The Two Schools of Islamic Finance

By Bernardo Vizcaino, CAIA

The global financial marketplace stands at a crossroads, undoubtedly the recent (and many) events in the capital markets have ignited a slow but steady analysis of regulation, governance, risk management and ultimately it's beneficial role in society. Islamic finance is no different – faced with equally important and far-reaching choices to make for itself. Nevertheless, the bifurcation in the road has little to do with clearinghouses, oversubscribed issues or exotic solutions. It has nothing to do with GCC versus Malaysia, nor AAOIFI versus IFSB, and most certainly this is not about petrodollars or tapping so-called Middle East liquidity. The latter has to be one of the most ill-conceived and utterly-shortsighted concepts in the history of finance.

The industry is being defined – at every level – by two increasingly polarized schools of thought. These two have enough energy and influence to supercede in importance the differing interpretations found in the Hanbali, Hanafi, Maliki or Shafi'i traditions. The stakes are that high. These two 'schools' embody the quintessential decision that practitioners, investors, economists, and even Scholars need to make. This choice has been made even more poignant as Islamic finance moves into the mainstream.

The first school of thought reminds us – with every possible chance – that this is a young, constrained, repressed, and isolated industry (and we the villagers). It calls for tacit acceptance of the status quo – whichever practice that may be – and categorically shuns inquiry, suggestions or the ocassional questionnaire. The industry is new, limited and forever under the shadow of conventional finance and hence it must accept its place in the corner of the marketplace. This school keeps reminding us that innovation is a dangerous scheme (unless of course it is a creation of their own) and standardisation efforts mere utopian discourse (cost effectiveness and efficiency left for future generations to figure out).

The key to understanding Shariah compliance seems to lie with their crystal interpretation of the law – nevermind that the explanation (and to an extent the holy scriptures) have been copyrighted in the process (black boxes and non-disclosure agreements are ubiquitous). Their closing arguments often include a sense of infalibility, where apologies or retractions are reserved for lesser mortals, where conviction and devotion have been translated into the unequivocal ownership of the truth.

One might be tempted to call it the 'old school' of Islamic finance, but that would imply the observance of age-old traditions and practices. In fact, it embodies a very young (and reckless) mentality, one which has left the door wide open for circumvention, manipulation and the box-ticking approach that has turned instruments such as sukuk looking like bonds.

Herewith the second school of Islamic finance - immediately concerned with de-mistifying the product range and removing (or at least easing) the barriers to entry for new comers. Here the focus of attention is not so much the form but rather the substance of instruments and structures. It forges ahead aided by growing calls for a practical and transparent product manufacturing process, as well as a cost-conscious and sustainable business model for Shariah compliance.

Nonetheless, this forward-looking perspective might give it a 'new school' label, seemingly handicapped for its limited understanding of industry intricacies, enthralled in absurd initiatives and guilty of collective naivete. Thus being diminshed as a superficial assessment, since this particular school is far more focused on the principles and objectives of compliance. It has placed a magnifying glass not on the inputs/devices bur rather on the outputs/byproducts of Shariah compliant transactions.

These two schools – as oppossite as they appear – are irrevocably intertwined with each other. Whether they like it or not, they need each other for the industry to develop further. Despite their seemingly polarizing characteristics, the new school is being fuelled by young & energetic Muslim professionals, a substantial undercurrent of human capital ready to be tapped. The old school is exemplified by several industry pioneers, holders of multiple awards and accolades, but ultimately aware that it will have to re-asess how sustainable is the business model they have erected over the past few decades.

It is beyond debate that the old school set the foundations for what is now a thriving industry, and did so while competing in the golden age of conventional finance. They provided the framework that – however flawed – has brought Islamic finance to where it is today. Then again, as the conventional world scrambles to redefine itself, a strong current of opinion is asking the same of Islamic finance. This is where the old is being met by the new.

Unfortunately there has been very little attention given to the revived Muslim identity and the throngs of practitioners eager and ready to contribute to the industry and to their faith. As they build their credentials one must wonder where are the Islamic finance graduate programs, internships, secondments, and apprenticeships that will utilize and maxmize their potential. Perhaps it will be an awakening of sorts for the industry, as this 'generational change' gradually brings the new school approach into the roles and positions held by their old school counterparts. Time will tell.

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Aside: Opening the Islamic window

Ramadan is very significant for the Muslim faith, but seldom attention is given to its importance and for that matter to the many other features of Islam. It is very much relevant to understand what drives the Muslim faith, as it has a direct relevance to why we have Islamic finance.

The Qur'an's central philosophy is that of tawhid (godliness), the acceptance of God's divine truth as revealed to the Prophet Mohammed (pbuh), a profound guide on how to lead one's life. It opens with the Bismillah ('In the name of Allah') and this phrase is repeated in almost all of its surahs (chapters), often offered in the call to prayer and at the beginning of any important activity (from conferences and gatherings, to textbooks and dissertations). Indeed the Qur'an has 114 surahs, and it can be further divided into ayats (verses) as well as sections (either thirty juz or seven manazil). This means that the entire text can be read through the month of Ramadan or within a single week. Moreover, the overall structure follows the rhythm and charactertistics of ancient oral poetry, and thus a devout Muslim can commit the Qur'an to memory (approx 80,000 words) earning the honorific title of hafiz.

The importanec given to every word of the Qur'an is by no means trivial, in fact this serves as a starting point to understand why Islamic finance is effectively 'Islamic finance'. Certainly the Bible and the Torah - as Abrahamic scriptures - are regarded by Muslims as important divine revelations, but Muslim belief is that the Qur'an is the literal word of God, as revealed to the Prophet through the Archangel Gabriel. There is even widespread agreement that the original Arabic should be respected, thus making translations particularly difficult (one can trace a variety of attempts over the centuries) and this is compounded by the fact that many Arabic words have different meaning (which varies according to the context). This partly explains why we talk about sukuk, maslaha, maqasid, and riba. These should be considered as broad concepts/ideas rather than specific items/nouns.

Structure and guidance is given for every aspect of daily life, and such interpretation has been extended into Islamic law. Scholars can therefore rely on the Qur'an and the hadith (the traditions about the life and sayings of the Prophet) to find guidance in almost every aspect of life - and business activity. Hence the origin, importance and serious debate given to Islamic finance.