characterized the range in implementation of Shari'a principles in the financial sector: "I would put Malaysia on a ten, in terms of permissiveness, Saudi Arabia at about a one, GCC [Gulf Cooperation Council] countries at about 4.5, Dubai exception, maybe five, London, . . . at about six, Pakistan, maybe at 9.5."<sup>77</sup>

Though these majority-Muslim countries are on the front lines of Islamic financial-product development, their differing approaches create two different-looking Islamic financial systems.<sup>78</sup> Not surprisingly, these systems are sometimes inconsistent with regard to acceptable financial practices and interpretation of Shari'a law.<sup>79</sup>

### *C. Risk of Changing Rules and Varying Legal Opinions*

The risk of unexpected rule changes is one of the central and most widely discussed obstacles to expanding Islamic finance into the mainstream and non-Muslim population. Because many Islamic countries do not endorse

---

75. See, e.g., Islamic Int'l Rating Agency, *supra* note 67 (recording that the IIRA began operating in July 2005).

76. See generally UBIQ CONSULTANCY, AN INTRODUCTION TO ISLAMIC FINANCE 3 (2007), [http://www.ubiqconsultancy.com/docs/islamic\\_finance.pdf](http://www.ubiqconsultancy.com/docs/islamic_finance.pdf) ("Malaysia is seen as more efficient and progressive, to the conventional banker, yet too liberal to Gulf Shariah scholars."); Qadri, *supra* note 19, at 59–60 (recommending that financial institutions comply with the rulings and opinions of several foreign supervisory agencies and entities); Boey Kit Yin, *Malaysia: A Natural Destination*, ACQUISITIONS MONTHLY (ISLAMIC FIN. 2009), Nov. 1, 2009, at 19, 20 ("Malaysian Sharia standards have always been perceived as too liberal in the [Middle East].").

77. Agha, *supra* note 14, at 187.

78. See *id.* at 188 (comparing the permissiveness of Malaysia in accepting the parties' determination that something is Islamic with that of Saudi Arabia, where it must conform with the basic principles in substance and form).

79. See UBIQ CONSULTANCY, *supra* note 76, at 3 ("Malaysia has one centralized standard setting board (IFSB), which harmonizes the various interpretations of Shariah law, whereas the Gulf banks[] release their own individual, and generally more conservative, interpretations.").

the notion of binding precedent,<sup>80</sup> meaning that clerics and scholars can change their opinions and disagree with past decisions, there is some degree of uncertainty as to whether a financial method or instrument currently considered Shari'a-compliant will remain so for the length of any given project or investment plan.<sup>81</sup>

A recent and notable example of this shift in opinion is the case of *sukuk* issuances. As discussed above, *sukuk* are the rough equivalent of a Shari'a-compliant bond issue, except without traditional interest payments.<sup>82</sup> In November 2007, an Islamic finance scholar, Sheikh Muhammad Taqi Usmani, questioned whether the issuance of *sukuk* was technically in compliance with the fundamental prohibition against interest.<sup>83</sup> Usmani stated in a policy paper, "The time has come to revisit this matter, and rid *sukuk* of these blemishes."<sup>84</sup> These "blemishes" include, among other things, the now-common practice of marketing asset-backed returns on the basis of the LIBOR rate benchmark, which is a "corruption" according to Usmani.<sup>85</sup> Usmani's discussion of *sukuk* also called into question "a popular type of *sukuk* that promised to pay back the face value of the bond at maturity or in case of default."<sup>86</sup> Because Islamic financial principles require risk sharing, many scholars agreed that this guarantee "ran counter to the spirit of Islamic finance."<sup>87</sup> Up to the time that Usmani released this statement, *sukuk* had been considered the backbone of Islamic finance and had allowed the system to grow and expand into more traditional investment arenas.<sup>88</sup>

After Usmani's pronouncement, *sukuk* issuances dropped off dramatically.<sup>89</sup> While many acknowledge that at least some of this decline may be attributed to the overall decline of worldwide financial markets, it is

80. See Box & Asaria, *supra* note 50, at 22 (noting Saudi Arabia's "lack of a system of binding precedent"); John H. Vogel, *Securitization and Shariah Law*, in ISLAMIC FINANCE NEWS: LEADING LAWYERS 2009, at 63, 64 (S. Sivaselvam et al. eds., 2009), available at <http://www.islamicfinancenews.com/fla-mag/legal09/legal09.html> ("[D]ecisions of courts are not often reported and, even if reported, are generally not considered to establish binding precedent for subsequent decisions.").

81. See Agha, *supra* note 14, at 189 ("[T]here is no requirement that just because a structure has been done in the past, that that structure will be considered viable a year from now.").

82. Box & Asaria, *supra* note 50, at 21–22.

83. Black, *supra* note 48, at 44.

84. *Id.*

85. *Id.* LIBOR stands for the London InterBank Offered Rate, which is the interest rate at which banks offer to lend to each other. British Bankers' Ass'n, The Basics, <http://www.bbalibor.com/bba/jsp/polopoly.jsp?d=1627>. This rate is commonly used as a benchmark for the quotation of interest rates for other types of loans, such as commercial loans. *Id.*

86. Roula Khalaf, *Islamic Finance Must Resolve Inner Tensions*, FIN. TIMES, Mar. 30, 2009, <http://www.ft.com/cms/s/0/4894b482-1d44-11de-9eb3-00144feabdc0.html>.

87. *Id.*

88. Roane, *supra* note 52.

89. See Syed Imad-ud-Din Asad, *An Overview of the Sukuk Market*, INVESTOR'S BUS. & FIN. J., Mar. 2009, <http://www.jang.com.pk/thenews/investors/mar2009/p2.htm> (noting a 66% decline in *sukuk* issuances worldwide in 2008).

likely that Usmani's comments also contributed to the trend.<sup>90</sup> Commentators, scholars, and investors were widely surprised and alarmed by how a single speech could set back progress and investment in a product that had proven so successful in recent years.<sup>91</sup>

Because of the religion-based, nonbinding legal nature of Shari'a-compliant financing, this danger of disagreement among religious leaders carries special weight that might not be present in other legal or regulatory systems. The purpose of engaging in Islamic finance is to make profits while at the same time adhering to the principles and directives of the Islamic faith. For non-Muslims, who lack this second prong of religious conviction, conventional financing would be equally appealing in many ways. However, those who engage in Islamic finance for religious purposes view their religious convictions as intertwined with their conduct both in their personal and professional endeavors.<sup>92</sup>

Some of the problems associated with these inconsistencies have recently gained international attention in the wake of the 2009 Dubai World Nakheel *sukuk* crisis.<sup>93</sup> Dubai World is a global holding company that manages investments for the government of Dubai.<sup>94</sup> In November 2009, the company announced its intention to delay upcoming payments on *sukuk* issued by Nakheel, Dubai World's real estate subsidiary.<sup>95</sup> This was the first large-scale potential *sukuk* default, and there were concerns among creditors as to how payments would be distributed and which creditors would receive priority.<sup>96</sup> The absence of a consistent and reliable system for determining the effect of market fluctuations and other common trends, in this case a near-default, results in tremendous uncertainty for investors.

---

90. Robin Wigglesworth, *Sukuk: Defaults Destabilise a Reviving Market*, FIN. TIMES, Dec. 7, 2009, [http://www.ft.com/cms/s/0/90e4c3d6-e2be-11de-b028-00144feab49a,dwp\\_uuid=aee0503e-e09e-11de-9f58-00144feab49a.html](http://www.ft.com/cms/s/0/90e4c3d6-e2be-11de-b028-00144feab49a,dwp_uuid=aee0503e-e09e-11de-9f58-00144feab49a.html).

91. See, e.g., Haider Ala Hamoudi, *Baghdad Booksellers, Basra Carpet Merchants, and the Law of God and Man: Legal Pluralism and the Contemporary Muslim Experience*, 1 BERKELEY J. MIDDLE E. & ISLAMIC L. 83, 101 (2008) (expressing surprise at the influence of the speech, despite Usmani's having "no current position of official authority in any nation"); Black, *supra* note 48, at 45 (noting the "furor" over Usmani's speech in the financial press).

92. See Robert R. Bianchi, *The Revolution in Islamic Finance*, 7 CHI. J. INT'L L. 569, 573 (2007) (discussing the concept that individual Islamic bankers are specially obligated to be honest and moral because "their religion holds them to a higher standard").

93. See Vikas Bajaj & Graham Bowley, *Arab Emirates Aim to Limit Dubai Crisis in Pledge to Banks*, N.Y. TIMES, Nov. 30, 2009, at A1 (discussing the global implications of a Dubai World default); Heather Timmons, *Dubai Crisis Tests Laws of Islamic Financing*, N.Y. TIMES, Dec. 1, 2009, at B4 (discussing creditors' reactions to Dubai World's request to delay payment on debt).

94. Dubai World, <http://www.dubaiworld.ae>.

95. Timmons, *supra* note 93.

96. Timmons, *supra* note 93 (citing Zaher Barakat, professor of Islamic finance at Cass Business School in London, who expressed concern over the inconsistent rules about repaying creditors in the event of *sukuk* default).

#### D. *Too Few Qualified Scholars*

Two issues closely related to the problems associated with perceived inconsistency are the methods by which decisions and rulings are made within Shari'a boards, and the composition of these boards.<sup>97</sup> Each Islamic financial institution maintains a Shari'a board, which is comprised of Islamic religious scholars as well as financial experts and businesspersons. Because the field of Islamic finance is a relatively recent development, there are only a select number of scholars that have the necessary educational and professional background to sit on the boards of Islamic institutions and regulatory agencies.<sup>98</sup> Most of these individuals serve on multiple Shari'a boards.<sup>99</sup> There is no formalized prohibition against serving on numerous boards, even when those interests might conflict.

This pattern arguably promotes consistency because a limited group of people can better coordinate the direction of Islamic financial development. But having only a small group of eligible people may hinder expansion and create greater opportunities for self-dealing than might occur otherwise. Additionally, the scholars are in such high demand that it might prove difficult for innovators or entrepreneurs to verify the Shari'a-compliant status of new products or proposals because the Shari'a board members' time is so valuable.<sup>100</sup>

#### IV. Change Is Needed

Islamic finance has prospered in recent years and made adjustments to accommodate the evolving state of worldwide financial affairs. Even in the wake of the recent financial crisis of 2008, Shari'a-compliant banks have fared relatively well in comparison to conventional ones.<sup>101</sup> However, the Islamic financial system may currently be at a crossroads. Since Sheikh

---

97. *See id.* at 575 (reporting that the Organisation of the Islamic Conference is "racing to develop common ethical standards for Shari'a advisory boards," implying that the boards employ differing, possibly inconsistent, ethical standards in making their decisions). Furthermore, the interconnectedness and opacity of current system create serious ethics issues:

The same religious scholars frequently advise competing businesses, government regulators, private entrepreneurs, Muslim-run companies in their own regions, and non-Muslim-owned multinational corporations headquartered in Europe, North America, and the Far East. The financial *ulama* often serve their clients not only as outside auditors, but also as permanent consultants or even as regular employees. These inherent conflicts of interest and temptations for self-dealing compromise advisors and clients alike.

*Id.*

98. *See Savings and Souls*, *ECONOMIST*, Sept. 6, 2008, at 81, 81 (recognizing that a small group of fifteen to twenty scholars repeatedly sits on the boards of Islamic financial institutions, largely due to the positions requiring knowledge of Islamic law and Western finance, fluency in English and Arabic, and investor and customer comfort with recognized names).

99. *Id.* at 83.

100. *Id.*

101. *See Hawser, supra* note 2, at 31 (discussing how Islamic financing's focus on real assets led to Islamic banks requiring fewer financial lifelines than conventional banks).

Usmani's warning about potential problems with Shari'a-compliant bonds, the incidences and amounts of *sukuk* issuances have fallen,<sup>102</sup> and questions have been raised about the sustainability of the system.<sup>103</sup> Recent concerns about the stability of Islamic investment giant Dubai World have also sparked criticism of the Islamic banking system, leading some to question whether Shari'a-compliant instruments actually offer more security than traditional tools.<sup>104</sup> With people everywhere looking for a safe place to invest, the current economic crisis is an important opportunity for Islamic finance to move more directly into the mainstream.

Some proposals for popularizing Islamic finance toe the line between actual and technical Shari'a compliance.<sup>105</sup> Some allege that these types of approaches emphasize profit maximization at the expense of marginalizing the religious and ethical aspects of Islamic banking.<sup>106</sup> There are dangers in abandoning the Shari'a roots of Islamic finance, and it remains important to adhere to traditional values even after implementing changes. In fact, some critics have suggested that the Islamic funds that have suffered the most in the recent downturn are those that have strayed from strict Shari'a compliance.<sup>107</sup> Therefore, the subparts that follow examine three proposals in areas in which Islamic finance could make minor adjustments and produce positive results that would benefit both Muslim and non-Muslim countries and companies. These proposals include both short- and long-term approaches designed to capitalize on the financial crisis and popularize Islamic finance, specifically in Western countries. These proposals recommend the following: (1) uniform educational requirements should be implemented for Shari'a board members and board advisors; (2) conflicts of interest on Shari'a boards should be better regulated; and (3) the current

---

102. See *supra* note 89 and accompanying text.

103. See Joanna Slater, *Dubai Deals 'Sukuk' Setback: Islamic Bonds Suffer from Bad Headlines Just as They Were Recovering*, WALL ST. J., Dec. 2, 2009, at C2 (reporting observations by a credit analyst, a CEO of an investment firm, and others concerned about the impact a potential default on Dubai World bonds may have on the overall *sukuk* market).

104. See John Foster, *How Sharia-Compliant Is Islamic Banking?*, BBC NEWS, Dec. 11, 2009, <http://news.bbc.co.uk/2/hi/business/8401421.stm> (noting the substantive similarities between traditional investments and those allegedly Shari'a-compliant instruments while expressing skepticism about Islamic finance).

105. See Hamoudi, *supra* note 5, at 605–06 (decrying the excessively formalistic analysis applied by proponents of Islamic finance as an approach that divorces the methods of Islamic finance from the goals of Islamic finance).

106. E.g., Siddiqi, *supra* note 39, at 5–6.

107. See John Foster, *How Islamic Finance Missed Heavenly Chance*, BBC NEWS, Dec. 1, 2009, <http://news.bbc.co.uk/2/hi/business/8388644.stm> (concluding that many of the problems behind Dubai's near-default may be linked to the innovative instruments that have been deemed Shari'a compliant, but that have actually just "circumvent[ed] the principles of [Shari'a] law"); Andrew Ross Sorkin, *A Financial Mirage in the Desert*, N.Y. TIMES, Nov. 30, 2009, <http://www.nytimes.com/2009/12/01/business/01sorkin.html> (describing the Dubai World *sukuk* as investments that "looked like bonds, walked like bonds and talked like bonds").

ratings system for evaluating the level of Shari'a compliance should include elements similar to a traditional peer-review rating system.

These proposals may offer a bridge to a more widespread acceptance of Shari'a law. In the wake of the financial crisis, new investment opportunities could prove beneficial for both struggling Western investors as well as Islamic financial institutions, which are growing but still comprise only a small portion of the international financial markets. The following proposals should help to assuage the fears of potential investors regarding risk and volatility. These fears may be especially pronounced in countries such as the United States, where the notion of incorporating religious standards into the business arena has not traditionally been part of the professional culture.

A. *Streamlining Educational Requirements for Shari'a Law Experts*

As discussed above, one of the perceived problems of Shari'a-compliant investing is that investors cannot necessarily rely on consistency in rulings and judgments. This is true in two senses. First, the different members of the Shari'a boards and their advisors in national governments, international regulatory agencies, and individual companies may each interpret Shari'a law differently.<sup>108</sup> Not only are there varying Qur'anic interpretations, but the secondary nature of the *hadith*, *qiyas*, and *ijm'a* increase the probability for widely divergent understandings of meaning.

Second, some investors view the ever-changing rules as an indication that the additional hassle and compliance measures are not necessarily worth the benefit, which may or may not be formal Shari'a compliance.<sup>109</sup> Studies have shown that Islamic finance still has difficulty attracting certain classes of Muslims in a wide range of geographically and socioeconomically diverse groups.<sup>110</sup> One reason for this may be the perceived increase in transaction costs from doing business in compliance with Shari'a law, without any guarantees that the "compliant" status of the transactions would not later be changed.<sup>111</sup>

Thus, increasing efficiency and consistency is a common goal advanced by many scholars and commentators. Though the Islamic financial community has made great strides in the past two decades with the creation of the AAOIFI and the IIRA, the need for further improvement is still evident. Scholars and experts have advanced various notions for achieving a more

---

108. See *supra* notes 75–79 and accompanying text.

109. See Mahmoud A. El-Gamal, *Limits and Dangers of Shari'a Arbitrage*, in ISLAMIC FINANCE: CURRENT LEGAL AND REGULATORY ISSUES 117, 121–22 (S. Nazim Ali ed., 2005) (noting that due to the close connection and similarity to conventional financing, most potential customers either continue to use conventional finance or avoid all forms of organized finance rather than using the Islamic finance industry).

110. See *id.* at 7 (analyzing the mostly negative responses of different Islamic schools of thought to various finance transactions); *infra* subpart V(B) (illustrating the range of responses to one Islamic financial instrument by various scholars, organizations, and nations).

111. *Savings and Souls*, *supra* note 98, at 82.

cohesive message and streamlined approach. However, one area in need of change that has been largely neglected is the possibility of creating a standardized curriculum for individuals who will sit on or advise Shari'a boards, whether it be at the institutional, national, or international-agency level.

Only in the past few years have educational institutions responded to what has been called one of the sector's greatest challenges—the need for more specialists and experts on Islamic finance.<sup>112</sup> For example, the University of Reading in England recently “launched a master's degree in investment banking and Islamic finance, making it one of a growing number of universities in the west to offer a postgraduate course in a sector that has boomed in the Muslim world in recent years.”<sup>113</sup>

As these formalized programs emerge and grow, it is important to structure them in a way that is most useful to the field and its long-term goals. First, educational requirements for sitting on and advising Shari'a boards and leading, managing, or engaging in ratings of Islamic financial institutions should be standardized to include both business and Islamic-religion-and-history curriculums. Though it appears that the newly developed programs at some institutions currently incorporate these issues in the course of study, it is less clear whether there is consistency among institutions. Though a strict version of standardization would be difficult, if not impossible, organizations such as the IIRA and AAOIFI could begin shaping how future Shari'a compliance will look by creating, funding, and publicizing Shari'a-compliant financing as a course of study. One option for this would be for these reputable and well-known agencies to allow universities in different countries to grant certification to engage in Shari'a-compliance evaluation. This way, these leading agencies would be able to set uniform requirements, curriculum, and accepted practices that the next generation of Shari'a scholars would adhere to.

One criticism of this proposal might be that making educational standards stricter could decrease the pool of individuals eligible and qualified to participate in shaping Islamic financial policy and products. However, it is equally feasible that a formalized program might actually increase the number of people interested in and eligible for careers in Shari'a law and Islamic finance. Additional benefits might include making the process for selection of Shari'a board members more transparent and democratic. The individual programs as instituted by universities could be managed and the curriculum controlled largely by the current leaders of the international Islamic financial institutions and agencies. Also, individuals who receive formalized training in Shari'a-compliant financial systems would be eligible to do more than merely serve as Shari'a board members. They would be

---

112. Shyamantha Asokan, *New Class for Islamic Finance*, FIN. TIMES, Jan. 19, 2009, at 13.

113. *Id.*

qualified to serve in management positions even in non-Muslim countries and for non-Islamic companies.

Though several of the international Islamic financial agencies have programs in place for training individuals for careers in Islamic finance, these sparse programs focus more on the basics of the system rather than on the larger overarching policy.<sup>114</sup> While these programs are a step in the right direction, the programs as they are currently administered do not mirror a university-level educational program. Instead, many of the opportunities for formalized and even certified Islamic-law training are more informal, of relatively short duration, and with relatively few restrictions on eligibility.<sup>115</sup> My proposal is to create a more formalized program with long-term training in the style of traditional university education systems. This would be an improvement over the current systems because of the opportunity to expose future leaders to a standardized curriculum. This might create a greater likelihood for consensus among leaders and promote a more uniform worldview. Having consistent standards across geographic and cultural boundaries may help mitigate the differences that have proved divisive in the past.

Some of the admitted challenges of such a proposal include the time lag for implementation and the variations that would inevitably still remain even after the creation of a formalized educational program.

#### *B. Avoidance of Shari'a Scholar Conflicts*

“The OIC is racing to develop common ethical standards for Shari’ah advisory boards and to set up training programs that can staff these boards with certified experts in Islamic finance.”<sup>116</sup> Streamlining the educational requirements for Shari’a board membership and other leadership positions in Islamic financial institutions also advances a related goal: reducing the opportunity for conflicts of interests among leaders in the Islamic financial community. In 2009, the top five Islamic scholars held nearly a third of all 956 available Shari’a board positions, and “the top three each sit on more than 60 boards each.”<sup>117</sup> It is arguable that by increasing funding and

---

114. See, e.g., Islamic Fin. Serv. Bd., *supra* note 65 (noting that the IFSB “coordinates initiatives on industry related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders”); Islamic Int’l Rating Agency, *supra* note 67 (explaining that the IIRA holds seminars to educate individuals about Islamic rating analysis).

115. See, e.g., Accounting & Auditing Org. for Islamic Fin. Insts., Certified Shari’a Adviser and Auditor (CSAA) Program, <http://www.aaofii.com/csaa2.html> (offering a certification program that includes education in the application of Islamic jurisprudence to Islamic finance); Islamic Fin. Servs. Bd., *supra* note 65 (offering workshops and seminars about Islamic finance and related laws, and opening most of these short educational events to anyone who registers).

116. Bianchi, *supra* note 92, at 575 (citing Rifaat Ahmed Abdel Karim, Address at the Islamic Financial Services Board 3d Summit on Aligning the Architecture of Islamic Finance to the Evolving Industry Needs (May 17–18, 2006)).

117. Robin Wigglesworth, *Scholars: Sharia Compliance Rulings Reverse Trend*, FIN. TIMES, Dec. 7, 2009, available at <http://www.ft.com/cms/s/0/8ec1abb4-e2be-11de-b028-00144feab49a.html>.

opportunities for universities to offer more Islamic finance certification programs, the number of Islamic finance experts will continue to grow in both Muslim and non-Muslim countries. However, it might also be prudent and effective for international Islamic finance regulatory bodies to implement conflicts-of-interest guidelines that are uniform across jurisdictions and must be adhered to by Islamic financial institutions and bodies.

The problem as it now exists is that the number of Shari'a law and financial-compliance experts is small. Therefore, all companies and financial institutions needing to meet their Shari'a board standards of having at least three Islamic law experts are required to compete for the valuable time of the same select individuals.<sup>118</sup> This leaves open the opportunity for conflicts of interests when those select scholars may have incentives that are not completely in line with conventional Islamic-finance theory.

For instance, the conflicts in this setting can be compared with those of U.S. boards of directors, which Sarbanes–Oxley (SOX) attempted to address.<sup>119</sup> SOX sought to make boards more independent from management and reduce the number of activities in which they may have a perceived conflict of interest.<sup>120</sup> Likewise, the problems with conflicts of interest on Shari'a boards might be addressed in the same way: with sweeping and enforceable laws that mandate certain measures to prevent conflicts of interest. The most problematic conflicts might stem from the number of loyalties and obligations that the world's top Shari'a law experts have via their participation in so many companies and other financial institutions.

To address this issue, new legislation might seek to limit the number of boards on which individuals can sit. It might also be modeled on SOX and similar acts by requiring that a certain number of board members be independent of management and having more wide-ranging disclosure of potential conflicts.

Critics may argue that such a proposal requires the passing of legislation-like guidelines that face the same problems as the other guidelines in the Islamic financial arena: enforcing adherence across national and cultural boundaries. However, because some agencies already exist and their “stamp of approval” instills confidence in investors, requiring the AAOIFI or the IIRA to oversee and enforce such new rules may help mitigate this danger.

---

118. Miller & Baylis, *supra* note 23.

119. See Christine Walsh, *Ethics: Inherent in Islamic Finance Through Shari'a Law; Resisted in American Business Despite Sarbanes-Oxley*, 12 FORDHAM J. CORP. & FIN. L. 753, 754, 773 (2007) (explaining that SOX tries to foster ethical business and eliminate conflicts of interest between auditors and management by requiring enhanced disclosure, increased accountability, and independent review and monitoring of companies).

120. *Id.*

### C. *Changes to Ratings System*

The IIRA, as discussed above, created a ratings agency that has proven highly successful over the past four years. Part of its appeal is (1) that it is the only entity that offers such a system specifically tailored to Islamic financial institutions and investors, and (2) it offers a “Quality Rating” that measures the degree of compliance with Shari’a law.<sup>121</sup> Slight modifications to this ratings system may work to create a more investor-friendly environment and, at the same time, advance the overall goal of streamlining Islamic leaders’ and scholars’ opinions on certain products.

These alterations would include adding a type of peer-review process to the Quality Rating calculation. If companies could rate each others’ Shari’a-compliance levels, that may benefit both companies and investors. First, companies who engage in Shari’a financing are more familiar with the intricacies of the business than outsider agencies or evaluators. Second, if companies were encouraged to be members of a peer-review-style model of Shari’a-compliance rating, they would have incentive to act reasonably and rate truthfully because their own interests might be at stake. This type of approach might give investors a more accurate picture of the compliance level of potential companies and institutions.

## V. Case Study: *Tawarruq*

### A. *A Closer Look at Tawarruq*

Though a rudimentary form of *tawarruq* has existed for many years, the modern form of *tawarruq* is an Islamic finance instrument that was developed in Saudi Arabia less than a decade ago.<sup>122</sup> As discussed briefly above, *tawarruq* can be generally described as an arrangement involving the purchase of an asset at an agreed price and a subsequent sale of that asset to a third party for monetary gain.<sup>123</sup> A common illustration of a *tawarruq* arrangement might look as follows:

- *F* (financial institution) buys ten tons of iron for \$20,000,000 from the international market (1 ton = \$2,000,000).
- *F* then offers to *C* (client) a ton of iron for \$3,000,000 to be paid in installments within ten years.
- At the same time *C* buys the iron, *F* offers to sell (through itself or via another agent) *C*’s iron on behalf of *C* in the international market for \$2,000,000 (the same price *F* paid originally).

---

121. See *supra* notes 67–69 and accompanying text.

122. Al-Shalhoob, *supra* note 54, at 2.

123. Mutalip & Hussin, *supra* note 25, at 1.

- Result: *F* credits \$2,000,000 in *C*'s account.<sup>124</sup>

*Tawarruq* has proven controversial among leading Islamic scholars, and there is an ongoing debate in the Islamic financial community over its Shari'a-compliant status.<sup>125</sup> Though highly popular when first introduced, *tawarruq* has been the subject of criticism from a small but vocal group of Islamic financial scholars.<sup>126</sup>

#### B. *Tawarruq as an Illustration of Islamic Finance Obstacles*

Among the more common complaints is that *tawarruq* has the potential to create a debt larger than the cash that it transfers.<sup>127</sup> Critics thus allege that despite involving the purchase and sale of real assets, *tawarruq* still violates Islamic principles. It is argued that a single asset can enable multiple *tawarruq* arrangements, essentially severing the tie to the "real sector of the economy."<sup>128</sup> This system of *tawarruq* treads dangerously close to conventional financial methods that freely allow the selling and trading of debt. Opponents also argue that as a matter of public policy, the Islamic community should resist *tawarruq* financing even if the arrangement is construed to be technically Shari'a compliant.<sup>129</sup> The mere fact that it appears to encourage inequity, inefficiency, and high risk is enough for some to deem it a disfavored method.<sup>130</sup>

Opponents to *tawarruq* typically rely on *hadith* directives to support their argument that such an arrangement is *haraam*. First, one *hadith* warns against having "two conditions relating to one transaction" in a financial contract—a phrase whose meaning is not altogether clear.<sup>131</sup> Some argue that this means that *tawarruq* is impermissible since it involves two transactions in one agreement. However, the more traditional view held by the vast majority of scholars is that this warning acts as a prohibition against uncertainty in contracts, meaning that naming two conflicting terms (such as price) in one contract promotes uncertainty.<sup>132</sup>

124. Al-Shalhoob, *supra* note 54, at 2. The given illustration is an edited version of an example provided in Al-Shalhoob's work.

125. MICHAEL AINLEY ET AL., FIN. SERVS. AUTH., ISLAMIC FINANCE IN THE UK: REGULATION AND CHALLENGES 18 (2007), available at [http://www.fsa.gov.uk/pubs/other/islamic\\_finance.pdf](http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf).

126. See, e.g., Siddiqi, *supra* note 39, at 1 (stating that the harmful consequences of *tawarruq* are much greater than the benefits generally cited by its advocates).

127. *Id.*

128. *Id.* at 3.

129. See ISLAMIC FIN. PROJECT, HARVARD LAW SCH. ISLAMIC LEGAL STUDIES PROGRAM, TAWARRUQ: A METHODOLOGICAL ISSUE IN SHARI'A-COMPLIANT FINANCE 5 (2007), <http://ifptest.law.harvard.edu/ifphtml/ifpseminars/WorkshoponTawarruq.pdf> (reporting that although many Shari'a scholars do not dispute the permissibility of *tawarruq*, many also support restrictions on *tawarruq* practice at the institutional level).

130. Siddiqi, *supra* note 39, at 6.

131. Al-Shalhoob, *supra* note 54, at 9.

132. *Id.*

Second, just as many argue that *tawarruq* should be disfavored on public-policy grounds, some scholars believe that *tawarruq* is, at its core, indistinguishable from conventional finance where interest is permitted. Indeed, some even argue that providing a loan with interest is actually less harmful to the client than in the case of *tawarruq* finance since “the financial institution lends to the client directly instead of engaging in a long procedure to buy commodities and sell[] them again in the same market.”<sup>133</sup>

The AAOIFI has taken the position that if the commodity in the transaction is sold back to the original seller (from whom it was purchased on a deferred-payment basis), then the transaction is invalid.<sup>134</sup> However, the transactional structure is deemed permissible if the commodity is sold to a third party.<sup>135</sup> Though these positions are fixed by the AAOIFI, there are numerous variables to the transaction that could make a *tawarruq* agreement less aligned with conventional Shari’a law. Some of these questionable modifications include the case where a bank would appoint someone as an agent to buy the commodity on its behalf and then sell it to himself, or where the *tawarruq* is carried out “through . . . national or international commodity [exchanges], wherein only brokers are doing . . . agency services and the goods always remain where they were without transfer of ownership from the seller to the buyer.”<sup>136</sup>

In addition to the AAOIFI, recently two other Islamic councils have formally considered the issue of *tawarruq*’s Shari’a compliance. The Fiqh Academy of the Organisation of Islamic Conference in Saudi Arabia forbade all *tawarruq* transactions outright.<sup>137</sup> Additionally, the Muslim World League issued two rulings: one that permitted *tawarruq* on the condition that there is no sale to the original seller and another that directly forbade the modern practice of having a bank sell commodities in global markets.<sup>138</sup> Meanwhile, the *Syariah* Advisory Council of Bank Negara Malaysia, which is responsible for determining Shari’a compliance of financial methods in that country, deemed *tawarruq* arrangements fundamentally permissible under Islam.<sup>139</sup>

Because *tawarruq* is a relatively new innovation that has produced conflicts among Islamic scholars, this product is useful as an illustration of some of the fundamental problems that arise in the Islamic financial community. Initially, *tawarruq* was widely supported among Islamic

---

133. *Id.* at 10–11. Al-Shalhoob explains the view that *tawarruq* and conventional financing of a loan with interest (usury in Islamic finance) are functionally equivalent, and that of the two, conventional finance is at least less costly to the borrower. *Id.*

134. AYUB, *supra* note 38, at 350.

135. *Id.*

136. *Id.*

137. EL-GAMAL, *supra* note 54, at 72.

138. *Id.*

139. Mutalip & Hussin, *supra* note 25, at 1.

scholars.<sup>140</sup> However, as different financial institutions and businesses have applied *tawarruq* and created hybrid forms of the arrangement, Islamic scholars have increasingly expressed doubt as to whether *tawarruq* is truly Shari'a compliant.

This reflects the sort of inconsistency that is likely to crop up in the Islamic financial system. Several notable, well-respected Islamic scholars have issued opinions on *tawarruq* that conflict with one another.<sup>141</sup> This conflict among scholars also exists at the national and international organizational level. While Malaysia has shaped policy in support of *tawarruq*, Saudi Arabia has largely forbidden some of *tawarruq*'s most familiar and useful forms.<sup>142</sup> The AAOIFI policy on *tawarruq* is at odds with national policy in some countries.<sup>143</sup> Additionally, some institutions are widely perceived as more "legitimate" (such as the Organisation of the Islamic Conference) than others, leading to further confusion among investors.<sup>144</sup>

### C. A Way Forward: Applying Modification Proposals to Tawarruq

The broad proposals outlined in Part IV above may be more clearly explained when applied to a particular ongoing controversy in the Islamic financial system, such as *tawarruq* financing. The three proposals as applied to *tawarruq* are outlined below and illustrate the potential usefulness of these targeted reforms.

1. *Educational Reform.*—Creating a standard curriculum for individuals pursuing careers as Islamic financial experts may help ease the problems associated with new financial products such as *tawarruq*. At a macro level, there is a split between Shari'a boards of various nations and international institutions as to whether the general structure of *tawarruq* is permissible. Then, between those two poles, there are numerous different opinions as to

---

140. See Liao Y-Sing, *Islam Allows Organised Tawarruq Asset Sales—Scholar*, ARABIAN BUSINESS.COM, June 4, 2009, <http://www.arabianbusiness.com/557758-islam-allows-organised-tawarruq-asset-sales---scholar> (recording that the opposition among some scholars to *tawarruq* is a recent development and noting that the majority of scholars still sanction its use).

141. See *id.* (citing instances of disagreement among Islamic scholars regarding the compatibility of the *tawarruq* practice with Islamic values).

142. See *supra* notes 137–39 and accompanying text.

143. Compare *supra* notes 134–36 and accompanying text (describing the AAOIFI policy), with *supra* note 137 and accompanying text (describing the policy in Saudi Arabia), and *supra* note 139 and accompanying text (describing the policy in Malaysia).

144. See Juan Solé, *Introducing Islamic Banks into Conventional Systems* 5 (Int'l Monetary Fund, Working Paper No. 07/175, 2007), available at <http://ssrn.com/abstract=1007924> ("[T]he Islamic Fiqh Academy, inaugurated . . . under the auspices of the Organization of the Islamic Conference, has earned the respect of Muslim scholars around the world."). But see Habbajan Singh, *Shariah Scholars Turn to AAOIFI over Tawarruq*, MALAYSIAN RESERVE, June 1, 2009, <http://islamicfinanceasia.blogspot.com/2009/05/shariah-scholars-turn-to-aaofii-over.html> (reporting that AAOIFI is better regarded than the Fiqh Academy with respect to Islamic finance because its board is comprised of financial experts rather than experts across various fields).

the permissibility of slight variations on the *tawarruq* structure. While some degree of inconsistency in opinions is to be expected along the spectrum according to the structure's characteristics, the fundamental disagreement over the core structure poses a significant problem for investors, financial institutions, and companies that wish to remain Shari'a compliant.

A uniform educational system that emphasizes core principles and offers thorough analysis of *hadith* might result in the next generation of Shari'a law experts approaching financial innovation in a more unified manner. Such education would necessarily have to promote somewhat broad, general concepts that advance dominant approaches to Shari'a interpretation. For instance, in the case of *tawarruq*, the above-mentioned *hadith* restricting transactions with "two conditions" is largely considered not to forbid contracts involving two transactions but instead to discourage vagueness in contract drafting.<sup>145</sup> If this popular interpretation of the *hadith* message could be clarified at a theoretical level and taught as the general standard, then a central conflict among scholars might be resolved.

However, this is only feasible at the broad and general level of interpretation. To continue with the same example, even if the next generation of scholars were educated to believe that vagueness in contracting is bad and that contracts are not necessarily limited to a single transactional issue, conflicts would inevitably remain with regard to degree. Around the margins and along the spectrum of permissibility, there would predictably be conflicting authority. However, a unified stance as to the permissibility of the general *tawarruq* structure might encourage greater investment and use of the method. Investors and financial institutions would be reassured that *tawarruq* agreements are in compliance with Shari'a law and could at that point assume whatever degree of risk they desire by varying their contractual preferences. In the current state of affairs, parties are unsure even as to whether the transaction could *ever* be made to comply with Shari'a law under any set of circumstances.

This type of educational reform that focuses on emphasizing general agreement on fundamental principles could potentially influence the structure of the system's overall regulatory apparatus. A future generation of scholars with shared understandings of Islamic finance fundamentals, despite their differences, might be more capable of shaping an umbrella organization to whose guidelines all other Shari'a boards would willingly adhere. Such guidelines would inevitably be general and incomplete, but they could serve to insulate individual institutions and individuals from responsibility for engaging in transactions of which a small minority of scholars disapprove.

2. *Avoiding Conflicts.*—Limiting the number of boards on which individuals may sit should increase the number of opportunities for new

---

145. See Al-Shalhoob, *supra* note 54, at 9 (explaining the competing interpretations espoused by Islamic scholars concerning the "two conditions" requirement in the *tawarruq*).

scholars. It should also limit the impact of any one individual's opinion. If scholars were required to disclose publicly all their affiliations in the Islamic financial community and are limited in the number of board positions they may hold, then the pool of Islamic scholars would likely grow and become more equalized. In the case of *tawarruq* and other similar products, such changes may result in a more accurate gauge of the majority opinion. Because the current leaders and decision makers on prominent Shari'a boards are pulled from such a small group, any single group's prohibition has a disproportionate impact on the instrument's viability. Such an impact was especially pronounced in the case of Usmani's cautionary comments regarding *sukuk* issuances.<sup>146</sup> Thus, an emphasis on strengthening conflicts laws and increasing transparency with regard to Shari'a scholars' personal and professional dealings should lead to a more accurate measure of expert opinion and consensus. This may enable *tawarruq* arrangements to avoid the fate of *sukuk*.

3. *New Ratings Methods.*—If companies and institutions were required to rate the practices of other institutions in terms of Shari'a compliance, this may have a moderating effect on Islamic financial policy. This effect might be similar to that of increased conflicts-of-interest monitoring, which works to give institutions and individuals a better indication of where majority opinion lies. Additionally, with products such as *tawarruq* that have many variations, providing a type of peer-review rating might better enable parties to draw the line as to which conditions will push an acceptable product into ambiguous territory where transactions may be altogether impermissible. In other words, the availability of peer review might make it more obvious where public and expert opinion cluster with regard to Shari'a compliance and which factors most affect their findings. Peer review would allow institutions to judge various forms of *tawarruq*, forcing them to draw lines that they might not be in a position to draw with regard to their own institution's business.

## VI. Conclusion

In the post-financial-crisis world economy, there will be opportunities for new financial products to develop in response to both the crisis and its regulatory fallout. The principles of Islamic finance may be just what are needed in these trying economic times. With an emphasis on morality, fairness, and aversion to excessive risk, these foundational premises can teach conventional finance a few helpful lessons. The key will be to find ways to translate Islamic finance's underlying goals and methods to a larger audience in the non-Muslim world.

---

146. See *supra* notes 82–91 and accompanying text.

These proposals for streamlining educational standards, reducing conflicts among Shari'a law leadership, and making Shari'a-compliant investing more investor friendly might offer a way to move in that direction. Though these proposals face the same hurdles that other developments in Islamic finance have faced in the past, the Islamic financial system has proven resilient and responsive in the four decades since its inception.

Presumably, those involved in Islamic investing seek to grow the industry and provide Muslims the opportunity to invest with the knowledge that their religious commitments have not been compromised. If the restrictions on such investments are such that they discourage investment in Islamic financial institutions and products altogether, the worldwide Muslim community as a whole suffers. Therefore, any movement to change the Islamic financial system should acknowledge that the restrictions in place do not exist to prevent the growth of Islamic finance or to make it more difficult. The purpose of such restrictions is quite the opposite. The restrictions exist to achieve the religious goals that form the basis of Islamic investing. Thus, proposals that aim to grow the Islamic financial system must not do so at the risk of trampling these fundamental goals. For this reason, these above-mentioned proposals are potentially viable reforms, aiming to increase the overall investment in the Islamic financial system without contradicting the fundamental purposes of the religious restrictions that form the system's base.

—*Holly E. Robbins*