
**ISLAMIC FINANCE: “LEGAL HYPOCRISY” MOOT
POINT, PROBLEMATIC FUTURE
BIGGER CONCERN**

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* J.D. and M.A. (International Relations) Candidate 2008, Boston University School of Law and Boston University. The author wishes to thank Professor Daniel Partan and her family, who helped read countless drafts along the way to the finished product. The presence of Islamic banking is growing larger by the day; anyone interested in Islamic law or commercial financing should learn the basics of this exciting field.

I. INTRODUCTION

In the past three decades, and especially post-9/11, Muslims around the globe have been transferring billions of dollars out of conventional Western banks and into Islamic banks, both for fear of being caught up in strict financial regulations in a post-9/11 world and in correlation with a resurgence of *Shari'ah* compliance. Though Islamic banking has been around since the 1960s, its popularity in the recent past has not gone unnoticed. As Ross Mohamad Din, director of HSBC Amanah Malaysia, the bank's Islamic division says, "Islamic banking isn't just for conservative or radical Muslims. It's mainstream business now. That's why every bank wants a bigger piece of it."¹ Not surprising, it is almost certain that the industry will experience increasing demand in the years to come. Its ability to develop and respond to such demands is crucial to its future success.

Unfortunately, the industry as it currently stands lacks sufficient stability and regulation to facilitate a growing future.² Regulatory problems suggest that the industry will not adequately meet the rising demand without change. Accordingly, the top concern should be a focus the industry's need to provide more comprehensive legal, regulatory guidelines for a larger and more diverse clientele who partake in Islamic banking. Expansion and stabilization is needed and this can be accomplished within *Shari'ah* compliant procedures, notwithstanding their similarity to conventional financial products. Much talk about Islamic financing, from scholars and legal academics, focuses on the "legal hypocrisy" of Islamic banking.³ This term refers to the similarities between conventional banking policies and Islamic law as applied in Islamic banking. While modern Islamic banking techniques may branch away from traditional Islamic law, this should not be the main concern for the industry.

This note has two goals. First, this note will show how and why many modern techniques of Islamic finance, in practice, are not strictly *Shari'ah* compliant and are actually very similar to conventional banking. Some may call this a "legal hypocrisy" while others claim it is a violation of Islamic law. To best establish this point I will explain the basics of Islamic finance; what is and is not permitted today and why. This requires delving into the ancient history of Islamic finance theory and a brief look at the *Qur'an*. The religious foundations are important today for two reasons. One, they translate directly into what is permissible under *Shari'ah*.

¹ *Islamic Banks: A Novelty No Longer*, BUSINESS WEEK ONLINE, Aug. 8, 2005, http://www.businessweek.com/magazine/content/05_32/b3946141_mz035.htm.

² In general, the Islamic banking industry has so far been remarkably stable. There has been no significant failure or widespread crisis associated with these businesses. The larger concern, and focus of this Note, is that the industry cannot withstand a drastically growing future or a financial shock (for example, a drop in the price of oil).

³ Barbara L. Seniawski, *Riba Today: Social Equity, the Economy, and Doing Business Under Islamic Law*, 39 COLUM. J. TRANSNAT'L L. 701, 726 (2001).

Two, they are directly linked to “legal hypocrisy” arguments because the religious roots are interpreted differently among conservative and progressive Islamic scholars, creating controversy and ambiguity within the industry. In short, bankers and clients are confused as to what services they should offer. This is seen by looking at the practical application of modern *Shari’ah* compliant tools among countries. This comparison will show the variety in interpretation of *Shari’ah* as well as stress the need for overall regulation. This part of the note will be used as a stepping stone to make the larger point of this note, which follows.

The second goal of this note is to argue that (1) coining the Islamic finance industry as a “legal hypocrisy”⁴ is unfair and harmful because the close resemblance between conventional and Islamic financing is acceptable and necessary in order to promote and develop Islamic financing in the future, and (2) the more pressing issue within the industry is not debate over its similarity with conventional banking but its existing legal and regulatory problems. To establish the first of these two points, this note will show that the historical reasons for Islamic banking law no longer fit in today’s modern banking world and that the industry will be more harmed than helped by an overbroad interpretation of Islamic law. To establish the second of these two points, this note will examine the current legal problems within the industry and why substantive changes are needed in order for the industry to attract and maintain clients and handle the future growth of the industry.⁵

The rapid expansion of the industry should be seen as an overarching framework from which to view the argument and analysis presented in this note. The industry’s future and all its baggage are knocking at our door. According to the International Monetary Fund (“IMF”), total assets in Islamic banking worldwide are estimated to exceed US\$250 billion, and are growing at an estimated 15 percent a year.⁶ The sheer num-

⁴ The term “legal hypocrisy” and terms with similar implications are sometimes used by academics, authors, and in general reference to Islamic banking topics. I use the term in the same general reference as others—that it seems hypocritical for Islamic banks, Muslims using their services, and the industry at large to claim they are *Shari’ah* compliant and dissimilar to conventional banking strategies when, in practice, Islamic banking is very similar to conventional banking, even in regards to collecting interest, which is the epitome of Islamic banking. I originally took note of this particular phrase, “legal hypocrisy,” in the following context: “The prohibition of *riba* is a worthy legal rule, but the rule’s current over-broad interpretation diminishes its usefulness by burdening lenders and causing legal hypocrisy in compliance efforts.” Seniaowski, *supra* note 3, at 726.

⁵ This note is an academic piece that does not address the important but corollary issues of the geopolitical and logistical challenges that creation of a unified regulatory system will inevitably present.

⁶ Mohammed el Qorchi, *Islamic Finance Gears Up*, FINANCE AND DEVELOPMENT: A QUARTERLY MAGAZINE FOR THE IMF, Dec. 2005, available at <http://www.imf.org/external/pubs/ft/fandd/2005/12/qorchi.htm>.

ber of people interested in these services illustrates the energy surrounding the industry. The almost guaranteed continued demand for such services shows the imminence of the industry's future. Now, banks are cashing in on the new clientele. The number of Islamic financial institutions worldwide has risen from one in 1975 to over 300 today in more than 75 countries.⁷ They are concentrated in the Middle East and Southeast Asia (with Bahrain and Malaysia as the biggest hubs), but are also appearing in Europe and the United States (particularly London, Switzerland, and increasingly New York).⁸ Global corporations like Citicorp, ABN Amro, American Express, ANZ Grindlayw Bank, Chase Manhattan, Deutsche Bank, Nomura Securities, and Union Bank of Switzerland all have in-house Islamic units.⁹ Islamic banks such as Dar Al-Mal Al-Islami Trust, Islamic Development Bank, Al-Rajhi Banking & Investment Corporation, Al-Baraka Group and Kuwait Finance House are also continuing to aggressively develop the market.¹⁰ Moreover, Islamic banking is not just catching the eye of Muslims. Nearly one-quarter of all Islamic banking business in Malaysia, which accounts for about 15% of all its banking business, is being transacted by non-Muslims.¹¹ When British banking giant HSBC Group began offering carefully formulated Shari'ah compliant banking products in Malaysia in 2004, it was surprised to see that more than half of its clients were non-Muslims.¹²

II. WHAT IS ISLAMIC FINANCING—HISTORICALLY AND TODAY

To best appreciate the current legal complications with Islamic financing, it is necessary to understand the background of Islamic finance theory and how this helped develop today's industry. Its religious foundations are the driving force behind the modern banking theory and illustrate why many people call certain parts of Islamic financing hypocritical or in violation of Islamic law.

⁷ *Id.*

⁸ *See id.*

⁹ Gohar Bilal, *Islamic Finance: Alternatives to the Western Model*, 23 FLETCHER F. WORLD AFF. 145, 148 (1999) ("Last year, Citibank asked the Federal Reserve Bank of New York to approve an unusual trade finance deal that charged no interest and was governed by Islamic principles. The New York Fed promptly gave its approval, a testament to the growing role of Islamic banking in mainstream global finance.").

¹⁰ *Id.* at 148-49.

¹¹ *See Islamic Banks: A Novelty No Longer*, *supra* note 1. (This article focuses on the growing popularity of *Shari'ah* compliant banking products even in Western countries. It quotes Moshin Nathani, Citigroup's Bahrain-based global head of Islamic banking, as saying, "The biggest explosion [in growth] right now is in Islamic consumer banking and investment products," and focuses on the current "trend" among banks to attract new clientele.)

¹² *See id.* (Why the attraction from non-Muslims? HBC Bank officials say that competitive pricing in their banks makes their mortgages—which operate more like leases than loans—competitive with traditional interest-based loans.)

A. *Religious, Historical Roots of Islamic Banking—Riba and Gharar*

Islamic finance is not an invention of Islamic extremist political movements but stems from the *Qur'an* and the sayings of the Prophet Muhammad.¹³ The modern role of Islamic Banking is best understood by examining these ancient roots. *Shari'ah*, or Islamic law, is a term that generally refers to all Islamic law. Laws on finance deriving from the *Qur'an* and sayings of the Prophet Muhammad are also *Shari'ah* law and imposed by countries that abide by *Shari'ah*. Thus, when a bank is trying to be “*Shari'ah* compliant” it means that they are trying to not violate the Islamic laws and traditions that govern finance and banking. There are a handful of verses from the *Qur'an* that constitute the religious basis for guidance on finance, including the following illustrative excerpt:

Those who devour [riba]
 Will not stand except
 As stands one whom
 The Evil One by his touch
 Hath driven to madness
 That is because they say:
 “[Sale] is like usury [(riba)].”
 But Allah hath permitted [sale]
 And forbidden [riba].¹⁴

The root of the Arabic word “*riba*,” translates best into English as “increase.”¹⁵ In general, it refers to interest or extra, unearned money. *Riba* actually was a pre-Islamic practice thereafter made illegal by the *Qur'an*. At the time of the revelation of the *Qur'an* (7th century C.E.), the Arab society’s economy was predominately barter-trade based.¹⁶ While no organized credit lending system existed, people relied on moneylenders and merchants in times of disasters, such as a famine or crop failure.¹⁷ When the borrower could not repay the loan by the specified date, the sum of the loan was often increased and the repayment date extended, thus creating an informal interest-based trade system.¹⁸ The *Qur'an* revealed and instructed that such unearned benefit was illegal under Islamic law. Essentially, it is unjust for someone to receive an advantage from idle money. *Riba* does not apply to voluntary gifts or charitable acts nor does it refer to sales or exchange of goods, both of which are permitted under Islamic law. It is precisely the occurrence of

¹³ FRANK E. VOGEL & SAMUEL L. HAYES III, *ISLAMIC LAW AND FINANCE* 4 (1998).

¹⁴ Seniawski, *supra* note 3, at 708 (quoting The Meaning of the Holy Qur’an, II:275 (‘Abdullah Yusuf’Ali trans., new rev’d ed. 1991) [hereinafter Qur’an]).

¹⁵ Seniawski, *supra* note 3, at 707.

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ VOGEL & HAYES III, *supra* note 13, at 72-73.

unequal and unearned increases (for example, earning interest) that cause such acts to fall under *Shari'ah* prohibition.

Similar to *riba*, gambling and other forms of risk, known as *gharar*, are prohibited under the ancient roots of Islam. According to *hadith*, *gharar* refers to a number of transactions characterized by risk or uncertainty at their inception.¹⁹ *Gharar* arises from the same notions as does *riba*—the wish to protect the weak from exploitation. Ideally, contracting parties should have “perfect knowledge” of the values intended to be exchanged as a result of their transaction.²⁰ To avoid *gharar*, parties predetermine the amount of money they will exchange, though such money is not required to be disbursed at that time.

The centuries-old prohibitions of *riba* and *gharar* were largely hidden during the colonial-era of the Middle East and reappeared in the mid-20th century. Because most of the Muslim world was ruled or strongly influenced by Western countries, most countries adopted Western-inspired banking systems and business models and pushed aside traditional religious notions of commercial practices.²¹ Consequently, the “rediscovery” of *riba* and its associations did not occur until the independence of most Middle Eastern countries following WWII. Egypt’s opening of the first official “Islamic Bank” in 1960 symbolizes the modern era of Islamic finance.²² Islamic bank products and institutions began to establish themselves in the 1970s. Islamic finance as an industry emerged as countries developed; its precise character differed among countries depending on how large a role Islam had in the legislation. Just as other regions and countries around the globe developed laws and finance standards when they were growing nations, many Muslim nations, too, created limits and barriers to what was financially acceptable.²³

B. *Today’s Islamic Finance Industry*

Since the 1970s, Islamic finance has developed, and offered financial products based on four basic rules: 1) avoid interest or unlawful gain, called *riba*; 2) avoid excessive risk taking, called *gharar*; 3) recognize that money has no intrinsic utility and that financial transactions are always asset-backed; 4) recognize that money has no time value, that is to say, money doesn’t change in value as time passes.²⁴ Consequently, many

¹⁹ *Id.* at 87, 88 (for example, the *hadiths* describe the prohibition of intentional gambling, as this is based on pure speculation—*hadiths* are the oral traditions originating from Prophet Muhammad that provide guidance to Muslims and are often considered a second legal authority behind the *Qur’an*).

²⁰ CHIBLI MALLAT, *ISLAMIC LAW AND FINANCE* 19 (1988).

²¹ VOGEL & HAYES III, *supra* note 13, at 4.

²² J. Michael Taylor, *Islamic Banking: The Feasibility of Establishing an Islamic Bank in the United States*, 40 AM. BUS. L.J. 385, 393 (2003).

²³ MALLAT, *supra* note 20, at 16.

²⁴ Bilal, *supra* note 9, at 146.

Islamic transactions are considered Profit-Loss Sharing (PLS) transactions, whereby profit is shared among parties and loss is shared by parties in proportion to their original contribution. These limitations, in cumulative effect, strive to maintain equality among Muslims and dispel greed and exploitation. To create the big picture of these four rules, below is a general comparison of a contract between a client and a bank showing differences between conventional and Islamic banking.²⁵

Conventional Banking	Islamic Banking
<ul style="list-style-type: none"> • Client wants to purchase a car. • Bank gives money to its client as an interest-bearing loan, after which Bank has no concern as to how the money is used by the client. • Loans may be advanced for any profitable purpose— e.g. casino. • Bank receives growing interest regardless of how risky the project was which required the money. The longer the loan the more interest to be paid off. 	<ul style="list-style-type: none"> • Client wants to purchase a car. • The financier himself purchases the car (asset-backed). No money is advanced. • The financier assumes the risk of the commodity before selling it to the customer. Client can still reject car. • The profit claimed by the financier is the reward of the risk he assumes. • A pre-determined selling price plus profit once agreed upon becomes and remains fixed.

Given such limitations, it is challenging to create a successful financial institution that meets the needs of individuals without breaching *Shari'ah* requirements. Not surprising, because of the strictness of Islamic finance law and because of the Middle East's western influence, many modern Islamic banking products are derived from conventional banking methods that were tweaked until they became *Shari'ah* compliant and are still very similar, in practice, to conventional financial products.²⁶ The below comparison is a more realistic assessment of many modern Islamic banking transactions, particularly those that involve parties from different countries and/or are not based in Islamic states.²⁷

²⁵ This model presumes that Islamic banks are strictly abiding by Islamic law and not attempting to avoid *Shari'ah* requirements by tweaking their contracts or responsibilities with a client.

²⁶ See Senawski, *supra* note 3, at 727 (Explaining how parties often incorporate interest-like figures into their transactions without calling it interest: "Parties continue to go from point A to point B to complete the transaction or settlement but, now, they must travel an indirect path.").

²⁷ Of the limited case law on this topic, Islamic Investment Company of the Gulf (Bahamas) Ltd. v. Symphony Gems N.V. & Others, is the first instance where a Western court ruled on Islamic finance transactions and is illustrative of how modern

Conventional Banking	Islamic Banking
<ul style="list-style-type: none"> • Client wants to start a business. • Bank gives money to its client through a contract as an interest-bearing loan. • If client breaches the contract, client is at fault and still owes loan to the bank. 	<ul style="list-style-type: none"> • Client wants to start a business. • The bank and client sign a contract for the loan, including a mark up fee similar to the current interest rate. • The contract includes a choice of law provision, stating English law as the governing law of their agreement. • If client breaches, parties go to English court, which can overlook the Islamic legal form and enforce the transaction pursuant to English law, which is frequently what parties desire and expect. The <i>Shari'ah</i> components are treated nominally only.

C. Financial Transactions Currently Used by Islamic Banks

Islamic banks and conventional banks with in-house Islamic banking units have taken the aforementioned four basic rules and developed several *Shari'ah*-compliant finance products. In general, “most Islamic funds are confined to short-term, low-risk investments, principally in the form of trade financing for inventory accomplished through markup contract, in which the bank buys inventory from the supplier from the supplier to resell it to the customer at a price covering the bank’s cost plus a markup,” otherwise

Islamic finance transactions deviates from classical Islamic law. Symphony Gems “illuminates the challenges and tensions within the industrial complex of Islamic finance as it seeks to exist and thrive in a commercial reality where the regulatory framework and its associated assumptions . . . differ markedly from those of Islamic law” In this case the parties had a choice of law clause asserting English or New York law as the governing law. Both parties “sought to benefit by choosing . . . a jurisdiction and a law which they expected would enforce the Contract as written,” instead of as a “truer” *murabaha* sale. Despite the acknowledgement of *Shari'ah* compliance, both parties likely knew it was blatantly problematic from an Islamic legal perspective. As further mentioned, *murabahah* contracts in the modern practices closely approximate conventional financing mechanisms. Not surprising, this is why the contracts are becoming so popular on one hand and viewed controversial on the other hand. See 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, 154-56, 190 (2003).

known as a *murabaha* contract.²⁸ At this point in time, the following types of transactions are used by Islamic banks and/or within Islamic finance divisions of conventional banks. Each is meant to be *Shari'ah*-compliant. Most are not without criticism from the more traditional Islamic scholars for being too similar to conventional banking—the legal hypocrisy.

1. *Murabaha* (cost plus profit)

Murabaha is a term commonly referred to in Islamic economic circles as a fundamental financial instrument. *Murabaha* refers to a particular kind of sale having little to do with financing in its original sense: if a seller agrees to provide the purchaser with product X at a certain profit added to his cost, it is called a *murabaha* transaction.²⁹ There are two essential ingredients for *murabaha*. First, the financial institution or seller must actually own the good before transferring title to the purchaser or customer. Second, the seller reveals his cost for the product and then adds a profit (either a percentage of lump sum) thereon up front.³⁰

The specifics of a *murabaha* transaction reveal its complexity and similarities to conventional banking. The seller is usually a financial institution that acts as a middle-man and purchases a good that its customer wants. The financial institution then turns around and sells the good to the customer at the acquisition cost plus a profit. Unlike in traditional banking, the customer in a *murabaha* sale is only liable to the bank for the contracted sales price, even if he defaults (in other words, no fees or interest rates).³¹ The bank does not receive the markup price unearned, as this would be against *Shari'ah*. The profit is justified because the bank assumes some risk in purchasing the commodity before the contact is made for its official sale. In theory, there is always the chance that the client will refuse the product, leaving the bank with product and without money. Because of this high risk, however, *murabaha* financing is only “available to trusted customers of a financial institution and to those that provide some form of guarantee or collateral.”³² The best method of *murabaha*, according to *Shari'ah* scholars, is that the financier himself purchase and possess the commodity before selling it to the client. More modern forms of *murabaha*, however, stray from this ideal situation. Instead of the client purchasing the asset from the finance institution, the institution and the client form a principal-agent relationship. The client purchases the product himself, but on behalf of the institution, and takes

²⁸ MUHAMMAD TAQI USMANI, *ARAB AND ISLAMIC LAWS SERIES: AN INTRODUCTION TO ISLAMIC FINANCE* 37 (2002).

²⁹ *Id.* .

³⁰ Taylor, *supra* note 22, at 395.

³¹ *Id.*

³² *Id.*

possession as an agent of the institution. The client then informs the institution that he has bought the item and at the same time offers to purchase it from the institution. The crucial element of this transaction is that the item *must* remain in the risk of the institution at all times until it is purchased by the client.³³ Without this risk element, the transaction is identical to a conventional interest-based transaction.

2. Ijara (leasing finance)

By definition, *ijara* means ‘rent.’³⁴ It is Islamic finance’s version of a leasing arrangement whereby the financial institution purchases an asset and then leases it to the client. For example, many *ijara* transactions are for the lease of equipment³⁵ for a given period of time throughout which the lessee pays the financial institution a rental fee.³⁶ Unlike conventional leasing agreements, the lessee is not liable for the full rent if the commodity is destroyed and the lease term begins the day the lessee actually receives the commodity (as opposed to the date the contract is signed).³⁷ This way, the risk of the commodity remains with the lessor until it is in the hands of the client.

As also seen with respect to *murabaha*, the client of an *ijara* transaction often creates a principal-agent relationship with the financial institution. The client acts on behalf of the institution to purchase the asset. The client separately, although often very shortly thereafter, receives the asset and, thus establishes the relationship of lessor and lessee. Again, the idea that the lessor bears the risk of owning the asset before it is delivered to the client and throughout the lease is fundamental; it justifies the markup of the rental fee. As it may seem, “even with these slight differences, the *ijara* is fairly similar to traditional lease financing.”³⁸ Akin to conventional leasing agreements, financial institutions use this transaction to earn a profit. For example, an Islamic bank leasing farm equipment will add the total amount it paid to purchase the farm equipment to stipulated “interest” it could have claimed on such an amount during the lease period. The bank then takes this total amount and divides it by the total payment cycles of the lease to derive a rental fee.

³³ USMANI, *supra* note 28, at 43.

³⁴ *Id.* at 69.

³⁵ For example, in 1997, the Oil & Gas Development Corporation of Pakistan used a five year US\$ 50 million *ijara* facility provided by the Faysal Islamic Bank of Bahrain to purchase oil pipeline equipment for a gas field development project. Chase Manhattan Bank provided a letter of credit for the project. Seniawski, *supra* note 3, at 725.

³⁶ Taylor, *supra* note 22, at 397.

³⁷ *Id.*

³⁸ *Id.*

3. Musharika (partnership finance)

Musharika is a special relationship between an Islamic finance institution and a client that typically involves a business venture in which the institution provides a percentage of the capital needed by its client with the understanding that the institution and client will share profits and losses in accordance with a pre-arranged formula.³⁹ The client contributes both capital and business management to the transaction. Unlike in conventional banking, the return in *musharika* is not fixed and is based on actual profit earned by the joint venture. The ratio of profit for each partner “must be determined in advance and in proportion to the actual profit accrued to the business and not in proportion to the capital invested by him.”⁴⁰

4. Mudaraba (venture capitalism)

Similar to *musharika*, *mudaraba* transactions involve a special partnership between a bank and a client where the bank provides *all* of the needed capital and the client provides *all* of the know-how and labor needed to put the money to work. The financial institution is guaranteed a pre-arranged percentage of any profits the investment should bring. If the venture fails (absent negligence or contractual breach), the financial institution bears the loss and loses its right to the profit.⁴¹ Because this sort of venture capital financing involves substantial risk (similar to conventional venture capitalism) for the bank, it is not uncommon for the bank to also act as the manager of the business venture for a fee.⁴² Financial institutions are also selective in working with *mudaraba* clients because of this risk. Not surprisingly, under the most optimistic accounts, *mudaraba* schemes represent less than 5% of banking operations within Islamic financing worldwide.⁴³

The Islamic Development Bank recently launched a “US\$1.5 billion infrastructure fund” accessible via *mudaraba* transactions, which is a modern example of such banking techniques.⁴⁴ Islamic funds like this are “being launched to cater to the growing demand of Muslim investors interested in investing in listed securities on the various stock exchanges. Between 1995 and 1998, 16 Islamic equity funds (based on the *mudaraba* concept) have been launched.”⁴⁵ Conventional banks, such as American Express Bank and Faisal Finance Switzerland, are also joining in *mudaraba* transactions and offering investment opportunities for Muslims.

³⁹ *Id.*

⁴⁰ USMANI, *supra* note 28, at 7.

⁴¹ Seniawski, *supra* note 3, at 722.

⁴² Taylor, *supra* note 22, at 398.

⁴³ VOGEL & HAYES III, *supra* note 13, at 135.

⁴⁴ Bilal, *supra* note 9, at 156.

⁴⁵ *Id.*

5. *Ba'i bithaman ajil* (deferred payment)

Ba'i bithaman ajil, literally “sale by deferred payment,” involves a credit sale of goods on a deferred payment basis.⁴⁶ The financial institution purchases the assets, equipment, or goods, and then turns around and resells them to the client either through a lump sum agreement or through installments over a contract period. The bank, in return, makes progressive payments to the original supplier, as the goods are purchased or manufactured.⁴⁷

6. *Istisna'* (commissioned manufacturing)

Under an *istisna'* contract, the sale of a commodity is transacted before it (the commodity) comes into existence.⁴⁸ The financial relationship involves an Islamic bank, a client, and a third party, often a manufacturer who can create the commodity the client desires.⁴⁹ Typical *istisna'* contracts are between banks and construction contractors, whereby the bank orders the manufacturer to make a specific good for the client. A valid *istisna'* transaction requires that the price be fixed with the consent of all parties.⁵⁰ “The price may be paid in advance (*ba'i al-salam*) or on a deferred basis (*ba'i bithaman ajil*).”⁵¹ *Istisna'* transactions create a moral obligation on the manufacturer to create the commodity and any party can unilaterally cancel the contract before work has begun.⁵²

D. *Variations in Use Among Countries*

Some countries and/or Islamic banks authorize use of all of the above tools while others are more restrictive. This creates irregularities in practice and different thoughts as to what is acceptable among countries and banks. Starting with countries with more traditional Islamic banking industries and leaning towards ones with more modern practices, the below analysis will show the varying views of what is permitted in Islamic Financing around the world. Accordingly, this comparison will illustrate the great variety among countries and demonstrate why there is a need for a more universal regulatory system.

States such as Iran, Pakistan, and Sudan are officially “Islamized” and produce state codes of Islamic law that oversee Islamic financing.⁵³ The

⁴⁶ Taylor, *supra* note 22, at 396.

⁴⁷ Seniawski, *supra* note 3, at 724.

⁴⁸ Maulana Taqi Usmani, *Salam and Istisna*, ONLINE PUBLICATION BY ACCOUNTANCY.COM.PK 7, http://www.accountancy.com.pk/docs/islam_salam_istisna.pdf (last visited Jan. 7, 2008).

⁴⁹ *See id.*

⁵⁰ *See id.*

⁵¹ Bilal, *supra* note 9, at 154.

⁵² *See supra* note 48.

⁵³ Mahmoud El-Gamal, “Interest” and the Paradox of Contemporary Islamic Law and Finance, 27 FORDHAM Int’l L. J. 108, 112 (2003).

state of Pakistan rigorously follows Islamic finance law. Under Pakistani law, any amount of interest is *riba* and thus prohibited.⁵⁴ Because of the important case *Mahmood-ur-Rahman Faisal v. Secretary*, twenty proposed provisions of Pakistani law, each containing a provision for interest in different situations, were held unconstitutional because they violated *Shari'ah*.⁵⁵ The Pakistani Federal Shariat Court interpreted *riba* conservatively in this case, setting a strict standard for all Islamic finance transactions in Pakistan. Ironically, as discussed further below, it stands out as being one of the few countries that provides default protection for Islamic banks.⁵⁶

Similar to Pakistan, Sudan also officially embraces Islam as its source of legislation and interprets *riba* as including any and all types of interest. According to the Bank of Sudan, "An Islamic bank is expected to be a socially responsive institution with social, cultural, and other responsibilities beside profit making."⁵⁷ The first case to prosecute a defendant for a *riba* violation in Sudan was *The State v. Laleet Raiinlahl Shah*, in which a non-Muslim lent money without a license and charged interest.⁵⁸

Egypt is more middle of the road than the aforementioned countries though still conservative in *riba* interpretation. Although its Constitution states that its legislation should be entirely *Shari'ah* compliant, in practice, it strays from this ideal. Prior to a pivotal Egyptian Supreme Constitutional Court case in 1995, Article 226 of the Egyptian Civil Code permitted a "fixed interest to be paid at a certain rate for mere delay in the fulfillment of an obligation to pay a debt of money."⁵⁹ The Rector of Azhar University, the official state Islamic university, facially challenged the Egyptian Civil Code as unconstitutional, as it permitted a form of *riba*. The Egyptian Supreme Constitutional Court agreed with the Rector and the Constitution was amended. Almost unexpectedly, the Egyptian court viewed the small, four percent interest rate as usurious.

The Egyptian, Pakistani and Sudanese courts' interpretations of *riba* are commonly known as the "Classical View" of judicial views on Islamic

⁵⁴ The Pakistani Federal Shariat Court held this in the important case of *Mahmood-ur-Rahman Faisal v. Secretary*. Because of this holding, twenty provisions in Pakistani law were struck down as unconstitutional because they permitted amounts of interest in various situations. See Seniaowski, *supra* note 3, at 715.

⁵⁵ *Id.*

⁵⁶ See discussion *infra* p. 25.

⁵⁷ Dr. Sabir Mohamed Hassan, *Issues in the Regulation of Islamic Banking: (The Case of Sudan)*, RESEARCH AND STUDIES SERIES ISSUED BY BANK OF SUDAN, Oct. 2004 (Issue No. 5), http://www.bankofsudan.org/arabic/period/studies/issue_5.pdf.

⁵⁸ Seniaowski, *supra* note 3, at 717.

⁵⁹ *Id.* at 716 (citing Rector of the Azhar University v. President of the Republic, Case No. 20 of Judicial Year No. 1 (Sup. Constitutional Ct.) (Egypt), reprinted in Supreme Constitutional Court (Egypt) - *Shari'a and Riba: Decision in Case No. 20 of Judicial Year No. 1, 1 ARAB L.Q. 100 (1985)*).

finance law.⁶⁰ The reasons for upholding this position can be best understood by viewing conventional banking as truly unjust and unfairly advantageous for lenders. Scholars from these countries argue that “the idea of social fairness in transactions coupled with historical abuses means that interest, all interest, is *riba*.”⁶¹ The following is one researcher’s list of why this notion is believed:

First, the management and owners of a bank are sophisticated and will use their market knowledge to increase profits and the institution’s net worth. Second, they are protected from their mistakes (arising from their willingness to take risks) by the state and the insurance companies whose premiums are in fact paid by lowering returns to depositors. Third, since depositors are guaranteed a certain rate of return on their deposits, banks place the full risk of lending on the borrower.⁶²

This view represents states at the most conservative end of the spectrum and supports a default in being overly cautious in times of questioning Islamic law, as the Egyptian case shows.⁶³ The countries like Iran, Pakistan, and Sudan have transformed their “entire internal financial systems to an Islamic form.”⁶⁴

Not all states and Islamic scholars believe all forms of *riba* are unacceptable. One author categorizes countries like Bahrain, Brunei, Kuwait, Malaysia, Turkey, and the U.A.E. as those that embrace Islamic banking as a national policy but also support dual banking systems, whereby conventional banks coexist within the country.⁶⁵ Next are the countries like Egypt and Yemen that neither support nor oppose Islamic banking and at the far end of the spectrum, countries that freely ignore Islamic banking rules though do not necessarily discourage separate Islamic banking practices within their countries, such as Saudi Arabia and Oman.⁶⁶ Scattered among these countries is a minority group of scholars and jurists that hold a “modern view” on judicial interpretations of Islamic finance law. This group generally interprets *riba* in relation to today’s banking world and permits flexibility where practically needed.⁶⁷ Some reform-oriented scholars “reject the entire medieval notion of *riba* as an obsolete idea, since they think the concept is neither relevant to modern theories of

⁶⁰ *Id.* at 717.

⁶¹ *Id.* at 713.

⁶² *Id.* at 717 (citing Jean-Francois Seznec, *Special Feature: Global Financial Reform, Ethics, Islamic Banking and the Global Financial Market*, 23 FLETCHER F. WORLD AFF. 161, 163 (1999)).

⁶³ See El-Gamal, *supra* note 53 (discussion regarding the Rector of Azhar University).

⁶⁴ VOGEL & HAYES III, *supra* note 13, at 11.

⁶⁵ See *id.*

⁶⁶ See *id.*

⁶⁷ See Seniaowski, *supra* note 3, at 717.

capital and interest nor pertinent to the rise of capitalism.”⁶⁸ These scholars believe that the *Qur’anic*, ancient reasons for prohibition of *riba* were never meant to apply to the “non-feudal, modern society and its anonymous transactions with prices based on relative scarcity, supply, and demand.”⁶⁹ Most of these countries permit modest interest rates.

Kuwait, for example, has passed legislation legitimizing interest for commercial (not civil) transactions, while other countries like Saudi Arabia turn a “blind eye” to the *riba* prohibition.⁷⁰ As of 1995 no banks in Saudi Arabia were licensed to conduct Islamic banking, though some businesses follow traditional Islamic law in practice.⁷¹ However, in the more recent years (since 2004), Saudi banks have offered more Islamic banking services to their clients.⁷² Illustrating Saudi bank’s support of conventional and Islamic banking requests, in recent years the image of Saudi banks has been blurred, meaning that it is not just the local or Islamic banks in Saudi Arabia that are considered credible for Islamic banking services. Most banks are beginning to offer the services, frequently alongside or in addition to conventional banking techniques.⁷³ Still, western banks with in-house Islamic banking units generally conform to their clients’ needs and requests (as non-*Shari’ah* as they may be) and offer the broadest range of products among banks.

Some countries and/or Islamic banks authorize use of all of the above tools while others are more restrictive. Starting with countries with more traditional Islamic banking industries and leaning towards ones with more modern practices, the below analysis will show the varying views of what is permitted in Islamic Financing around the world. Accordingly, this comparison will illustrate the great variety among countries and emphasis why there is a need for a single regulatory system.

One of the most illustrative ways to show the differences between a classical perspective and modern view differ is by comparing their view on *murabaha* contracts. As aforementioned⁷⁴, *murabaha* contracts greatly resemble conventional financing contracts and many classical scholars don’t approve of them. Many *murabaha* contracts, in practice, routinely involve mark-ups that are similar, if not identical, to the existing interest rate. For example, in 2002 Fortune magazine published an article

⁶⁸ *Id.* (quoting ZIAUL HAQUE, RIBA: THE MORAL ECONOMY OF USURY, INTEREST AND PROFIT 5 (2d ed. 1995).

⁶⁹ *Id.* at 717, 720.).

⁷⁰ *Id.* (citing Nabil A. Saleh, *Financial Transactions and the Islamic Theory of Obligations and Contracts*, in ISLAMIC LAW AND FINANCE at 18.).

⁷¹ Seniawski, *supra* note 3, at 720. See also *supra* note 44 (the Islamic Development Bank launched a *mudaraba* project in Saudi Arabia, which the country permitted).

⁷² *Banking in Saudi Arabia*, 6TH SENSE OF BUSINESS, July 6, 2004, <http://www.ameinfo.com/42242.html>.

⁷³ *Id.*

⁷⁴ See *supra* section IC.1 (“*Murabaha*”).

discussing a case where an Islamic bank and a customer agreed to enter into a *murabaha* contract, whereby the bank would purchase a chosen car for the customer.⁷⁵ Not surprisingly, the contract included a pre-specified profit-margin (mark-up) that paralleled the prevailing market interest rate for similar auto loans.⁷⁶ “Reflecting on the transaction, the author of the article exclaimed that the ‘result looked a lot like interest, and some argue that *murabahah* is simply a thinly veiled version of it; the mark-up [bank’s name] charges is very close to the prevailing interest rate. But bank officials argue that God is in the details.’”⁷⁷ The classical view of *murabaha* would not condone the above mentioned example.

In addition to interest-like mark-ups, some *murabaha* contracts do not actually place risk on the seller-bank.⁷⁸ “The very substance of a *murabahah* dictates, among other things, that the seller be exposed to risks normally associated with ownership, such as the risk of loss, damage, and deterioration of the goods prior to delivery.”⁷⁹ Such risk always includes the customer’s right to not purchase the good after the seller has purchased it.⁸⁰ In many modern contracts this risk is being contractually transferred to the buyer, as opposed to the traditional practice of staying with the bank/seller.⁸¹ Given that the buyer often charges a mark up and often does not actually possess ownership of the good, the seller-banker has “now effectively avoided many, if not all, of the risks and responsibilities that classical jurisprudence expects it to bear.”⁸²

What is the solution? *Murabaha* contracts are straying from their traditional footings yet banks are still approving them⁸³; is this a signal

⁷⁵ See El-Gamal, *supra* note 53, at 125.

⁷⁶ See *id.*

⁷⁷ *Id.* (quoting J. Useem, *Banking on Allah*, FORTUNE, June 10, 2002 (illustrating that cynical “God is in the details” is particularly distasteful)).

⁷⁸ See Moghul & Ahmed, *supra* note 27, at 181 (“According to many *murabahah* contracts, the buyer is responsible for compliance with all applicable laws and regulations . . .”).

⁷⁹ *Id.* at 180.

⁸⁰ See *id.* (“The seller must also accept the buyer’s ability to return the good and rescind the sale if the goods are damaged, deficient, do not meet the buyer’s preferences, or involve a mistake in pricing.”).

⁸¹ See *id.*

⁸² For example, a *murabahah* contract of Faisal Islamic Bank of Egypt states: The client is responsible for all other expenses, which are not included in the cost structure of this [Murabaha] [sic] contract, and also for all costs arising from cancellation of a documentary credit, or refusal of the exporter to supply the goods. The client does not have any right to demand from the Bank any compensation in case the exporter refuses to supply the goods for any reason whatsoever.

See *id.* at 181 (citing MOHAMMAD HASHIM KAMALI, ISLAMIC COMMERCIAL LAW: AN ANALYSIS OF FUTURES AND OPTIONS 66-83 (2000)).

⁸³ “Given the manner in which typical *murabahah* sales (and most Islamic financial transactions) are carried out today, we wonder about the extent to which the jurists

that the modern view is taking over? One Islamic Justice, Taqi Usmani, believes that the classical view of Islamic law should never be given discretion and reminds followers that *murabaha* should be used only as a “transitory step taken in process of Islamization of the economy” and, thus, should only be available to those situations where *musharika* or *mudaraba* contracts aren’t practicable.⁸⁴ To Islamic scholars like Usmani, *murabaha* is not an ideal instrument for carrying out the actual economic objectives of Islam.⁸⁵ Consequently, there is a conflict of interest and of practice in the real Islamic banking world.

III. THE FUTURE OF ISLAMIC BANKING AND ITS LIMITATIONS

The future of Islamic banking likely will be turbulent. The industry is on the brink of facing unprecedented increases in demand and will bear commensurate anarchy without some change.⁸⁶ Although the industry has remained remarkably stable thus far, a future financial crisis (perhaps, the drop in oil prices) or surfacing legal dilemmas, will test the industry’s ability to juggle such problems with the demands of a growing clientele. In regards to the grand picture of the industry⁸⁷, there are two paths the industry could follow into the future. (1) The emphasis from scholars and the disputes within the industry can remain focused on the “legal hypocrisy” argument, or (2) the industry can set aside emphasis on this so-called legal hypocrisy and funnel efforts towards organizing Islamic banking globally. As said, the industry is in trouble. It will be in particular trouble if the industry follows the former path and not the latter. The fact that the industry may or may not be a “legal hypocrisy,” because of its defenseless similarity to conventional banking, should not be the main concern for two reasons. One, there is no longer the need for such stringent requirements to ancient Islamic banking law, and thus a close resemblance is permissible. Two, there are more pressing legal needs required for a prosperous future.

who sit on Shari’ah committees at Islamic financial institutions actually meditate on the wisdom their legal reasoning is supposed to contain rather than rely mainly on the formal aspects of what they approve, based on mere appearance, as Shari’ah-compliant.” *Id.* at 189.

⁸⁴ *Id.* at 183. See generally USMANI, *supra* note 28.

⁸⁵ See *id.* See also *infra* section IC1 (“*Murabaha*”) (“*Murabaha* refers to a particular kind of sale having little to do with financing in its original sense.”).

⁸⁶ As a generalized observation, Mohammed el Qorchi, a journalist for the IMF, wrote, “Yet despite this rapid growth, Islamic banking remains quite limited in most countries and is tiny compared with the global financial system.” See generally el Qorchi, *supra* note 6 (article focuses on both the strengths and weaknesses, including its limited regulatory abilities, that correlate with the growing industry).

⁸⁷ There are many small changes, as there could be in any global industry, that would offer improvement but this article focuses on shifting focus from one area that has previously been of emphasis, the questionable Shari’ah compliance of the industry, and to the greater need for a regulatory plan within the industry.

A. *Necessity for Overlap in Conventional and Islamic Banking*

A close resemblance between Islamic and conventional financing is necessary for the industry to prosper and respond to increasing clientele in the future.⁸⁸ Fortunately, a close resemblance is not as “un-Islamic” as critics claim it is. After all, Islamic financing is a *technique* and not a wholly unique system—its goal to abide by *Shari’ah* principles and not to avoid any overlap with today’s conventional practices is unnecessarily cautious and no longer needed.

The historic reasons for traditional *Shari’ah* finance law are not necessary today—the reasons for borrowing money have changed. At the time Islam began to reach trade, exploitation of the weak was common among vendors and social standing was a contributing factor to whether fair business could occur.⁸⁹ It is questionable at best whether social abuse of the impoverished, disadvantaged classes, those who originally instigated the need for religious regulation, still exists.⁹⁰ The situation today is different. Modernity has cured many of the problems of fair trading with market created supply and demand and overall greater sophistication among traders. Borrowers are borrowing money for more items, often larger, luxury items and using credit cards to expand their options.⁹¹ *Riba*, some scholars argue, cannot realistically be eliminated, especially in common situations like interest accruing on bank accounts and increases in value due to inflation.⁹² Similarly, when *riba* is prohibited across the board and without case-by-case consideration, unnecessary burdens are placed on lenders, who, instead of paying interest, take on other responsibilities

⁸⁸ To aid understanding the structure of this Note: establishing that overlap between the religious and conventional banking is permissible is a preliminary step to showing why regulations discussed in the Part IIB of this paper are the predominant issue.

⁸⁹ “Contemporary Islamic banking and finance operate on the assumption that all interest is *riba* (i.e., a usurious increase), despite evidence that the *historically-targeted dangers do not exist in business and transnational transactions today*.” Seniaowski, *supra* note 3, at 726, 727 (emphasis added). See also Taylor, *supra* note 22, at 4 (“In the Islamic bank, the seventh century meets the 21st, as the partnering of investors and entrepreneurs continues to be an effective and economically viable technique,” arguing that a blending of beliefs from both centuries is possible).

⁹⁰ *Id.* at 712.

⁹¹ See *id.* (“Nor is all borrowing by individuals (as opposed to borrowing by businesses) for life’s necessities: it is becoming commonplace to carry debt to purchase luxury, or at least non-necessary, items.”).

⁹² Seniaowski, *supra* note 3, at 717-8 (referring to *Ur-Rahman Faisal v. Secretary, Ministry of Law, Justice, & Parl. Affairs, Gov’t of Pak.*, 39-40 (1992) P.L.D. 1, 135-37, 149-50 (Federal Shariat Ct. 1992) (Pak.) (“Fazlur Rahman argues that even if bank interest is subject to the *riba* prohibition, while a Muslim society may seek elimination of bank interest as an ideal, it cannot realistically eliminate it today.”)).

such as profit and loss sharing.⁹³ When rigorous, ancient legal theories are applied in today's world, it is the lenders who are penalized; without interest collections they have fewer funds available for larger loans and consequently, "a result contrary to that desired is achieved."⁹⁴ Legal theories of Islam can still be applied—promoting social justice is possible without the unnecessary stringent compliance to ancient Islamic banking beliefs.⁹⁵ In sum, people today go to banks and lenders for different reasons and expect and deserve different service.⁹⁶

Given that it is now easier to understand how overlap between conventional and religious banking is permissible, desirable, and likely necessary, it is easier to see why the more pressing issue is how ill-equipped the industry is for the future. Despite the definite excitement surrounding Islamic financing and the somewhat diverse *Shari'ah*-compliant products banks offer, it is unlikely that Islamic financing will develop into a dominant force within the Middle East in the future without substantive change. As one scholar notes, "As societies constantly change, the legal particulars of Islam as they pertain to financial transactions must modulate and adapt if the *Shari'ah* is to remain relevant to contemporary human life and thought"⁹⁷ The focus of this discussion is not to propose solutions to the current situation but rather to recognize and analyze the current legal problems within the Islamic finance industry. These will indicate and explain why the industry will not ultimately meet the growing demand without change.

There are two main legal problems for the future of Islamic banking. First, it is possible that the Islamic banking industry will become more conservative in its interpretation of *Shari'ah* finance law, which would detract from its popularity and financial capabilities. Second, and arguably more important, there is no comprehensive regulatory or supervisory framework for the industry. Both problems need to be addressed to keep up with the growing demand for *Shari'ah*-compliant products and to facilitate the industry's future development.

⁹³ See *id* at 726 ("The prohibition of *riba* is a worthy legal rule, but the rule's current over-broad interpretation diminishes its usefulness by burdening lenders and causing legal hypocrisy in compliance efforts.").

⁹⁴ See *id.* at 714.

⁹⁵ See Taylor, *supra* note 22, at 401.

⁹⁶ See Seniaowski, *supra* note 3, at 712. ("This point is not to discredit or invalidate the difficult situation existing for some individuals and families, but rather to argue that sustenance is no longer the sole reason for which money or goods are borrowed or exchanged, and that the *riba* prohibition should be interpreted to reflect this changing reality.").

⁹⁷ See Moghul & Ahmed, *supra* note 27, at 192.

1. Problem One: Conservative Legal Influence Within the Industry

Recent announcements by conservative Islamic scholars arguably indicate a bleak future for the Islamic finance industry.⁹⁸ Specifically, conservative scholars are arguing for the end to *murabaha* transactions. The “phaseout” of *murabaha* investments of all types has been formally adopted by Al-Rajhi Bank (one of Saudi Arabia’s major banks), al-Baraka (bank based in Bahrain), and the Government of Sudan.⁹⁹ This presents problems because *murabaha* transactions represent a majority of transactions in Islamic banking and are an indispensable tool as the industry now operates.¹⁰⁰ Should the conservative influence dominate and such transactions become prohibited, the industry’s clientele would be greatly inconvenienced and encouraged to work with conventional banks.

Conservative scholars are concerned with *murabaha* transactions because they so closely resemble conventional banking techniques. A key ingredient of *Shari’ah*-compliant *murabaha* transactions is that the bank assumes ownership of the product before selling it to the client, as this makes their profit earned. Many doubt that the banks truly assume possession of inventory. These “synthetic” *murabaha* transactions are “nothing more than short-term conventional loans with a predetermined interest rate incorporated in the price at which the borrower repurchases the inventory.”¹⁰¹

Though *murabaha* transactions are criticized, they are a necessary element to Islamic financing. This is the main medium available to clients who wish to purchase any item that they cannot afford up front. *Murabaha* transactions are also often used internationally when clients want a product available abroad, where the banks in those situations act as *de facto* importers of such goods. In terms of weighing which could do more harm to the Islamic banking institute, it seems that working with clients on a more flexible basis as opposed to excluding them does far less damage. If this product is banned within the Islamic finance industry, there is a high chance that clients will become frustrated with the absence of such a utilized service and take their business elsewhere, to a bank that can meet all their needs. Some bankers believe that the future of Islamic banking will depend on its ability to attract the funds of savers and investors who currently opt for the superior returns and risk characteristics of conventional banks.¹⁰² With *murabaha* being one of the most attractive and used products among clients, the industry needs to keep the option open to sustain its popularity. In any case, it is certain that the retraction

⁹⁸ VOGEL & HAYES III, *supra* note 13, at 9.

⁹⁹ *See id.*

¹⁰⁰ USMANI, *supra* note 28, at 7.

¹⁰¹ VOGEL & HAYES III, *supra* note 13, at 9.

¹⁰² *Id.* at 7.

of approval on *murabaha* transactions will greatly inconvenience many Muslim investors seeking to utilize Islamic banking.

Conservative Islamic scholars are also inhibiting a much needed solution to the industry's lack of a default protection law. Unlike in conventional banking, when a client defaults on a loan or delays payments of the cost of a commodity, Islamic banks are left unarmed and unprotected. For example, in a *mudaraba* transaction, if a capital venture project fails, the bank loses 100% of its loan; recall that according to *Shari'ah*, the client only bears loss of his actual input. The same outcome occurs when clients fail to make payments for commodities on time. The bank, left unarmed by a law that could protect it, is typically stuck waiting for the money.

Shari'ah supervisory boards have mixed opinions on how to deal with this drastic disadvantage to the bank. Such supervisory boards are typical at Islamic banks and oversee transactions to assure *Shari'ah*-compliance. Some of the supervisory boards believe that when payment is delayed, representing a profit forgone as a result of not being able to utilize the amount delayed in other operations, the bank should be compensated for the delay.¹⁰³ More commonly, however, scholars reject this theory out of fear that it creates a slippery slope and will open a back door for collecting interest on defaults. Only one Muslim country, Pakistan, has opted to adopt a law protecting its Islamic banks in such situations.¹⁰⁴ If conservative Islamic scholars continue to prohibit default protection to banks, the industry will be less likely to attract new clients in the future or gain the financial credibility it needs to expand. This unattractive outcome and the legal aspects of default protection will be further discussed below.

In sum, the conservative influence Islamic scholars currently have over Islamic financing and the potential negative influence they may have in the future threatens the flexibility the industry needs to attract new clients. Regardless of whether the conservative scholars succeed in their ways, it is crucial that supervisory bank boards know what the consensus is from scholars. Many bankers and institutions are understandably confused by the different rulings of the *Shari'ah* councils. Individual transactions or instruments are approved or disapproved and then later the

¹⁰³ AHMED AL-SUWAIDI, FINANCE OF INTERNATIONAL TRADE IN THE GULF 152 (1994) (citing AHMED A. AL-ASHKER, THE ISLAMIC BUSINESS ENTERPRISE 132 (1987)).

¹⁰⁴ In short, Pakistan legally permits its banks to impose late fees on delinquent clients, so long as the proceeds of such penalty are to be used for charity purposes. If the bank suffers actual financial loss, however, the bank can keep such late fees (actual loss is typically seen by looking at profit made from comparable portfolios). State Bank of Pakistan, Islamic Banking Department, Frequently Asked Questions: Is it permissible for an Islamic bank to impose penalty for late payment?, <http://www.sbp.org.pk/ibd/faqs.asp#q9> (last visited Jan. 31, 2008).

ruling is reversed.¹⁰⁵ For example, scholars have a different take on purchasing stock in a company that does not deal with prohibited activities but does its banking on a conventional basis.¹⁰⁶ Conservative scholars do not allow investment in such companies while other scholars do. This sets confusing precedents for supervisory boards around the world. This confusion is abundant because of the lack of a well established forum where *Shari'ah* scholars and councils who follow different schools of thought can get together and form a consensus about particular issues.¹⁰⁷

2. Problem Two: Lack of a Regulatory and Supervisory Framework

Though Islamic financing has found a niche within the modern financial complex, its growth has not been accompanied by a coherent body of governing rules "native to the Islamic intellectual perspective."¹⁰⁸ The Governor of the Central Bank of Malaysia, Dr. Zeti Akhtar Aziz, appropriately addressed this issue at the 3rd Annual Islamic Finance Summit when he stated, "The hallmark of a well-developed financial infrastructure is an effective legal, regulatory and supervisory framework which would underpin the stability of the financial system . . . [This] is an indispensable and vital component of the financial infrastructure."¹⁰⁹ Without such a system, each Islamic financial institute can offer different products, some regulated by state law, some not.¹¹⁰ Each bank typically has a *Shari'ah* advisory board to oversee transactions, some more conservative, others more flexible. With no overarching supervisory or regulatory framework, the future of the industry will be at best unorganized yet available and at worst unreliable and inadequate.

Granted, some regions already have supervisory and regulatory systems for Islamic banking. Forums like the Accounting and Auditing Organization for Islamic Financial Institutions ("AAOIFI")¹¹¹, which publishes the widely followed *Shari'ah* Standards, or the Islamic Financial Services Board ("IFSB"), which publishes various technical standards for Islamic banks.¹¹² But, as the below section will explain, a more universal

¹⁰⁵ See FAUD AL-OMAR AND MOHAMMED ABDEL-HAQ, *ISLAMIC BANKING: THEORY, PRACTICE, AND CHALLENGES* 110 (1996).

¹⁰⁶ *Id.* at 111.

¹⁰⁷ *Id.* at 112.

¹⁰⁸ Moghul & Ahmed, *supra* note 27, at 151.

¹⁰⁹ Dr. Zeti Akhtar Aziz, Governor of the Cent. Bank of Malay., Speech at the 3rd Annual Islamic Finance Summit in London: Ensuring Stability in the Islamic Financial System (Jan. 13, 2004) available at <http://www.bis.org/review/r040121c.pdf>.

¹¹⁰ The potential Islamic regulatory banking system is compared to the Basel core principles that supervise conventional banks. See *id.*

¹¹¹ AAOIFI Overview, <http://www.aaofii.com/overview.html> (last visited Jan. 31, 2008).

¹¹² Islamic Financial Services Board, <http://www.ifsb.org/> (last visited Jan 31, 2008).

system is needed to establish generally accepted principles among Islamic banks and satisfy confused clerics, clients, and banks.

a. *Why a Regulatory System is Needed*

A key reason why Islamic financing requires more comprehensive regulation is the high risks such banks unilaterally take on through profit-loss sharing (PLS) transactions. PLS transactions involve banks in activities that “go beyond conventional banking” because of the pre-determined profit-and-loss ratios with investment and loan projects.¹¹³ *Mudaraba* contracts are great examples of high risk to banks. Recall that under *mudaraba* example given above, if a project fails, the bank cannot recover its loan. Consequently, some banks only offer *mudaraba* transactions to trusted clients. There is nonetheless always the risk that a *mudaraba* bust will occur and leave the bank unprotected. It is a unique vulnerability of Islamic banks.

A second risk to the industry is its lack of a general default protection rule. In conventional banking, for example, if a mortgagee fails to make payments on his house to the bank, there are legal repercussions. The debtor is still liable for his loan. Because banks are protected by customary default laws, delinquent clients will not deplete their capital. Banks can guarantee sufficient capital reserves to all its investors. By contrast, in the *mudaraba* example discussed above, the client did not legally default under *Shari'ah* law. Recall that the loss in Islamic contracts is shared and pre-determined to each party's original input. Because in *mudaraba* transactions the bank contributes *all* the assets, it is *solely* liable (this relates to the PLS nature of a *mudaraba* transaction). Default protection problems do not apply only to *mudaraba*; for example, if a bank purchases a requested product under a *murabaha* transaction, the client can legally decide not to purchase the good from the bank, leaving the bank with an unwanted product and less money. Fortunately, the bank is not entirely without protection. In some countries, Islamic banks can file a complaint against delinquent clients through a banking tribunal, which often passes a decree in favor of the bank and imposes a fine on the client.¹¹⁴ Many Islamic banks, however, either do not offer banking tribunals, have no means to enforce decrees, or simply have no complaint system available to clients.¹¹⁵ Either way, this haphazard dealing with delinquent clients is far from the protection a universal default regulation could offer.

Pakistan and Iran are the sole Islamic countries to formally adopt a default protection law. The Pakistani government has passed an ordinance allowing banks to recover finance provided to customers who default, which in turn makes the bank more reliable to its other investors.

¹¹³ See el Qorchi, *supra* note 6.

¹¹⁴ See AL-SUWAIDI, *supra* note 103, at 154.

¹¹⁵ See *id.*

Pakistani banking tribunals have the support of civil and criminal courts to enforce payment from defaulting customers. If payment still is not made after a decree has been given in favor of a bank, the tribunal authorizes banks to sell any property held by them as a security for finance that was originally provided by the customer.¹¹⁶ On the flip side, clients investing with Pakistani banks know that neither the bank nor their investments will be lost. Conventional banks with in-house Islamic finance units in Britain and Denmark, for example, also offer protection of depositors. Pakistan is unique because prides itself for upholding the purest form of *Shari'ah* in its legislation yet at the same time offers a controversial, albeit much needed, version of default protection.

Many bankers argue that to combat the inherent risks of PLS and defaulting, Islamic banks should be required to maintain a minimum capital adequacy.¹¹⁷ In both PLS and default situations the bank can potentially lose great amounts of cash.¹¹⁸ At the same time, there is no “bank discount window” to turn to when a troubled bank needs quick liquidity as well as no deposit insurance program to reassure investors and help prevent panic bank runs.¹¹⁹ Without protection of the banks, clients are likely to trust banks with less of their money (simply put, the banks using their money for loans could lose it and delay the original client’s access). In fact, this is the current situation. Most relationships between clients and banks are short-term and do not involve large, high risk, or long-term investments.¹²⁰ Instead of reaping larger profits from long-term investments, “the bulk of Islamic funds are aimed at short-term mark-up deals with slim profit margins.”¹²¹ This unattractive situation for long term relationships with banks consequently defers many investors to conventional banks. In order for the industry to grow it will need to attract the funds of clients who currently opt for the superior returns and risk characteristics offered by conventional banks.¹²²

In sum, the current system is unattractive to those clients that can offer banks the most prosperity.¹²³ Furthermore, problems with the vulnerable

¹¹⁶ *Id.* at 153.

¹¹⁷ *See Aziz, supra* note 109 (“A fundamental issue is the setting of prudent and appropriate minimum capital adequacy requirements for Islamic banks. Such requirements need to reflect the risks that the banks undertake.”).

¹¹⁸ Thus far, Islamic banking has been spared from a serious financial crisis, with the exception of a few small cases (such as the Dubai Islamic Bank in 1998 and Ihlas Finans in Turkey in 2001). *See id.* *See also* el Qorchi, *supra* note 6.

¹¹⁹ VOGEL & HAYES III, *supra* note 13, at 7.

¹²⁰ *See id.* at 8.

¹²¹ *Id.*

¹²² *Id.* at 6.

¹²³ It is interesting to consider what might happen if wealthy countries like Saudi Arabia, which often turns a blind eye to Islamic law’s role in finance, invested its money in Islamic banks. Arguably, things would change faster. Oil money, which is more often invested in Western, conventional banks, could instigate the need for bank

spots such as PLS and defaulting will only be exacerbated and open to abuse with the increase of the industry's size in the future.

b. *Inadequacy of Current Regulatory Efforts*

The lack of a supervisory and regulatory framework has not gone completely unnoticed, though current efforts need much more development in order to best handle the industry's expanding future. Many international institutions have been working to create a single set of *Shari'ah*-compliant standards, applicable in Muslim and non-Muslim countries alike. As mentioned earlier, these include the AAOIFI, the IFSB, and the Bahrain Monetary Agency sponsored International Islamic Financial Market ("IIFM"), the Liquidity Management Center ("LMC"), and the International Islamic Rating Agency ("IIRA").¹²⁴

Though many agencies are interested in facilitating the future of Islamic financing by providing regulatory framework, there still is no universal set of rules to abide by. As mentioned above, the IFSB was established in 2002 with an aim to set global regulatory and supervisory standards for Islamic financial institutions and has made some progress. In 2004 it finalized standards on the capital adequacy and risk management framework within Islamic banking and is developing international corporate governance standards.¹²⁵ If these standards are accepted by banks, supervisors could provide justified and consistent oversight. Similarly, a number of countries and institutions, though not all, have adopted accounting standards developed by the AAOIFI, which complement the International Financial Reporting Standards.¹²⁶ The Islamic Development Bank is somewhat parallel to the Muslim world's personal World Bank. It finances development projects for poor Muslim countries in accordance with *Shari'ah* law, thereby stopping them from borrowing heavily on an interest basis from international banks.¹²⁷

B. *Non-Legal Problems for the Future of Islamic Banking*

Though the legal problems of Islamic banking by far require the most attention if the industry is to have a prosperous future, smaller social,

protection and standard regulations. Clients and countries with more money at stake have a greater reason to demand better protection and, thus, seek and bring about change. And, there certainly is a "rich lode of Muslim savings to tap"; billions of dollars were taken out of the Middle East and into conventional banks post 9/11 and "more than \$50 billion of savings fled the gulf region during the gulf crisis of 1990-91." VOGEL & HAYES III, *supra* note 13, at 6. Much of this was oil wealth, and little of this money has returned.

¹²⁴ See el Qorchi, *supra* note 6. The Bahrain Monetary agency sponsors the IIFM, LMC, and IIRA.

¹²⁵ See *id.*

¹²⁶ See el Qorchi, *supra* note 6.

¹²⁷ See AL-SUWAIDI, *supra* note 103, at 149; Taylor, *supra* note 22, at 386.

political, and technological problems also contribute to the industry's problematic future. Politically, the possibility of upheaval in Middle Eastern countries, where many of the Islamic financial transactions occur, almost always exists. Though the instability of the political economy of the Middle East is not the topic of this paper, it is worth generalizing its relation to Islamic banking. There are many disputes within and among countries that create a generally unstable banking environment. In many countries, Islamic banks have been forced to invest their deposit funds outside their own country to enable them to compete with other conventional banks in paying the depositors a fair share from their profits.¹²⁸ Some Middle Eastern states, such as those in the Gulf and Libya, rely on oil sales to sustain and develop different sectors of their economy. Similarly, some Middle Eastern countries concentrate on one commodity for their income (e.g. oil), which constitutes a major jeopardy for the economy if the prices or production of such commodity face any rapid change.¹²⁹ Should oil revenue decrease or oil reservoirs see their end, the general flow of finances within states will decrease. With less cash in the government and in people's purses, Islamic banks will have fewer clients with less to offer.

Islamic banking also faces unique social problems. First, the promotion of Islamic banking may be difficult since many Muslim businessmen have traditionally used conventional banks. As mentioned in Part I above, Islamic banking did not become available to most people until the 1970s and 1980s. Prior to this development, many people used traditional banks and grew accustomed to gaining interest on their investments. The switch to a less lucrative system with fewer personal gains can be unattractive enough to dissuade investors from switching to *Shari'ah*-compliant banks. Moreover, a businessman who is a devout Muslim and has always used the state approved banks in the past may have assumed that Islamic banks and conventional banks are the same. They simply may be unaware of the different principles of each system.¹³⁰

Second, many Islamic banks hire employees based on social reasons instead of qualification which often creates wasted money on training and overall inefficiency. Islamic finance researcher Ahmed Al-Suwaidi argues that "in most firms, including the Islamic banks, especially in developing countries and particularly in Gulf Arab States," some employees are hired because of the following factors, in order of frequency: 1) friendship, 2) family 3) recommendation 4) reasons of ideology 5) family traditions 6) previous experience and knowledge 7) qualifications and experience.¹³¹ Given that the stability and reputation of a firm are based

¹²⁸ See *id.* at 148-49 (quoting Qasim M. Qasim, presentation on Islamic Banking to Businessmen's Luncheon Club, p.4 (Doha: 16 Dec. 1984)).

¹²⁹ See generally AL-SUWAIDI, *supra* note 103, at 149.

¹³⁰ *Id.* at 150.

¹³¹ *Id.* at 155-56.

on efficient administration and qualified employees, these ought to be a goal of Islamic banks. Compared to the other, larger problems, reviewing employment standards also seems an achievable goal. This is particularly relevant given the guaranteed increase in use of Islamic banks and their need to meet such demands.

Third, transaction costs are costly for Islamic banking clientele. When clients go to the many banks that offer Islamic in-house financial services, as a specialty but not as their main practice, they require special service. Though banks and attorneys are willing to offer this, greater specialization requires more time, which creates higher fees and transaction costs for clients.

IV. CONCLUSION

The Islamic financing industry is on the verge of either major transformation or a period of frustration and probable decline.¹³² I believe that Islamic banking will rise to the challenge. Many academics and scholars are quick to spot the industry's problems, its legal hypocrisy, and slower to answer practical questions—who is going to create a single regulatory and supervisory system? How can it be enforced worldwide? Some scholars believe that the only way to save the industry is to branch away from mimicking conventional finance and rebuild a purely Islamic system that bans techniques like *murabaha*. This way, they argue, Islamic financing will stay true to the fundamental principals of Islam and will be less likely to lean too close to conventional banking.¹³³ Other scholars believe that because Islamic banking is moving into western banks, and in order to attract new clientele, the appropriate route is to take conventional techniques and modify them to be *Shari'ah*-compliant.¹³⁴ A more 'middle-ground' approach might propose that bankers should hone in on areas of Islamic law that have not yet been fully exploited and find innovative ways to stay within *Shari'ah* limits while mimicking the advantageous aspects—for example, longer-term, higher-return investments—of conventional banking.

Regardless of the path chosen, the first problem to be addressed is installation of a regulatory and supervisory system that outlines what is and is not permitted. If this is available, then the second large problem—lack of harmonization among *Shari'ah* boards—will presumably be less of an issue. Scholars and advisory boards will, at the very least, be able to defend their decisions by pointing to the universal system as a default. This does not suggest that harmony will be reborn and problems will

¹³² VOGEL & HAYES III, *supra* note 13, at 292.

¹³³ *E.g.*, *see id.* at 292-94.

¹³⁴ *E.g.*, Taylor, *supra* note 22; Seniawski, *supra* note 3, at 726 (“The prohibition of *riba* is a worthy legal rule, but the rule's current over-broad interpretation diminishes its usefulness by burdening lenders and causing legal hypocrisy in compliance efforts.”); *See generally* Seniawski, *supra* note 3. .

cease, but a general regulatory system creates a “fall back” option for banks to give some assurance to customers that they are legitimately following *Shari’ah*-approved rules.

One fundamental component of a new regulatory system is a new definition of *riba*. The conservative interpretation of *riba* creates a bright line rule, a “better safe than sorry” rule that in a society like it was centuries ago probably was useful in protecting the poor from exploitation.¹³⁵ In today’s world, financial transactions (especially those with multinational banks) are controlled by more sophisticated parties that protect both lenders and borrowers. Evidence shows that the historically-targeted dangers “do not exist in business and transnational transactions today.”¹³⁶ Why then, should a burdening rule continue to burden? A new definition of *riba* might permit a lender to gain interest equal to the rate of inflation on loans. Such nominal amount does not exploit the borrower.¹³⁷ A more flexible and realistic definition of *riba* will benefit clients and lenders. From an international law perspective, a more clear definition of *riba* will enable attorneys and multinational banks to confidently conduct business in foreign countries and with interest Muslim and even non-Muslim clientele.

¹³⁵ Seniawski, *supra* note 3, at 726.

¹³⁶ *Id.* at 727.

¹³⁷ *See id.* (“Given the Qur’anic injunctions, narratives of Muhammad’s words and acts, and historical evidence, it is reasonable to argue that a modest interest rate (one that is less than or equal to the rate of inflation) is not *riba*.”).