

CSFI

CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

5 DERBY STREET
LONDON W1J 7AB

TEL: 020 7493 0173
FAX: 020 7493 0190

Revisiting Shari'a financial instruments. A round-table discussion with Richard Thomas (Gatehouse Bank), Nigel Dennison (BLME), Mohammed Amin (PwC) and Siti Faridah Abdul Jabbar (National University of Malaysia) held on Monday, November 3, 2008, at Watermen's Hall, 18 St-Mary-at-Hill, London, EC3R 8EF, from 12:30-2:15pm.

As conventional markets crumble, attention is increasingly focused on the role that Islamic finance can play. Is it just a bull market phenomenon or does it have real underlying demand that will sustain it? The first speaker said one had to go back to the Koran and principles of Islamic economics – pro-free trade, anti-protectionism, anti-customs and anti-usury. The modern Islamic banking system is based on decades of advice from Shari'a scholars who assess compliance with Islam.

The speaker acknowledged this was a keen area of debate. He said there was a growing consensus between scholars about how to assess compliance. He defended the fact that Shari'a boards were funded by banks as akin to the funding of audit firms and said the practice of having a majority view was no different from English appeal courts. In the UK there are now five Islamic banks approved by the FSA and groups such as the Institute of Islamic Banking and Insurance are emerging as trade bodies representing scholars.

While Islamic finance began as an anti-colonial initiative in the 1960s it has been taken on by mainstream business, and particularly by corporate treasurers who need to know how to invest excess funds in ways that do not bear interest. Sadly products have not kept pace with demand and that demand may have led to the distortion of existing products in a way that has offended traditionalists and caused disputes between scholars. This means that a time when Islamic finance could have taken advantage of the hiatus in conventional markets, it is in disarray over scholarly interpretation.

The second speaker divided Shari'a finance into two categories – Shari'a compliant business "windows" and Shari'a-based organisations. The former are subsidiaries of conventional bank who offer Shari'a products but whose financing is based on non-compliant money. The latter are banks whose whole operation is compliant. True observance gives that second category two challenges. The first is balance sheet size. Given one cannot issue interest-bearing debt the amount of business they can do is constrained by their balance sheet. The challenge is to find a system of syndication and distribution that allow banks to expand their operations. The second is liquidity management as the Koran sees money as a means of exchange not a store of value. It would be helpful if the UK government pressed ahead with plans for a Treasury *Sukuk* – bonds that comply with the ban on interest – that would create liquidity.

The third speaker said Shari'a was not a bull market phenomenon but was based on economic growth in Muslim countries and a greater desire to be religiously observant. He warned that the sector faced risks such as excessive concentration on real estate and on a

small number of countries. Are there any real Islamic principles underpinning finance? The speaker said there were. Firstly banks are obliged to take care that their customers do not take on excessive debt. Secondly contracts with excessive complexity can be declared void. Thirdly the ban on gambling effectively outlaws financial speculation. While Islamic finance cannot be immune from the credit crunch, these facts should make it more resilient.

The fourth speaker said it did not wash to say Islamic finance could be immune from the credit crunch as its banks operated in the same markets. On the other hand, Islamic finance will be more resilient as it has inherent strengths. As well as the bans on gambling and complexity, Shari'a law would not accept a contract that contained uncertainty whereas English courts would interpret parties' intentions. Islamic finance requires tangible assets rather than ones conjured out of thin air. As long as petrodollars flowed and Muslims wished to be compliant, Islamic finance had a future.

However the speaker said there were a few outstanding issues that could hinder growth. Firstly Islamic finance lacked a complex regulatory framework and an investor protection regime. Secondly Shari'a boards lacked good governance. Thirdly where Shari'a law is operated in non-Muslim jurisdictions there was room for misinterpretation and over-interpretation. The first speaker said that this tension was highlighted by a ruling by a Shari'a scholar that many *Sukuk* bonds were not compliant following an increasing trend of banks to test the limits of Shari'a compliance, for example by attempting to include alcohol-based revenues. The fourth speaker said that case was in fact decided on its merits as the scholar who approved a particular deal later realised he had not been shown the full facts.

Where is Islamic finance headed? The fourth speaker acknowledged concerns over scholars' identity and qualifications and suggested putting all scholars under an umbrella organisation such as the Organisation of the Islamic Conference to increase standardisation. The first speaker said Islamic banks needed to concentrate on designing products that appealed to customers, and less time on exotic products that no one wanted to buy and which might breach Shari'a. The third speaker said the key challenge was to improve products and drive down costs while the second echoed that, adding that banks may have to get bigger to address the balance sheet challenge.

The first speaker highlighted an example of how Islamic finance might benefit. He recalled trying to construct a compliant product with Enron based on gas contracts. The project fell down when it became impossible to ascertain where the physical gas assets were. Only later did it emerge why that was so! That, in a nutshell, is the advantage that Islamic finance has over conventional finance.