ISLAMIC FINANCE

The Convergence of Faith, Capital, and Power

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ABSTRACT

This dissertation assesses how Islamic finance fares as an example of 'civil compromise' in Islamic law. By focusing on the Islamic project finance sector, my research examines how the industry's main stakeholders (representing faith, capital, and power) cooperate and compete to bring about this compromise through the 'Game of Islamic Bank Bargains'.

The Islamic finance industry is a work in progress, and while it has made some significant strides, it is still a niche in the global conventional financial order rather than an alternative to it. It has fallen short of fulfilling its originally-stated social justice aspirations, but has provided a previously unavailable form of banking and finance for Muslims to transact, at least formalistically, in accordance with widely-believed tenets of their faith. Thus, those who hold up Islamic finance as a universal panacea or dismiss it outright as a fraud have both got it wrong. It is neither. It is, rather, a complex myriad of incentives and aspirations of a multitude of stakeholders muddled together across numerous geographies and evolving incrementally and constantly.

The state of the industry is the result of how the stakeholders (the *shariah* scholars, lawyers, bankers, government officials, and customers) have pursued their self-interest in the Game of Islamic Bank Bargains. My research examines who are the 'winners' and 'losers' of this game, and what religious, commercial, and political factors have influenced this outcome. I assess what may incentivise the incumbent 'winners' to guide the Islamic finance industry away from a formal and legalistic approach towards one that also incorporates principles from Islamic economics. I explore how the 'losers'—whose interests are not accounted for due to their lack of sufficient financial and political clout—can sway the outcome of the game in their favour.

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AIG:	American International Group
ASAS:	Association of Sharia Advisers in Islamic Finance
ASSIF:	Association of Sharia Scholars in Islamic Finance
BCCI:	Bank of Credit and Commerce International
BIMB:	Bank Islam Malaysia Berhad
BIS:	Bank for International Settlements
CTA:	Common Terms Agreement
DFSA:	Dubai Financial Services Authority
DIB:	Dubai Islamic Bank
DIFC:	Dubai International Financial Centre
DJIMI:	Dow Jones Islamic Market Index
ECA:	Export credit agency
EPC:	Engineering, procurement, and construction
EU:	European Union
FIBE:	Faisal Islamic Bank of Egypt
FDI:	Foreign direct investment
GCC:	Gulf Cooperation Council
GDP:	Gross domestic production
GIIS:	FTSE Global Islamic Index Series
IASB:	International Accounting Standards Board
IBF:	Islamic banking and finance
ICC:	International Chamber of Commerce
ICD:	Islamic Corporation for the Development of the Private Sector
IDR:	Islamic dispute resolution
IFI:	Islamic finance institution
IFRS:	International Financial Reporting Standards
IFSB:	Islamic Financial Services Board
IIBI:	Institution of Islamic Banking and Finance
IIFM:	International Islamic Financial Market
IILM:	International Islamic Liquidity Management Corporation
IIRA:	Islamic International Rating Agency
IMF:	International Monetary Fund
IMMCs:	Islamic Money Management Companies
IOC:	International oil company

IPF:	Islamic project finance
IPO:	Initial public offering
IsDB:	Islamic Development Bank
ISRA:	International Shariah Research Academy for Islamic Finance
KSA:	Kingdom of Saudi Arabia
LIBOR:	London Bank Interbank Offered Rate
LMA:	Loan Market Association
LMC:	Liquidity Management Center
MLA:	Mandated lead arranger
MTN:	Medium Term Note
NGO:	Non-governmental Organisation
NOC:	National Oil Company
NSB:	National shariah board
OECD:	Organisation for Economic Co-operation and Development
OIC:	Organisation of Islamic Cooperation
PLS:	Profit-and-loss sharing
RfP:	Request for Proposal
SAIBOR:	Saudi Arabian Interbank Offered Rate
SAMA:	Saudi Arabian Monetary Authority
SAR:	Saudi Arabian Riyal
SDGs:	Sustainable Development Goals
SPV:	Special purpose vehicle
SSB:	Shariah supervisory board
UAE:	United Arab Emirates
UK:	United Kingdom
UKEF:	UK Export Finance
UKIFC:	Islamic Finance Council UK
US:	United States of America
USD:	United States Dollar
VAT:	Value added tax

GLOSSARY OF TERMS

Allah	God
Bidaa	Innovation to or diversion from Islam
Bumiputra	Literally the sons of the land, term for Muslim Malays
Dharurah	Necessity
Fatwa (sing.) / Fatawa (pl.)	Religious ruling(s), similar to legal opinions issued by lawyers
Fiqh	Islamic jurisprudence
Gharar	Excessive risk/speculation
Hadith (sing.) / Ahadith (pl.)	Reports describing the words, actions, or habits of Prophet Muhammad
Halal	Permissible
Hajj	The pilgrimage to Mecca that Muslims are generally required to undertake during their lifetime
Haram	Forbidden
Hila (sing.) / Hiyal (pl.)	Legal stratagem(s)
Hudud	Criminal punishments set out in primary sources of Islamic law such as the Quran. These include lashings, amputation, and execution
Ijara	Lease (a nominate contract used in Islamic finance)
Ijtihad	Literally, striving/exerting. The independent or original interpretation of problems not precisely covered by the Quran or sunna
Ikhtilaf	Differences of opinion
Istisna	Construction/procurement (a nominate contract used in Islamic finance)
Madhab (sing.) / Madhahib (pl.)	School(s) of Islamic thought
Maghasid al-Shariah	The objectives of Islamic law, often considered to be promoting the wellbeing of humankind through safeguarding their faith, their physical body, their intellect, their progeny, and their wealth
Maslaha	Expediency, public good
Muamelat	Transactions

Mufti	A person issuing a *fatwa*
Mudaraba	Form of investment partnership where one party provides capital and the other provides labour/expertise (a nominate contract used in Islamic finance)
Murabaha	Cost-plus financing (a nominate contract used in Islamic finance)
Musharakah	Partnership (a nominate contract used in Islamic finance)
Pari passu	Literally, with equal step. The equal treatment and ranking amongst financiers in a transaction
Primubis	Muslim Indonesians
Pro rata	Literally, according to the rate. Proportional treatment of financiers in a transaction
Quran	The holy book of Islam, considered the verbatim word of God as revealed to Prophet Muhammad
Riba	Often equated to usury/interest
Sadaqa	A voluntary charitable act
Shariah	Often equated to Islamic law
Sukuk	Often equated to an Islamic bond
Sunna	The sayings, deeds and omissions of the Prophet Muhammad that are a source of Islamic law
Tayeb	Wholesome
Takaful	Islamic insurance
Tahawutt	Islamic hedging
Tawarruq	A form of commodity-based cost-plus financing (a nominate contract used in Islamic finance)
Ulema	Islamic (religious) scholars
Umma	The totality of the Muslim community
Usul-ol-figh	Principles of Islamic law
Wakala	Agency (a nominate contract used in Islamic finance)
Waqf (sing.) / Awqaf (pl.)	Trust(s)/endowment(s)
Zakah	Alms, also the 2.5% corporate tax of Saudi Arabia

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Qanun Madani Iran [Iran's Civil Code] 1928

Kuwait

Kuwaiti Civil Code Law No. 67/1980

Kuwaiti Commercial Code Law No. 68/1980

Kingdom of Saudi Arabia

Al-Nizam Al-Asasi lil Hukm (The Basic Law of Saudi Arabia) 1992 (Royal Decree No A/90)

United Arab Emirates

Dubai Law on the Application of Civil and Commercial Laws No 3 2004

United Kingdom

Arbitration Act 1996

Contracts (Applicable Law) Act 1990

Finance Act 2003

International Instruments

The Convention on the Law Applicable to Contractual Obligations 1980

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CHAPTER 1: INTRODUCTION

1.1	**RESEARCH BACKGROUND – CIVIL COMPROMISE**	**1.4**	**RESEARCH METHODOLOGY**
1.2	**RESEARCH FOCUS – ISLAMIC FINANCE**	**1.5**	**TERMINOLOGY & TECHNICAL MATTERS**
1.3	**RESEARCH QUESTION**	**1.6**	**STRUCTURE**

'Oxford [University] is like Islamic law, it made sense a thousand years ago.'

– Overheard in St Antony's College, University of Oxford

1.1 RESEARCH BACKGROUND – CIVIL COMPROMISE

Modernity has posed challenges to certain systems and practices of the Muslim world. The Islamic legal system has adapted in creative ways to address these challenges. For me and my research, this ability to adapt is one of the most interesting features of Islamic law. There exists this general, yet often ignored, trend pervading Islamic law whereby seemingly inflexible religious commands are pragmatically adapted to civil realities—what I call 'civil compromise'. Civil compromise is a de facto and on-going occurrence in contemporary Muslim societies. It is a pragmatic tool for renewal within Islamic law, which challenges a common misconception that Islamic legal reform must be led by theory, not practice.

For centuries Islamic law has been evolving in response to internal and external factors. More recently, this evolution has been hastened by a multiplicity of forces including:

Legal pressure: International forces such as colonialism and globalisation have brought Islamic law into contact with modern legal systems. This has resulted in codification and development of case law. Through constant contact with citizens, as the primary consumers of the codes and courts, the substance and procedures of Islamic law have been contextualised to some extent.[1]

1 See eg Chibli Mallat, 'From Islamic to Middle Eastern Law: A Restatement of the Field (Part II)' (2004) 52 The American Journal of Comparative Law 209; Werner Menski, *Comparative Law in a Global Context: The Legal Systems of Asia and Africa* (2nd edn, CUP 2006) ch 5.

Socio-political pressure: As members of civil society (especially women) in the Muslim world gain greater access to knowledge, resources, and power, they challenge unequal treatment under Islamic legal systems. This has resulted in numerous NGOs and activists across the Muslim world demanding legal reform to end perceived discriminations. Moreover, discriminatory practices may have implications under international law and can damage the violator's standing in the international community. This factor adds an element of external pressure to the internal demand.

Economic pressure: As Muslims gain a greater role in the global economy, they strive to develop innovative responses to the challenges posed by capitalism.[2] By restructuring and combining Islamic contract and corporate forms, Islamic scholars and practitioners have sought to offer *shariah*-compliant solutions to address modern business demands.

Confronted with these pressures, divinely-inspired Islamic law is being brought down to earth—restructured and adapted for greater compatibility with socio-political and economic realities. Through this process, key stakeholders seek to expand the remit of Islamic jurisprudence to encompass more situations within the scope of *shariah*-compliance and craft an Islamic legal system compatible with the current reality of civil societies. 'Civil compromise' is this dialectical process—between legal commands perceived to be divine and civil realities on the ground—that incrementally refines Islamic law.

An attempt at civil compromise will be successful if the destination reached is deemed by the majority of society to be Islamic, modern, and just. The most salient feature shared by these three terms is that the meaning of each is hotly contested and not free from controversy. By way of clarification, when I use the term 'Islamic' in this context a metaphysical dimension is not intended, rather (as is also the case for the terms 'modern'

2 See eg M Umer Chapra, *Islam and the Economic Challenge* (Islamic Foundation 1992); Charles Tripp, *Islam and the Moral Economy: The Challenge of Capitalism* (CUP 2006).

and 'just') it is sufficient for my purposes that the legal system is deemed to have these features by the majority of those to whom it applies.

It is through this process of civil compromise that various religious, commercial, and political factors push and pull each other until one interpretation out of many comes to prominence in a particular jurisdiction. The diversity of approach that results from this process is an important and fascinating feature of Islamic law. Ibrahim Warde states in this regard:

> Any successful belief system, whether religious or secular, has seemingly contradictory characteristics: it is malleable enough to adapt to a variety of geographical settings and survive the test of time, yet it must be able to maintain its specificity, or else it would disappear or become fused with competing belief systems; it is idealistic, sometimes even utopian, yet capable of adjusting to human imperfection and making the kinds of compromises that are endemic to political and economic life.[3]

The resurgence of Islam in the public sphere, notably with events such as Iran's Islamic revolution in 1979 and more recently with the 'Arab Spring', and calls for a greater role for *shariah* in the legal order of Muslim (and even non-Muslim)[4] countries, makes my dissertation particularly pertinent.

1.2 RESEARCH FOCUS – ISLAMIC FINANCE

Amongst the many areas in which civil compromise is on-going,[5] I have chosen to study where the Islamic legal system comes into contact with modern banking and financial practices, leading to the emergence of Islamic banking and finance. In other words, my dissertation focuses on how civil compromise shapes the Islamic finance industry. The rich and nuanced interplay of numerous stakeholders that are influencing the industry's shape

3 Ibrahim Warde, 'Status of the Global Islamic Finance Industry' in Craig Nethercott and David Eisenberg (eds), *Islamic Finance: Law and Practice* (OUP 2012) para 1.27.

4 See eg Riazat Butt, 'Archbishop Backs Sharia Law for British Muslims' *The Guardian* (7 February 2008).

5 These include Islamic constitutionalism, Islamic political systems, women's rights, and so on. On Islamic constitutionalism and political thought see eg L Ali Khan and Hisham M Ramadan, *Contemporary Ijtihad: Limits and Controversies* (EUP 2012).

makes this vibrant sphere of activity a great source for the study of civil compromise. Moreover, the fast pace of the Islamic finance industry's expansion has necessitated innovation in the *shariah* techniques underpinning it, making it the most innovative area of Islamic law.[6] I have chosen to focus on this sector because of its growing size and importance, as well as my personal motivation and background. I further explore each of these below:

Industry's size and importance: Inspired by early Islamic commercial practices, modern Islamic finance can trace its origins to the 1960s, with practical experiments starting in the 1970s.[7] It has since grown tremendously, evolving through a variety of religious, economic, and political factors. Modern Islamic finance started as a small rural banking project in the remote villages of Egypt. From these humble beginnings, it has now reached a level where most major financial institutions are offering Islamic finance products or are somehow involved in the industry. Once confined to the outer fringes of global finance, Islamic finance is now increasingly relevant to mainstream finance, with legions of bankers, lawyers, accountants, consultants, and scholars specialising in the sector from East to West, Malaysia to America. This nascent industry, which amounted to a few hundred thousand dollars in 1975, reached US$1.46 trillion in 2012, and US$2 trillion in 2014.[8] Islamic finance's growth outpaced that of conventional finance in all market segments over the 2006-2010 period. The growth of the industry has somewhat stagnated around the US$2 trillion mark at the

6 As claimed in Frank Vogel and Samuel Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Kluwer Law International 1998) 29.

7 For a brief historical overview of the sector see Mehmet Asutay, Ahmet Faruk Aysan and Cenk C Karahan, 'Reflecting on the Trajectory of Islamic Finance: From Mit Ghamr to the Globalisation of Islamic Finance' (2013) 2 Afro Eurasian Studies 5.

8 S&P Global Ratings, 'Islamic Finance Outlook 2017 Edition' (2016).

end of 2016 given continued low oil prices and wider geopolitical policy shifts—eg Brexit and 'America First'—that have led to an uncertain global economic outlook.[9]

Currently estimated at just over 1% of global financial assets,[10] Islamic finance is considered to be the preferred way of banking for a quarter of the world's population.[11] It is not only Muslim countries that are looking for a piece of the action. With the globalisation of Islamic finance, countries such as the United Kingdom, Hong Kong, and Singapore are also vying for a seat at the table of an industry that has nearly doubled in half a decade.

As Islamic finance grows in size, it also grows in importance. Islamic finance has captured the attention of researchers, regulators, businesses, banks, and government officials the world over. Academics have become interested in Islamic finance as an important facet of Muslim life. Islamic banking and finance is now an important part of the financial systems of many Muslim countries. In Iran, Pakistan, and Sudan, there were attempts to make the entire banking system *shariah*-compliant, to the exclusion of conventional banking. In countries where Islamic banking coexists in a dual system with conventional banking, it has achieved systemic importance—comprising at least 15% of total banking assets—in Brunei, Kuwait, Malaysia, Qatar, Saudi Arabia, the UAE, and Yemen. Islamic banking also accounts for around 5% of total banking assets in Egypt, Indonesia, and Turkey.[12]

International organisations such as the World Bank and the International Monetary Fund (IMF) have also gotten involved to demonstrate that they are able to cater to the needs of all of their members and are on top of all financial trends. Islamic finance has also

9 Islamic Financial Services Board, 'Islamic Financial Services Industry Stability Report 2017' (2017).

10 TheCityUK, 'The UK: Leading Western Centre for Islamic Finance' (2015) 6.

11 PricewaterhouseCoopers, 'Shariah-Compliant Funds: A Whole New World of Investment' (2009).

12 TheCityUK (n 10) 21.

emerged as a potential ally in the global ethical banking movement that has gained significance in the post-financial crisis world.

My motivation and background: As a young lawyer working on market-leading Islamic finance deals over the past decade, I was struck by the level of creativity permitted when structuring *shariah*-compliant products—especially when they formed a small part of a massive multi-billion dollar Middle Eastern development project sponsored by a government-connected entity. It became obvious that the political connections of those pursuing the deal had as much, if not more, relevance in determining a product's *shariah*-compliance than any substantive divergence from the conventional in the Islamic product's structuring. This became more striking when I noticed the strict interpretations applied to other areas of Islamic law in some of the same countries in which I was doing these Islamic finance deals. For example, in Saudi Arabia, home to some headline-grabbing Islamic finance deals, women were, until recently, not allowed to drive. This is while Quranic injunctions on how women should dress and protect their modesty are scant and vague, while verses 2:278-79 of the Quran denounce in the strongest terms those who deal in *riba* as having declared war on Allah and His messenger. These interpretations are by no means uniform or universal. Indeed, Saudi Arabia's neighbour and close ally, the UAE, not only allows women to drive but also allows them to pilot fighter jets—to much media fanfare.[13] In fact, women have been at the steering wheel of entire Muslim nations, with Bangladesh, Indonesia, and Pakistan having been led by female heads of state.

This variety can also be seen within the Islamic finance industry. Warde states in this regard:

> There is a great deal of diversity in Islamic finance. When it comes to the main characteristics of the Islamic sector, no two countries are identical. … Islamic finance reflects the diversity of a fourteen-hundred-year-old, 1.4 billion strong religion spread over every continent. Islamic financial institutions come in all shapes and forms: banks and

13 See eg 'UAE Female Fighter Pilot Honoured' (*GulfNews*, 17 October 2015).

> non-banks; large and small; specialised and diversified; traditional and innovative; national and multinational; successful and unsuccessful; prudent and reckless; strictly regulated and freewheeling, etc. Some are virtually identical to their conventional counterparts, while others are markedly different. Some are driven solely by religious considerations; others use religion as a way of sidestepping regulation, as a shield against government interference, as a tool for political change, or simply as a marketing ploy.[14]

It was against this backdrop that I became interested in examining how faith, capital, and power have converged to form the many flavours of Islamic finance as the Islamic legal system's response to modern banking realities of the world.

1.3 RESEARCH QUESTION

The questions I seek to answer are: How does Islamic finance fare as an example of civil compromise in Islamic law? How do the industry's stakeholders cooperate and compete in the 'Game of [Islamic] Bank Bargains'[15] to bring about this compromise? Who are the winners and losers of this game? What are the factors that drive this outcome?

To answer these questions, I set out to understand the incentives of each of the industry's various stakeholders, which include politicians and government officials, Islamic and conventional bankers, lawyers, *shariah* scholars, international and Islamic finance-specific multilateral organisations, and of course the customers and consumers of Islamic finance products. I break down my question by studying how the modern Islamic finance industry is influenced by:

Faith: The 'Islam' in Islamic finance. What is the role of Islamic law and/or ideology? How is it represented by *shariah* scholars and the customers they ultimately serve?

Capital: How do global business interests (represented by lawyers and bankers) influence the industry? Are these actors driving the shape of the industry or merely responding to client demand?

14 Warde (n 3) para 1.34.

15 This is a slight modification of the term coined in Charles W Calomiris and Stephen H Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit* (PUP 2015) ch 2.

Power: How do governments and international considerations affect the industry? Do governments reflect the religious desires of their populations or do they strive to get ahead in regional rivalries? What instruments does the state use to promote or stifle the industry?

1.4 RESEARCH METHODOLOGY

To respond to my research questions, my dissertation uses a combination of two methods: first, a primarily literature-based review of the history of Islamic finance; second, an empirical study of the incentives driving the various industry stakeholders.

The past is key to understanding the present. The first part of my dissertation looks at the history of Islamic finance from pre-modern Islamic commercial practices to its current state in the post-financial crisis and depressed oil price world. It also sets up Islamic project finance (IPF) as my main area of focus.

Despite Islamic finance's rich diversity and expansive scope, I have attempted to answer my research questions by focusing on the Islamic project finance sector. IPF uses *shariah*-compliant financing structures to fund large infrastructure projects. It is often used in the development of energy and power projects in the Middle East. I have chosen to focus on this sector because, given the sheer size of these projects, Islamic banks, and their *shariah* scholars, must work alongside conventional banks to raise the necessary funds to execute these projects. This provides an excellent opportunity to study the interaction between conventional and Islamic finance. These projects often have national significance and therefore governments are also involved. This means the actors involved in the IPF sector are the same ones involved in the broader Islamic finance industry, which allows me to see general trends pervading the industry as a whole. In other words, IPF provides a 'macro' perspective on the Islamic finance industry.

It also provides a 'micro' perspective—getting into the details of the actual Islamic finance instruments used (through reviewing the underlying contracts themselves) provides insight into how civil compromise is underway in day-to-day practice. IPF is at the cutting edge of innovation in Islamic financial products. Various bespoke Islamic finance instruments and techniques have been developed and implemented in this sector. This provides ample opportunity to study the negotiation process between *shariah* scholars and international lawyers and bankers—against a backdrop of development drive and political push from the host governments where these projects are situated.

The project I have chosen to focus on by way of demonstrating the intricacies of the IPF sector is a major project finance transaction, incorporating a significant Islamic finance portion, recently undertaken in Saudi Arabia. This is not used as a case study per se, but rather an avenue through which I can provide micro-level insights on the inner workings of the practice of IBF. The Project[16] was a joint venture between Saudi Arabia's national oil company and a major international oil company. I have chosen to focus on this transaction because it provides a great opportunity to study the interaction between *shariah* scholars, international lawyers and bankers, government officials (at the national oil company and the capital market authority), and international businesspeople at the international oil company. I hope to elucidate how the various actors shaping the IBF industry perceive their roles.

The second part of my dissertation is a qualitative empirical study of the incentives driving the various industry stakeholders, presented over three chapters on faith, capital, and power. I have developed my dissertation by conducting over 50 open in-depth interviews with industry stakeholders—from prominent 'rock star' *shariah* scholars to lay customers. These are my formal interviews, but I have had many more conversations with customers of Islamic products, Islamic and conventional bankers and lawyers, academic and *shariah*

16 To ensure business confidentiality and encourage candid discussions with the participants, I have anonymised the transaction and refer to it only as the 'Project'.

scholars, national and international regulators, executives at state-owned companies in Muslim countries and their foreign counterparts. I had these discussions on the sidelines of conferences, meetings, and events and as part of my work as a lawyer working in this sector since 2007 in New York, London, and the Middle East.

Securing some of these interviews was exceedingly difficult, given that the interviewees are often quite prominent and hence protective of their reputations and do not take kindly to being quizzed by a student over their role in an industry that is often criticised. I was able to build rapport and secure rare interviews because of my own experience and network as a lawyer with an Islamic finance specialisation.[17]

This insider's perspective helped me conduct insightful interviews and push my participants into specifics rather than let them get away with broad and bland statements. The experience was quite enlightening and exciting, and I believe this practitioner's insight provides an important contribution to the academic literature.[18] To encourage my interviewees to be candid and frank, I have agreed to keep their identities confidential and anonymise all their contributions. The interviews have been transcribed and coded with Nvivo.

The main categories of my interviewees correspond with my research question as follows:

Shariah and Academic Scholars: I interviewed ten *shariah* scholars, some of them amongst the most prominent in the world. I have discussed how they, in practice, abide by Islamic finance principles and/or navigate the prohibitions on a day-to-day basis. I have discussed

17 I was ranked as an 'Associate to Watch' for Islamic finance by *Chambers* in 2013 and 2014 and by *Who's Who Legal* in 2016 and 2017.

18 For another example of a practitioner's insight into the industry see Harris Irfan, *Heaven's Bankers: Inside the Hidden World of Islamic Finance* (Constable 2014).

how they perceive their role in approving these structures and how they respond to criticisms that Islamic finance is 'form over substance' and a 'mere marketing ploy'. Relevant to this discussion, I have also interviewed eight academic scholars who are often the most outspoken critics of the *shariah* scholars. These academic scholars provide a counter argument and challenge the assertions of the *shariah* scholars.

Lawyers and Bankers: I interviewed 11 bankers and 12 lawyers, many of whom are leading figures in the Islamic finance industry, working on significant transactions on a daily basis. The influence of international business interests is seen by many as an important source of criticism for the industry, as critics believe Islamic finance is now only Islamic in name and the substance is in effect identical to conventional banking. I have sought to explore whether my interviewees see themselves as responsible for structuring these innovative instruments, or are they merely responding to client and market demand.

Regulators, Government Officials and Customers: I interviewed eight regulators (five with domestic mandates and three at multilateral and international regulatory bodies), three managers at a national oil company (who are in effect government officials), and four customers using Islamic finance products. In speaking with the domestic regulators, I sought to elucidate the relevant government initiatives designed to promote or stifle Islamic finance (eg favourable tax treatment, outlawing 'conventional' interest-bearing transactions, or not allowing banks to advertise themselves as 'Islamic'). Speaking to the managers at the national oil company I sought to determine whether their use of *shariah*-compliant funds was driven by financial feasibility or other considerations (such as promoting the domestic Islamic finance sector, political necessity, religious preference of the managers themselves or the wider public who are the constituents they ultimately represent). In my interviews with customers I sought to understand what drives or dissuades them from using Islamic finance products.

For this part of the dissertation I used Calomiris and Haber's 'structural narratives' approach.[19] In this approach, to be useful in identifying causal patterns, the narratives gleaned from the interviews on specific events and transactions must be connected to the logic of law, economics, and politics to ensure they are more than a string of facts. As Poincaré states, 'Science is built up with facts, as a house is with stones. But a collection of facts is no more a science than a heap of stones is a house'.[20] This approach can provide convincing evidence about the factors and incentives that are most important in shaping the Islamic finance industry.[21]

To the extent that the Islamic finance industry is believed to suffer from shortcomings and setbacks, I am not seeking to apportion blame to any of the stakeholders—even though my interviewees often do. I aim to demonstrate how each stakeholder is incentivised to create coalitions to cooperate or compete with other stakeholders in pursuit of their self-interests. No individual or group is to 'blame' for what happens as a result of such coalitions. Indeed, as Calomiris and Haber state, 'placing blame trivialises the problem: it distracts us into thinking that our problems are caused by the moral flaws of other people rather than focusing on how our political institutions encourage socially costly coalitions'.[22]

Many times throughout this dissertation I have reproduced what my interviewees have told me as direct quotes, as I found that this was the most effective way of conveying their viewpoint. It also gives a flavour of the conversation through the language and expressions used by the interviewees. These quotes are reproduced with only minor editing for clarity and brevity. Sometimes quotes follow the various chapter and section headings to provide

19 See Calomiris and Haber (n 15) 452–54.

20 Quote from Jules Henri Poincaré, *La Science et l'Hypothèse* (1908) cited in ibid 451.

21 For the shortcomings of this approach see section 8.5 (*Limitations & Future Research*).

22 Calomiris and Haber (n 15) 213.

piercing insight into the topic at hand, as well as introduce a note of levity in an otherwise serious subject.

1.5 TERMINOLOGY & TECHNICAL MATTERS

Here it is helpful to articulate some approaches I have adopted vis-à-vis terminology throughout my dissertation.

The industry has settled on the terms 'Islamic banking', 'Islamic finance', or most often 'Islamic banking and finance' (abbreviated as IBF) to name itself. These terms are not free from debate or disagreement. Some believe the industry is better described as *shariah*-compliant banking (not Islamic banking), as Islamic banking implies that it is somehow a part of Islam. The opponents believe that Islamic finance is not a part of Islam per se, but is rather a man-made product that may—at best—comply with Islam. Some instead prefer terms such as *shariah*-inspired or *shariah*-tolerant banking. Others, especially in the United States, believe the term '*lariba*' (roughly translated as 'interest-free') better represents what makes the activities of this sector unique—namely the avoidance of *riba*. They further argue that the term *lariba* presents the field to the widest possible potential audience, including ethical investors and non-Muslims.[23] Others have suggested it be named 'socially-responsible' or 'faith-based' finance for the same reason. Irrespective of the merits of these arguments, they have not gained sufficient traction or recognition in scholarship or practice. The terms Islamic finance and IBF continue to be most commonly used, and are the terms I use in my dissertation.

As I am using it in this dissertation, IBF refers to a worldwide phenomenon present in Malaysia to America. A broad definition of IBF includes all financial or economic activities that seek to avoid the prohibitions set out in Islamic law, the chief amongst which is *riba*.

23 See eg Rodney Wilson, 'Islamic Banking in the West' in Kabir Hassan and Mervyn Lewis (eds), *Handbook of Islamic Banking* (Edward Elgar 2007).

Whilst *riba* is often equated to interest or usury, defining it is the subject of substantial academic debate and disagreement.[24]

The Islamic finance industry consists of bank and non-bank components. The banking component—comprising 79% of the industry—is made up of over 1,000 institutions, with two-thirds claiming to be fully Islamic and the remaining third providing *shariah*-compliant products from within a conventional institution.[25] These banking institutions offer offshore and onshore deposit-taking, and commercial and investment banking services.[26] The non-bank component consists of *sukuk* (Islamic bonds, accounting for 17% of the industry), Islamic funds (3%) and *takaful* (Islamic insurance, 1%).[27] There is also an ever-increasing number of institutions specialising in brokerage services, asset management, microfinance, venture capital, and private equity financing.[28]

Islam's general approach (including to commercial matters) is that anything that is not expressly forbidden is allowed. Thus, the best way to understand what Islamic finance is, is to understand what it is not. IBF is a means of finance that seeks to avoid the following prohibitions:[29] (i) *riba*,[30] which means interest-based lending should be replaced by contracts based on profit-and-loss sharing and equity (*mudaraba*, *musharaka*), sale (*murabaha*), or leasing

24 See section 2.4.1 (*The Question of* Riba*: Legalist & Moralist Approaches*).

25 TheCityUK (n 10) 17, 19.

26 Hossein Askari, Zamir Iqbal and Abbas Mirakhor, *Globalization and Islamic Finance: Convergence, Prospects and Challenges* (John Wiley & Sons 2010) 16.

27 IFSB Report 2017 (n 9).

28 Askari, Iqbal and Mirakhor (n 26) 16.

29 See eg Warde (n 3) para 1.13. See also Vogel and Hayes (n 6) ch 3 for the Quranic verses and *ahadith* that cover commercial dealings in Islam.

30 For a discussion on the prohibition against *riba* see eg Vogel and Hayes (n 6) 71–87; Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects* (Palgrave Macmillan 2005) 7–12; David Eisenberg, 'Sources and Principles of Islamic Law' in Craig Nethercott and David Eisenberg (eds), *Islamic Finance: Law and Practice* (OUP 2012) paras 2.58–65; John Dewar and Mohammad Munib Hussain, 'Islamic Project Finance' in John Dewar (ed), *International Project Finance: Law and Practice* (2nd edn, OUP 2015) paras 11.11–12.

(*ijara*); (ii) *gharar*[31] (a notion encompassing excessive risk, deceptive ambiguity, and risk shifting), which means certain common conventional practices (such as insurance, speculation, leverage, and short-selling) should be avoided; (iii) transactions involving *haram* (religiously forbidden) activities, which means any involvement in industries that deal with gambling,[32] adult entertainment, alcohol or pork, or *riba* and *gharar* should be avoided. The implications of this can be more far-reaching than initially meets the eye. If strictly construed, this prohibition can prevent dealings with hotel chains and airlines that serve alcohol, the film and music industries that come uncomfortably close to adult entertainment, and all institutions that deal with conventional finance; and (iv) unjust enrichment, which includes deception, misrepresentation, and other forms of unethical behaviour.

Additional implications that have emerged in practice from these prohibitions are that: (i) the realm of finance should be linked directly to the real economy (generally tangible assets with a recent exception for intangible assets, such as intellectual property); (ii) transactions should be governed by the principles of risk and profit-and-loss sharing; (iii) transactions must be clear and transparent and must fulfil social and developmental goals; and (iv) financial innovations must be monitored by religious scholars.[33]

This is, however, the theory or the ideal form of Islamic finance. The reality involves a range of varied adherence to these principles in the evolving context of the industry and its interaction with conventional finance in a variety of jurisdictions—ranging from those who

31 For a discussion on the prohibition against *gharar* see eg Vogel and Hayes (n 6) 87–94; Iqbal and Molyneux (n 30) 12–15; Eisenberg (n 30) paras 2.66–75; Dewar and Hussain (n 30) para 11.13.

32 For a discussion on the prohibition against *maysir* (games of chance and gambling) see eg Iqbal and Molyneux (n 30) 15–16.

33 See generally Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons 2007).

have attempted to Islamise their entire financial systems (Iran, Pakistan, and Sudan) to countries where Islamic finance has been actively discouraged (eg Oman).[34]

English is the *lingua franca* of IBF, but certain Arabic terms supplement it. Most of those supplementary terms are nouns naming contracts or concepts (eg *murabaha*, *musharaka*, and *ijara*). These terms are sometimes seen by critics as obfuscation and a mere marketing ploy—providing an Islamic veneer over practices whose status under *shariah* is uncertain.[35] Leading Islamic economist, Mahmoud El-Gamal, points out that Arabic terms are commonly used for IBF contractual forms while good translations are readily available (eg 'cost-plus sale', 'partnership', and 'leasing' for the three contracts mentioned above). In contrast, El-Gamal continues, 'The use of the English terms "interest" or "usury" … has all but replaced the use of the term *riba*, for which no English translation is available'.[36] In light of this, as attempting to translate the Arabic terms *riba*, *gharar*, and *shariah* tends to cause more confusion than clarity, I have not done so in my dissertation and will refer to the original Arabic terms.[37]

In this dissertation, Arabic terms are transliterated according to the most common practices of those IBF scholars and practitioners whose primary language of professional or academic communication is English. As they rarely use diacritical marks in their writings, I have omitted them in this dissertation as well. Instead, a simplified system of transliteration is used. Thus, Quran is used instead of Qurʾān and *shariah* instead of *sharīʿa*. Where Arabic

34 See eg Vogel and Hayes (n 6) 11.

35 See eg Bill Maurer, *Mutual Life, Limited: Islamic Banking, Alternative Currencies, Lateral Reason* (PUP 2005) 25; Mahmoud El-Gamal, *Islamic Finance: Law, Economics, and Practice* (CUP 2006) 11–12, 20–21; Tripp (n 2) 145–46; Muhammad Saleem, *Islamic Banking – A $300 Billion Deception* (Xlibris Corp 2006); M Kabir Hassan and Mervyn K Lewis (eds), *Handbook of Islamic Banking* (Edward Elgar 2007) 135–36; Warde (n 3) para 1.34.

36 Mahmoud El-Gamal, 'An Introduction to Modern Islamic Economics and Finance', *Proceedings of the Fourth Harvard University Forum on Islamic Finance: Islamic Finance: The Task Ahead* (CMES, Harvard 2000) 146–47.

37 This approach is also adopted in Usman Hayat and Adeel Malik, *Islamic Finance: Ethics, Concepts, Practice* (CFA Institute Research Foundation 2014) 1.

terms are used, they are followed with their English equivalents in parentheses. Indeed, the terms should not necessarily be thought of as Arabic, but as supplements to the global English of IBF.[38] Arabic terms are pluralised using the Arabic language convention (eg *fatawa* instead of *fatwas, ahadith* instead of *hadiths*). *Sukuk* is the plural of *sakk*; however, IBF literature uses *sukuk* without necessarily worrying about singular or plural use. For simplicity, I have also used *sukuk* in this way.

Translations from Arabic of the Quran and *ahadith* are my own, unless stated otherwise. In references to individuals, terms of reverence, and status signifiers are included where such inclusion is common cultural practice. All dates are based on the Gregorian calendar unless stated otherwise. The acronyms CE and BCE stand for 'Common Era' and 'Before the Common Era' and correspond to the Latin abbreviations AD and BC. These are omitted unless the context requires their inclusion for clarity. The symbol 'US$' and the term 'dollar' denote the lawful currency of the United States of America. All acronyms used are spelled out in full the first time they are used in each chapter and also in the Table of Abbreviations that follows the Table of Contents. A brief glossary of Arabic and other significant foreign terms also follows the Table of Abbreviations.

The term 'conventional' banking and/or finance refers to the common interest-based financing (rather than *shariah*-compliant financing) that dominates much of the world. What I refer to as the 'West' consists of European societies that, from the twelfth to the early-sixteenth century, shared a common political, legal, and religious subordination to the papal hierarchy of the Roman Catholic Church. Some of these countries later experienced a

38 This concept is further explained in Maurer (n 35) 32–33.

reformation directed partly at Roman Catholicism. Areas subsequently settled largely by Westerners (eg Australia and North America) are also part of the West.[39]

In my dissertation the term 'Middle East' is intended to have, by way of general shorthand, an elastic meaning to include the Arab states of the Persian Gulf and the predominantly Muslim areas of North Africa. It also typically includes Iran and Turkey, unless stated otherwise. The term excludes India, central Asia, East Asia, and sub-Saharan Africa. Apologies for any offence that this formulation may render to more scholarly conceptions.

IBF's development is, of course, not limited to the Middle East alone, which only accounts for a third of the Muslim world's population. There is significant geo-economic diversity in the Muslim world.[40] Differences between jurisdictions and among the different *madhahib* (schools of Islamic thought) are not considered in detail unless otherwise expressly noted.[41] Many, if not most, of my examples are drawn from the Middle East region, as this is where the pioneering work in IBF started and most significant subsequent developments took place. Today, the Middle East accounts for 72.2% of all IBF activity in the world.[42]

1.6 STRUCTURE

My dissertation consists of two main parts, namely background and empirical work. Following this introduction, the first three chapters on background are the foundational chapters for the next three chapters covering the empirical study. The chapters are interrelated and cross-referenced as appropriate. My dissertation is structured as follows:

39 This approach is also followed in Harold Berman, *Law and Revolution: The Formation of the Western Legal Tradition* (HUP 1983) 1–3; Timur Kuran, *The Long Divergence: How Islamic Law Held Back the Middle East* (PUP 2012) 6.

40 See eg Ibrahim Warde, *Islamic Finance in the Global Economy* (2nd edn, EUP 2010) 10–11.

41 This approach is also adopted in Michael McMillen, 'Shari'a Compliant Project Finance: A Structural Overview' in Humayon Dar and Umar Moghul (eds), *The Chancellor Guide to the Legal and Shari'a Aspects of Islamic Finance* (Chancellor Publications Ltd 2009).

42 IFSB Report 2017 (n 9).

Chapter 2 – Origins: In this chapter I set out my project's theoretical framework and conduct a literature review—examining the origins of IBF and how it has developed from pre-modern times to the post-colonial era. I show that Islamic finance's current form was not inevitable, and is rather the result of its historical circumstances. I identify the spectrum of debate over the issue of *riba* and explain how one interpretation has come to dominate the industry. I explain in detail the effects of state sponsorship on the IBF industry in the 1970-80s, including the impact of the oil boom during that period.

Chapter 3 – Current State: In this chapter I look at the current state of IBF—how it was further developed through globalisation and impacted by the September 11th attacks and the 2008 financial crisis—to determine how the industry has changed shape from its original state. I explore the triumph of capitalist logic over the industry, the potential for alliance with ethical banking in the wake of the financial crisis, and the impact of oil price fluctuations on the industry.

Chapter 4 – Islamic Project Finance: In this chapter I introduce Islamic project finance (IPF) as my main area of focus and explain why it is appropriate for helping me answer my research questions. I look at an actual transaction to demonstrate practical insights and show how IPF works in practice. I do this by demonstrating the technical workings of the Islamic finance products and instruments used in this sector. I examine the social, political, and commercial factors that have led to IPF's growth. Finally, I explore some tensions that arise amongst the sector's various stakeholders.

Chapter 5 – Faith: In this chapter I analyse my interview data to determine how faith, often represented by the *shariah* scholars, impacts IBF. I show who these scholars are and what they do. I examine issues such as the scholars' fee income, potential for conflict of interest, and their role in the industry's standardisation. I also look at their relationship with other

stakeholders. I also explore the role of customers in the industry and how issues of class factor into the industry's development.

Chapter 6 – Capital: In this chapter I analyse my interview data to determine how financial and commercial considerations, often represented by lawyers and bankers, impact IBF. I show how commercial interests are seen to be co-opting the industry and moving it away from its initially-stated objectives. I consider why, despite its many detractors, IBF continues to grow as a niche in global finance. I look at the gap between the promise and reality of IBF and explore its two main criticisms—namely that it is 'form over substance' and a 'mere marketing ploy'—and the responses offered by practitioners in rebuttal.

Chapter 7 – Power: In this chapter I analyse my interview data to determine the impact of governments, represented by regulators and state entities, on IBF. Political support is critical for the IBF industry, as legal and regulatory frameworks determine whether IBF will flourish or wither within a given jurisdiction. I will explore the various policy approaches adopted by states—from full Islamisation to active discouragement—and consider the objectives they pursue with these policies. I will also examine the tools that states use to implement their desired policies (eg kick-starting the industry and 'levelling the playing field'). I will finally explore the geopolitics of Islamic finance and the role played by multilateral and international agencies.

Chapter 8 – Conclusion: In my conclusion I bring together and sum up my findings to respond to my research questions. I provide a summary of my dissertation, highlighting the nuanced role each of the various stakeholders plays in shaping the industry. I identify the winners and losers of the Game of Islamic Bank Bargains and how the industry fares as an example of civil compromise. I also highlight other key findings that have emerged through my research. I look at the way forward for the industry and how the 'losers' can create coalitions to compete with the incumbent 'winners' to move the industry from *halal* (permissible) to

tayyib (wholesome). I finish with acknowledging the limitations of my research and suggestions for future research.

CHAPTER 2: ORIGINS

2.1 THEORETICAL FRAMEWORK

2.2 TRADITIONALIST IDEAL: THE PRE-MODERN PERIOD (PRE-1850)

2.3 DOMINANCE OF NON-DERIVATIONISTS: MODERN PERIOD (1850-1950)

2.4 RISE OF REVIVALISTS (1950-1970)

2.4.1 THE QUESTION OF *RIBA*: LEGALIST & MORALIST APPROACHES

2.4.2 PRACTICAL EXPERIMENTS WITH ISLAMIC BANKING

2.5 STATE SPONSORSHIP OF IBF (1971-1990)

2.5.1 OIL WEALTH

2.5.2 ESTABLISHMENT OF THE ISLAMIC DEVELOPMENT BANK

2.5.3 SUPPORT OF PRIVATE ISLAMIC BANKS

2.6 CONCLUDING REMARKS

'Islamic finance is a young industry rooted in a very old tradition.'

– Ibrahim Warde[1]

This chapter will look at the origins of this young industry and demonstrate that its current form was not inevitable, and is rather the result of its historical circumstances. I examine the Traditionalist and Modernist paradigms and the intellectual and political movements they have inspired throughout the years. I explore their impact on political, commercial, and religious affairs, how they have responded to the all-important question of *riba,* and their influence on the early formation of the Islamic finance industry. This provides a historical backdrop for how certain trends have emerged or disappeared over time to eventually give us the Islamic finance industry we see today.

I will start from the very beginning with the commercial practices of pre-Islamic Arabia and move on to show how traditional Islamic commercial practices that had well served the early Islamic civilisation were eclipsed by European colonialism in the nineteenth century. The humiliation of colonialism and shortcomings of secular governments after independence led to the rise of Islamic revivalist movements in the 1950s, which called for

1 Ibrahim Warde, 'Status of the Global Islamic Finance Industry' in Craig Nethercott and David Eisenberg (eds), Islamic Finance: Law and Practice (OUP 2012) para 1.06.

society to be ruled in accordance with the *shariah*. This resurgence of Islamic identity meant a rejection of the ideologies of the capitalist West and the socialist East. In practical terms, this meant the elimination of interest in the banking sector as a form of forbidden *riba*.

This was followed in the 1960s with important theoretical work and small-scale practical experiments with interest-free banking. The most significant of these experiments were the Mit Ghamr Savings Bank and the Tabung Haji. It was not, however, until state sponsorship was lavished on this fledgling industry in the 1970s that Islamic finance moved from the realm of theory into reality in a significant way. Muslim states, using their newfound oil wealth to promote the industry domestically and internationally, helped IBF emerge as a viable form of financial intermediation.

2.1 THEORETICAL FRAMEWORK

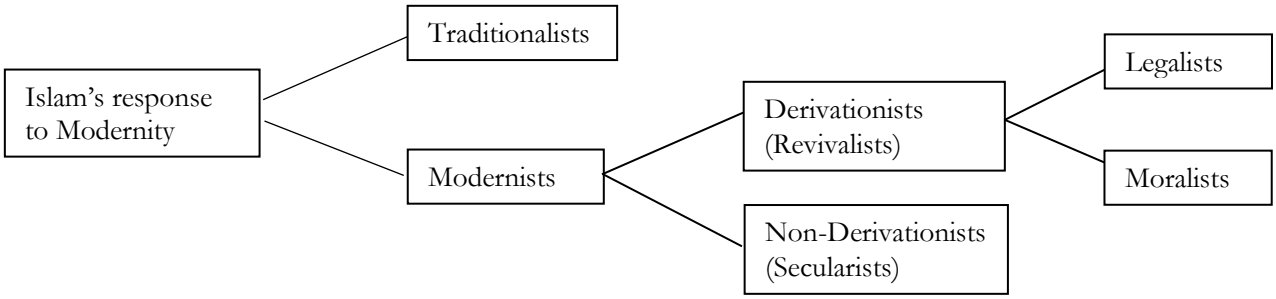

Figure 1: Taxonomy of Theoretical Framework

Modernity has challenged certain systems and practices of the Muslim world. Through civil compromise, the Muslim world has responded to these challenges. When encountering modernity, Muslim intellectuals and the *ulema* (religious scholars) have broadly adopted one of two approaches: the 'Traditionalists' have dismissed it and the 'Modernists' have accepted it. The Modernists have either sought to derive modern ideas from within the *shariah* (the 'Derivationists'), or have recognised independent authority for modernity over and above *shariah* and believed derivation was not required (the 'Non-Derivationists'). These paradigms

have not been—historically or theoretically—mutually exclusive, but it is still useful to study the advent of modern banking in the Muslim world through this framework.[2]

Traditionalists: In this paradigm, divinely-inspired *shariah* is viewed as inflexible and unyielding vis-à-vis modernity. Adherents of this view believe that the 'gate of *ijtihad*'[3] has closed and a literalist interpretation of the *shariah* is sufficient to respond to all needs in the modern world. The Wahhabiyyah Movement of Muhammad ibn Abd al-Wahhab (1703-92) in Arabia, the Idrisi Movement of Ahmad ibn-Idris (1760-1836) in Morocco, and the Sanusiayyah Movement of Muhammad ibn Ali al-Sanusi (1787-1859) in Libya can be cited as prominent Traditionalist movements.[4] Traditionalists are considered at the extreme end of the IBF spectrum. Staunch Traditionalists reject every permutation of banking ('Islamic' or otherwise) as it had no place in early Islam. Prophet Muhammad did not bank, therefore banking has no merit.[5] Accordingly, this view has had only an insignificant impact on the IBF industry.

Modernists: The Modernists can be divided into Derivationists and Non-Derivationists:

Derivationists: In this paradigm, *shariah* has intrinsic value, and modern ideas (such as banking and finance) should be derived from within it. Derivationists, who are also referred to as 'Revivalists', believe that the *shariah* should be revived, reinterpreted, and refined

2 I have come up with these labels as an aid to description and comparison. For a useful disclaimer for labels that can 'belong to Western categories and perceptions, are frequently politically charged and seldom fit Islamic realities', see Ibrahim Warde, *Islamic Finance in the Global Economy* (2nd edn, EUP 2010) 16–18.

3 The classical presentation of this 'gate closure' argument is in Joseph Schacht, *An Introduction to Islamic Law* (OUP 1964) 69–73, 209–210. This view was subsequently challenged in Wael Hallaq, 'Was the Gate of Ijtihad Closed?' (1984) 16 International Journal of Middle East Studies 3. See also Werner Menski, *Comparative Law in a Global Context: The Legal Systems of Asia and Africa* (2nd edn, CUP 2006) 339–44.

4 For a description of these movements see Ahmed Abdel-Fattah El-Ashker and Rodney Wilson, *Islamic Economics: A Short History* (Brill 2006) 316–18.

5 See Nicholas Ray, *Arab Islamic Banking and the Renewal of Islamic Law* (Graham & Trotman 1996) 8. See also Charles Tripp, *Islam and the Moral Economy: The Challenge of Capitalism* (CUP 2006) 32 where Tripp discusses the Wahhabi movement's attempt to reinstate 'pure' Islam by looking back to an image of Arabia at the time of the Prophet Muhammad.

incrementally with reference to its sources (eg the Quran, *sunna*,[6] and *ijtihad*)[7] in a way that is compatible—as far as possible—with modernity. Derivationists believe that the function of *ijtihad* is to provide solutions for problems not explicitly covered by the Quran and *sunna*.[8] Muslims need to apply rules covered in the Quran and *sunna* without modification irrespective of time, place, and level of social or economic development.[9] In short, Derivationists believe that the *shariah* is good for all times and places.[10]

Mohammed Abduh (1849-1905), his teacher Jamal al-Din al-Afghani (1839-97) and his closest disciple Muhammad Rashid Rida (1865-1935), Hassan al-Banna (1906-49) and Sayyid Qutb (1906–66) (founder of the Muslim Brotherhood in Egypt in 1928 and its chief theorist respectively), Abul Ala Maududi (1903-79) (founder of the *Jamaat-e-Islami* in India in 1941), and Iran's Ayatollah Ruhollah Khomeini (1902-89) and Ali Shariati (1933-77) can all be cited as prominent Derivationists.[11]

The Derivationists have sought to define the role of Islam in modern banking through one of two approaches. The 'Legalists' have adopted a legalistic approach and have focused predominantly on the prohibition of *riba*, focusing on contractual form to replicate modern banking functions using recognised Islamic contracts in a way that avoids *riba*. The

6 The *sunna* is the living tradition of Prophet Muhammad, meaning a rule deduced from the sayings or actions or approval/acquiescence of someone else's actions by Prophet Muhammad. The *sunna* is recorded and reported in the form of *hadith*, and thus the two terms are often used interchangeably. See Fuad Al-Omar and Muhammad Abdel-Haq, *Islamic Banking: Theory, Practice and Challenges* (Zed Books 1996) 1.

7 *Ijtihad* (literally meaning striving/exerting) can be defined as the independent or original interpretation of problems not precisely covered by the Quran or *sunna*. The believer doing the work of *ijtihad* is situated in an Islam that considers the 'gate of interpretation' to be open—that is, an Islam that does not consider all questions of Islamic practice to have been settled in the first centuries after Prophet Muhammad's revelation.

8 Fazlur Rahman, 'Islam: Challenges and Opportunities' in Alford Welch and Pierre Cachia (eds), *Islam: Past Influence and Present Challenge* (EUP 1979).

9 Chandra Muzaffar, *Islamic Resurgence in Malaysia* (2nd edn, Fajar Bakti 1987).

10 Abdullah Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and Its Contemporary Interpretation* (Brill 1996) 5ff.

11 Each with a dedicated chapter in Ali Rahnema (ed), *Pioneers of Islamic Revival* (2nd rev edn, Zed Books 2005). See also El-Ashker and Wilson (n 4) 333ff.

'Moralists' have emphasised the moral aspect of the prohibition, focusing on the substance of contracts and their role in achieving social justice through a moral economy.

Non-Derivationists: In this paradigm, modern ideas have intrinsic value and need not be derived from within the *shariah*. Modern philosophy, science, and technology are the resources upon which the Non-Derivationists draw to regulate society instead of the *shariah*, which they relegate to rules for personal conduct.[12] Accordingly, Non-Derivationists are also referred to as 'Secularists'.[13] This approach was adopted by many Muslim intellectuals and policymakers, such as Taha Hussein (1889-1973), Mojtahed Shabestari (b. 1936), Mustafa Kemal Ataturk (1881-1938), Reza Pahlavi (1887-1944) and his son Mohammed Reza Pahlavi (1919-80), and Gamal Abdel Nasser (1918-70).[14] Through economic and financial reasoning, Non-Derivationists view modern banks (and the interest they charge) as legitimate and beneficial to Muslim societies. When it comes to IBF, Non-Derivationists are considered at the opposite extreme end of the spectrum from the Traditionalists. Interestingly, however, they both reach the same conclusion—a rejection of Islamic finance as unnecessary. Like the Traditionalist view, this view also has an insignificant impact on the IBF industry.

2.2 TRADITIONALIST IDEAL: THE PRE-MODERN PERIOD (PRE-1850)

At the advent of Islam, and even before,[15] people of Arabia were able to conduct commerce, mobilise resources, and finance productive activities using a system that did not include

12 Muzaffar (n 9) 10–12.

13 See eg El-Ashker and Wilson (n 4) 319–25.

14 All discussed in Vali Nasr, *Islamic Leviathan: Islam and the Making of State Power* (OUP 2001) 20ff.

15 See El-Ashker and Wilson (n 4) ch 1. It is worth noting that even before Islam, Mecca was a sacred site attracting pilgrims from far and wide, making it a hub of international trade and a centre for financing, insurance, and money-changing, see eg Shaikh M Ghazanfar (ed), *Medieval Islamic Economic Thought: Filling the 'Great Gap' in European Economics* (RoutledgeCurzon 2003).

interest.[16] Well before Islam, Middle Eastern traders benefited from partnership structures where participants shared in both profit and loss. Such was the commercial nature of the society in which Islam emerged.

The Prophet Muhammad (r. 610-632 CE) and his four ruling successors (r. 632-661 CE) were all merchants.[17] For centuries, major trade routes were under Islamic control and merchants played a central role in spreading Islam to various parts of the world. This system served Islamic civilisation well for centuries.[18] However, by the nineteenth century the centre of economic gravity had shifted westward. Western financial practices came to overshadow Islamic commercial traditions which, due to stagnation and decline, were stuck in the Middle Ages.[19]

Successive governments of the Middle East upheld Islamic institutions (such as Islamic courts, contracts, and commercial structures), believing they would achieve greater economic efficiency and social justice. Thus, the Umayyad (661-750 CE), Abbasid (750-1000 CE), Fatimid, Mamluk, Safavid, Seljuk, and Ottoman (1000-1800 CE) dynasties all sought to incorporate Islamic economic principles into their governing structures and extended these structures to all lands that came under their rule.[20] They did so by consulting the *ulema* included in their administrations and using Islamic courts for dispute resolution. Whilst at no time was every facet of economic life ruled by Islam, religion played a

16 Judaism and Christianity share Islam's prohibition of interest, see eg Jared Rubin, 'Bills of Exchange, Interest Bans, and Impersonal Exchange in Islam and Christianity' (2010) 47 Explorations in Economic History 213; Rodney Wilson, *Economics, Ethics and Religion: Jewish, Christian and Muslim Economic Thought* (NUP 1997).

17 Warde, 'Status of Global Islamic Finance Industry' (n 1) para 1.06.

18 See generally SD Goitein, *A Mediterranean Society: The Jewish Communities of the World as Portrayed in the Documents of the Cairo Geniza*, vol I: Economic Foundations (UC Press 1967) ch 3.

19 See eg Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects* (Palgrave Macmillan 2005) 36; Nicholas HD Foster and Simon Archer, 'Islamic Financial Law: Law without a Legal System', *Business in between Cultures: The Development of Islamic Finance* (EABH 2012).

20 El-Ashker and Wilson (n 4) ch 4–7.

significant role as governments tried to come up with creative solutions to the challenges they faced, not least in the area of commercial dealings.[21]

The pre-modern economic and commercial institutions of the Middle East were grounded largely in Islamic law, which was by no means uniform or static and was reinterpreted often and repeatedly. But still, in the areas critical to economic modernisation, change did not happen quickly enough during the millennium when the West gradually made the transition from medieval to modern. Thus, classical Islam's distinct combination of economic institutions, which were compatible with success in the medieval global economy, failed to produce the transformations necessary for keeping the Middle East globally competitive.[22] In the eleventh century, a profound deterioration—known as *Usur-al-Inhitat* (The Ages of Decline)—affecting all aspects of political, economic, social, and cultural life, began to take hold of the Muslim world.[23] By the fourteenth century the intellectual output of Muslim scholars came to be known as 'ponderous and repetitive, unoriginal, pedantic, and superficial'.[24]

2.3 DOMINANCE OF NON-DERIVATIONISTS: THE MODERN PERIOD (1850-1950)

This decline was not without consequence.[25] From around the mid-nineteenth century, most of the Middle East came under Western colonial rule or influence. Under direct or indirect pressure, these countries abandoned their Islamic legal traditions and adopted laws based on Western models—particularly in the commercial sphere, which were the first to go.[26] The

21 Timur Kuran, *The Long Divergence: How Islamic Law Held Back the Middle East* (PUP 2012) 26.

22 ibid 6ff. For a different view see Adeel Malik, 'Was the Middle East's Economic Descent a Legal or Political Failure? Debating the Islamic Law Matters Thesis' (2012).

23 Abdelkader Chachi, 'Origin and Development of Commercial and Islamic Banking Operations' (2005) 18 Journal of King Abdulaziz University Islamic Economics 3.

24 Fazlur Rahman, *Islam and Modernity: Transformation of an Intellectual Tradition* (UCP 1984) 45 cited in Saeed (n 10).

25 For a list of what Chachi calls 'disastrous consequences' see Chachi (n 23).

26 See Menski (n 3) 344ff; Foster and Archer (n 19).

centuries-old Islamic commercial practices were eclipsed by European colonialism and the rise in the West of modern finance.[27] In other words, Muslim societies did not retain an unbroken link to their pre-modern commercial practices. In some instances this link was broken through colonialism (eg Egypt), in others it was broken through state-led modernisation drives (eg Turkey and Iran). The Traditionalists were replaced by Non-Derivationists or non-Muslim foreigners.

In Turkey, Egypt, Iran, and elsewhere in the Middle East, Western transplants gradually curtailed the dominance of dysfunctional indigenous Islamic institutions. An example of this is the adoption of the French Commercial Code of 1807, which explicitly legalised interest, by the Ottoman Empire in 1850 and Egypt in 1875.[28] In addition, courts were established to adjudicate cases according to the French commercial code. These commercial courts gradually claimed the lion's share of all commercial disputes, to the exclusion of the Islamic courts. The transplanting of these Western commercial courts also resulted in the proliferation of Western commercial practices and a decline of traditional Islamic ones. As a significant next step, in 1904 Egypt, interest was legitimated by religious authorities through the controversial *fatwa* of Egypt's Grand Mufti, Sheikh Muhammad Abduh.[29] The Non-Derivationist approach thus received the official stamp of religious approval during this period.

It would be wrong, however, to assume that the Non-Derivationists were calling for wholesale 'economic Westernisation' through indiscriminate acceptance of Western transplants. In the view of Timur Kuran, the collective accomplishments of the transplants

27 Frank Vogel and Samuel Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Kluwer Law International 1998) 4–5.

28 Kuran, *Long Divergence* (n 21) 143.

29 See Chibli Mallat, 'The Debate on Riba and Interest in Twentieth Century Egypt' in Chibli Mallat (ed), *Islamic Law and Finance* (Graham & Trotman 1988) 69–88; Tripp (n 5) 127; Warde, *Islamic Finance* (n 2) 46.

in question can be better described as 'economic modernisation' rather than 'economic Westernisation'.[30] The Non-Derivationists that dominated this era aimed to reproduce specific Western achievements and believed that this 'secular' modernisation was the most effective way to catch-up with developed countries in terms of economic productivity and consumption.[31] It was not a blind imitation of Western institutions or a purposeful eradication of their own cultural distinctions and Islamic traditions.[32] In fact, many of the Non-Derivationists were faithful believers themselves, but contended that while Islamic norms were of great religious value, they should be confined to the personal sphere and were not effective in managing the governmental or economic affairs of the modern world.[33]

In the realm of banking and finance, the Middle East's pre-modern financial markets—advanced though they were compared to prevailing practices elsewhere in the world—failed to develop a capacity for handling large amounts of private capital for long periods as required for modern practices. The *musharakah* (partnership) structure was not suitable as a vehicle for long-term capital mobilisation, as it would have to be disbanded and reorganised at a partner's death or when she/he wished to withdraw her/his capital.[34] The *waqf* (trust) structure also suffered from operational restrictions as the purpose, function,

30 Kuran, *Long Divergence* (n 21) 12–13.

31 El-Ashker and Wilson (n 4) 326.

32 See eg Şerif Mardin, *The Genesis of Young Ottoman Thought: A Study in the Modernization of Turkish Political Ideas* (SyracuseUP 1962) ch 3–6; Afaf Lutfi as-Saiyid, *Egypt in the Reign of Muhammad Ali* (CUP 1984) ch 8; Niyazi Berkes, *The Development of Secularism in Turkey* (Routledge 1998) ch 12–14. For related insights, see Philip Curtin, *The World and the West: The European Challenge and the Overseas Response in the Age of Empire* (CUP 2002) 109–10.

33 El-Ashker and Wilson (n 4) 316.

34 Kuran, *Long Divergence* (n 21) 156–57.

and beneficiaries of the trust had to be set for perpetuity at the outset, which was a significant constraint for mobilising large amounts of capital.[35]

This is while commercial banking emerged in the West in the late-eighteenth century, free from these limitations.[36] These foreign banks found their way to the Middle East in the nineteenth century to fill the vacuum of indigenous banking or equivalent alternatives. These Western banks were at first welcomed by Middle Eastern businesses thirsty for access to greater capital than could be provided indigenously, and in due course even became creditors to the cash-strapped Islamic governments.[37] By the mid-nineteenth century several examples of successful Western commercial banking could be found in the Middle East.[38] These banks were largely, if not wholly, owned and operated by Europeans. Locally-owned banks entered the scene in the 1890s, followed by Muslim-owned ones in the early twentieth century.[39] These banks were Muslim-owned, but did not claim to operate on an 'Islamic' basis.

2.4 RISE OF REVIVALISTS (1950-1970)

The dominance of the Non-Derivationists did not go unchallenged. Since the nineteenth century, Derivationists (also known as Revivalists) were concerned with the social and moral

35 ibid 158–61. See also Malik (n 22).

36 Center for Medieval and Renaissance Studies, UCLA, *The Dawn of Modern Banking* (YUP 1979).

37 Warde, *Islamic Finance* (n 2) 46.

38 See eg New East Bank (Tehran, 1850), Bank of Egypt (Alexandria, 1855), Ottoman Bank (Istanbul, 1856), Anglo-Egyptian Bank (Cairo, 1864), and Imperial Bank of Persia (Tehran, 1885). For more on the origins of commercial banking in the Middle East see David Landes, *Bankers & Pashas: International Finance & Economic Imperialism in Egypt* (HUP 1980); Cyril Black and L Cari Brown (eds), *Modernization in the Middle East* (Darwin Press 1992) 73–77, 226–27; CGA Clay, 'Western Banking and the Ottoman Economy before 1890: A Story of Disappointed Expectations' (1999) 28, 3 Journal of European Economic History 473; Adrian Tschoegl, 'Financial Integration, Dis-Integration and Emerging Re-Integration in the Eastern Mediterranean, c.1850 to the Present' (2004) 13 Financial Markets, Institutions & Instruments 245 cited in Kuran, *Long Divergence* (n 21) 326.

39 The most notable of the predominantly Muslim-owned banks were Banque Misr, Türkiye İş Bankası, and Bank Melli (founded in 1920 in Egypt, 1924 in Turkey, and 1928 in Iran respectively and all still in operation today).

degeneration of Muslim societies, and called for a return to the fundamentals of Islam, namely the Quran and the *sunna,* as a remedy for the troubles of the Muslim world.[40]

The Derivationists argued that Islam, as a divine religion and founder of a brilliant civilisation, had answers for all the modern-day ills of both the East and the West. Their idea—that Islam was self-sufficient—was successful in boosting the morale of the Muslim masses and strengthening their identity as Muslims.[41] Western colonialism, and later the crushing defeat of the Arab armies in the 1967 Six Day War with Israel, left Muslims feeling deeply humiliated. This gave the Derivationists the boost they needed in their on-going struggle with the Non-Derivationists. In the words of El-Ashker and Wilson:

> Whenever Muslims are in a state of despair they turn to their religion for help and assistance. Throughout the history of Islam, religious leaders emerge, invariably identifying the problems of Muslims as being the result of their desertion of the correct path of their religion. To improve their conditions, the argument always goes, Muslims have to return to the purity of Islam and apply its fundamental teachings to their daily life.[42]

Islamic economics and finance were envisaged as a means of putting Islamic teachings into practice in the economic realm. Attempts to develop an Islamic economy were a further manifestation of the desire of Derivationists to retain, or regain, their own Islamic identity vis-à-vis the capitalist West and the socialist East.[43] Accordingly, Derivationists expressed their reservations with the commercial banking practices prevalent in the Muslim world due to its reliance on interest.

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40 See eg El-Ashker and Wilson (n 4) ch 8; Hans Visser, *Islamic Finance: Principles and Practice* (2nd edn, Edward Elgar 2013) para 1.2.

41 Saeed (n 10) 5–6;

42 El-Ashker and Wilson (n 4) 316.

43 Visser (n 40) para 1.2. See also Mehmet Asutay, 'Conceptualisation of the Second Best Solution in Overcoming the Social Failure of Islamic Finance: Examining the Overpowering of Homoislamicus by Homoeconomicus' (2007) 15 IIUM Journal of Economics and Management 167.

Despite some *fatawa* legitimising bank interest by leading figures such as Muhammad Abduh and his disciple Rashid Rida,[44] the Derivationists—driven by what appears to have been genuine religious concern—called for the development of an alternative form of financial intermediation for Muslim societies.[45] While Muslim masses refrained from dealing with commercial banks to a significant extent,[46] farmers, merchants, and other entrepreneurs, faced with growing capital requirements, could not remain competitive whilst turning down the much cheaper credit offered by commercial banks.[47]

Contrary to the Traditionalists, who had turned their backs on the modern world and believed the 'gate of *ijtihad*' to be closed, most Derivationists rejected the finality of the traditional schools of law[48] and believed the fruits of modernity and technological progress must be fully enjoyed.[49] Thus, Islamic banking emerged as an 'invented tradition'[50] through 'creative borrowing' from Western banks. From a historical perspective, an 'Islamic bank' is

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44 These high profile *fatawa* distinguished between *riba* and bank interest, but were seen as coming from the ranks of government-appointed 'official' *muftis*. The Muslim public viewed the operations of foreign banks as being based on a prohibited activity and the majority of *fatawa* issued by independent *ulema* confirmed this prohibition. Good examples are the 1907 *fatawa* of Sheikh Bakri al-Sadafi, then Grand Mufti of Egypt, and the *fatawa* of Sheikh Abdel Megid Selim, who was Grand Mufti during the 1930s and 1940s, see Center for Islamic Economy, *The Guide to Fatwas in Banking Affairs: The Most Important Fatwas on Usury, Interests, Modarabat, Mosharakat and Murabahat* (Islamic International Bank for Investment and Development 1986).

45 Sami Homoud, *Islamic Banking: The Adaptation of Banking Practice to Conform with Islamic Law* (NH Karam tr, Kluwer Law International 1985) 115ff.

46 Iqbal and Molyneux (n 19) 36–38.

47 CGA Clay, 'The Origins of Modern Banking in the Levant: The Branch Network of the Imperial Ottoman Bank, 1890-1914' [1994] International Journal of Middle Eastern Studies 589. See also Leila Tarazi Fawaz, *Merchants and Migrants in Nineteenth-Century Beirut* (HUP 1983) 66–67; Charles Issawi, *The Fertile Crescent, 1800-1914: A Documentary Economic History* (OUP 1988) 76, 411–12 cited in Kuran, *Long Divergence* (n 21) 163, which provides that at a time when traditional moneylenders in the Middle East charged farmers exorbitant interest rates varying between 20% and 100% per annum, European agricultural interest rates had fallen to 4%. Commercial interest in the Middle East was as high as 24% while it was 5% in Europe.

48 See eg Rahman, 'Islam: Challenges and Opportunities' (n 8).

49 See eg Javed Majeed, 'Modernity' in Richard Martin (ed), *Encyclopedia of Islam and the Muslim World* (Macmillan 2004) 456; Warde, *Islamic Finance* (n 2) 16ff.

50 See generally Eric Hobsbawm and Terence Ranger, *The Invention of Tradition* (CUP 1992); Tyler Cowen, *Creative Destruction* (PUP 2002).

an organisational structure alien to Islamic law.[51] In fact, the closest thing that Islam had to 'legal personhood' was the *waqf*, which had no claim towards or suitability for meeting the credit needs of twentieth-century Muslim societies.[52]

From the mid-twentieth century, Derivationists produced valuable theoretical work taking up the challenge of developing a *shariah*-compatible model of financial intermediation that was a competitive alternative to the Western commercial banks.[53] The field was formed by writings such as Anwar Iqbal Qureshi's *Islam and the Theory of Interest* (1946), Muhammad Uzair's *An Outline of Interestless Banking* (1955), Maududi's *al-Riba*[54] (1961) and Sayyid Qutb's *Tafsir Ayat al-Riba* (1970).[55]

Further works were subsequently prepared by Islamic economic scholars such as Muhammad Nejatullah Siddiqi (b. 1931),[56] Muhammad Baqer as-Sadr (1935-80),[57] and Muhammad Abdul Mannan (b. 1938).[58] These Derivationist scholars not only extolled the virtues of Islamic economic principles, but also attacked capitalist and socialist economic

51 See Timur Kuran, 'The Absence of the Corporation in Muslim Law: Origins and Persistence' (2006) 53 American Journal of Comparative Law 785.

52 For the cash *waqf* alternative, itself of ambiguous religious merit, yet with significant shortcomings compared to banking see Kuran, *Long Divergence* (n 21) 158–61.

53 See Monzer Kahf, 'Islamic Banks: The Rise of a New Power Alliance of Wealth and Shari'a Scholarship' in Clement Henry and Rodney Wilson (eds), *The Politics of Islamic Finance* (EUP 2004); Timur Kuran, *Islam and Mammon: The Economic Predicaments of Islamism* (PUP 2004) 7–19; Mahmoud El-Gamal, *Islamic Finance: Law, Economics, and Practice* (CUP 2006) 7–25.

54 See also Abdul A'la Maududi, *The Economic Problem of Man and Its Islamic Solution* (Islamic Publications 1947); Abdul A'la Maududi, *Economic System of Islam* (Islamic Publications 1984).

55 See also Sayyid Qutb, *Social Justice in Islam* (Islamic Publications International 2000).

56 See eg Muhammad Nejatullah Siddiqi, *Banking without Interest* (Islamic Foundation 1983); Muhammad Nejatullah Siddiqi, *Partnership and Profit-Sharing in Islamic Law* (Islamic Foundation 1985).

57 See Muhammad Baqer Sadr, *Al-Bank al-Laribawi fi al-Islam (The Interest-Free Bank in Islam)* (Jami' al-Naqi 1970); Muhammad Baqer Sadr, *Iqtiṣādunā [Our Economics]* (2nd edn, World Organization for Islamic Services 1994). See also Tripp (n 5) 134–36; El-Ashker and Wilson (n 4) 392–99 for a summary of as-Sadr's *Iqtisaduna* and an explanation of its significance.

58 See Muhammad Abdul Mannan, *Islamic Economics: Theory and Practice* (rev edn, Arnold Overseas 1986).

thought, especially on the necessity of interest.[59] By the early 1970s there was an explosion in publications on Islamic banking.[60]

Given the dominance of Non-Derivationists during this era, the early literature on IBF was of a social, economic, and religious nature, and made a conscious effort to side-step political matters in an attempt to avoid any clash with the secular governments.[61] When Derivationists did venture into political arenas, the Non-Derivationists and their secular governments reacted harshly against this encroachment on their authority. In Pakistan, Maulana Maududi was imprisoned several times and sentenced to death by a court martial in 1953 (commuted to two years' imprisonment under immense public pressure).[62] In Egypt, Hassan al-Banna's Muslim Brotherhood was disbanded in 1948 and he himself was assassinated in 1949 at the age of 42.[63] Sayyid Qutb did not fare much better. After enduring ten years of imprisonment (1954-64) at the hands of Nasser's government, he was re-arrested eight months after his release and executed in 1966.[64] In Iraq, Ayatollah Muhammad Baqer as-Sadr was sentenced to life imprisonment in 1977, but released two years later only to be re-arrested, tortured, and executed (along with his sister) in 1980 at the age of 45 by Saddam Hussein's regime.[65] In Iran under the Shah, Ali Shariati was held in solitary confinement for 18 months until 1975, and fled to the United Kingdom in 1977,

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59 See El-Ashker and Wilson (n 4) 366; Bill Maurer, *Mutual Life, Limited: Islamic Banking, Alternative Currencies, Lateral Reason* (PUP 2005) 29ff; Visser (n 40) para 1.2.

60 Muhammad Nejatullah Siddiqi, 'Muslim Economic Thinking: A Survey of Contemporary Literature' in Khurshid Ahmad (ed), *Studies in Islamic Economics* (Islamic Foundation 1980) cited some 700 titles of original and commentary works on Islamic economics between the early 1950s and the late 1970s.

61 El-Ashker and Wilson (n 4) 355.

62 Vali Nasr, 'Mawdudi and the Jama'at-I Islami' in Ali Rahnema (ed), *Pioneers of Islamic Revival* (2nd rev edn, Zed Books 2005); Visser (n 40) box 1.1.

63 David Commins, 'Hasan Al-Banna' in Ali Rahnema (ed), *Pioneers of Islamic Revival* (2nd rev edn, Zed Books 2005).

64 Charles Tripp, 'Sayyid Qutb: The Political Vision' in Ali Rahnema (ed), *Pioneers of Islamic Revival* (2nd rev edn, Zed Books 2005).

65 Chibli Mallat, 'Muhammad Baqer as-Sadr' in Ali Rahnema (ed), *Pioneers of Islamic Revival* (2nd rev edn, Zed Books 2005).

where he died at the age of 43, under suspicious circumstances only three weeks after leaving Iran. Even his remains were not allowed to be returned to Iran and were laid to rest in Damascus, Syria.[66] Imam Khomeini, who was the *marja-e-taqlid* (religious leader) of millions of Shia followers, was exiled by the Pahlavi regime for more than 14 years (1964-79) returning to Iran only with the victory of his Islamic revolution.[67]

2.4.1 The Question of Riba: Legalist & Moralist Approaches

Riba is the *raison d'être* of Islamic banking.[68] As Bill Maurer puts it, IBF '*is* the debate over its own origins and the debate over *riba*: how it is defined, how it is avoided, and how it has become the absent centre of IBF practice today'.[69] Since the 1960s, the prohibition of *riba* has been one of the most contested issues amongst Muslims.[70]

Two main approaches have emerged regarding *riba*. One is legalistic, focusing on contractual form to replicate modern banking functions using recognised Islamic contracts (the 'Legalists'). The other has emphasised the moral aspect of the prohibition, focusing on the substance of contracts and their role in achieving a moral economy (the 'Moralists').

No doubt, both the Legalists and Moralists believe that *riba*, as forbidden by the Quran and *sunna*, is reprehensible and has no place in an Islamic society. They, however, differ on whether modern bank interest falls within the definition of *riba*. The Moralists believe this question should be answered by looking at the rationale for the Quran's

66 Ali Rahnema, 'Ali Shariati' in Ali Rahnema (ed), *Pioneers of Islamic Revival* (2nd rev edn, Zed Books 2005). For a summary of Shariati's anti-capitalist economic beliefs see Tripp (n 5) ch 5.

67 Baqer Moin, 'Khomeini's Search for Perfection' in Ali Rahnema (ed), *Pioneers of Islamic Revival* (2nd rev edn, Zed Books 2005).

68 Saeed (n 10) 3.

69 Maurer (n 59) 39. Emphasis in original.

70 For a good summary see Jonathan Ercanbrack, 'The Law of Islamic Finance in the United Kingdom: Legal Pluralism and Financial Competition' (SOAS 2011) 169–73.

prohibition of *riba*, which they believe to be injustice.[71] They go on to discuss instances where modern bank interest, especially when of a modest nature, does not lead to exploitation or injustice and thus cannot be said to automatically qualify as *riba*.[72]

Moralists have called for fresh *ijtihad* to derive relevant principles from the Quran and authentic *sunna* and formulate new banking laws based on these principles. Moralists criticise what they called the Legalist's 'atomistic' approach to deriving rules from the Quran and their failure to understand its underlying unity. The Quran, according to the Moralists, was a phenomenon that occurred against a socio-historical context, providing moral, religious, and social pronouncements in answer to specific problems in specific historical situations.[73] According to the Moralists, to insist on a literal reading of the Quran despite the social change that has occurred and is so palpably occurring, is tantamount to deliberately defeating the Quran's socio-moral purposes and objectives.[74] Mahmoud El-Gamal, Abdullah Saeed, Izzud-Din Pal, Sheikh Muddassir Siddiqui, and Ayatollah Seyyed Mostafa Mohaghegh Damad can be cited as prominent Moralists of our time. These scholars have built on the work of an earlier generation of Moralists like Fazlur Rahman, Ayatollah Morteza Motahari, Ayatollah Muhammad Beheshti, and Muhammad Asad.[75]

Legalists, on the other hand, take a literal approach to the *riba* prohibition. They rely on the Quranic injunction that only the loan principal can be reclaimed, and state that there is no scope to interpret interest in any form as anything but prohibited *riba*. To them, the

71 See M Umer Chapra, *Islam and the Economic Challenge* (Islamic Foundation 1992); M Umer Chapra, *The Future of Economics: An Islamic Perspective* (Islamic Foundation 2000).

72 For a full discussion of the arguments put forward by the Moralists see Saeed (n 10) 41–49.

73 ibid 7.

74 Rahman, *Islam and Modernity* (n 24) 2–19.

75 See eg Fazlur Rahman, 'Riba and Interest' (1964) 3 Islamic Studies 1; Saeed (n 10) ch 8; Izzud-Din Pal, *Pakistan, Islam, and Economics: Failure of Modernity* (OUP 1999); El-Gamal (n 53); Muddassir Siddiqui, 'Form and Substance in Islamic Finance – Challenges, Problems and The Way Forward' (London, 12 December 2011).

existence or otherwise of injustice is irrelevant. Even though leading Legalists like Maulana Maududi and Sayyid Qutb have explored the injustice of *riba* in their writings, they have stopped short of stating that injustice is the *raison d'être* of the prohibition. Muhammad Nejatullah Siddiqi and Muhammad Abdul Mannan are prominent Legalists of our time.[76]

The Legalist approach is supported by classical *fiqh* literature and by most prominent *shariah* scholars active in the IBF industry.[77] The Legalists argue that Islam, as a divine religion from an omniscient God, has proposed an economic system that has the best responses to humanity's desire for an efficient and effective economic system, and is thus a superior alternative to 'conventional' finance.[78]

The proponents of this view believe that the divine economic principles passed down through the Quran and *sunna* are a fountain of economic wisdom waiting to be tapped.[79] This view is premised on the fact that Prophet Muhammad was a merchant and he incorporated fair and just economic principles expressed in Quranic verses into his teachings and daily life. This draws on a long line of scholarship asserting that while Christianity regarded business as a degrading occupation for centuries,[80] Islam has a

76 See Abdul A'la Maududi and Muhammad Asim al- Haddad, *Al-Riba* (Dar al-Fikr 1961); Sayyid Qutb, *Tafsir Ayat Al-Riba (Interpreting the Quran's Verses on Riba)* (Dar al- Shuruq 1970); Siddiqi, *Banking without Interest* (n 56); Siddiqi, *Partnership and Profit-Sharing* (n 56); Mannan (n 58); Saeed (n 10) 49–50.

77 See eg Saeed (n 10) 118, 140; Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Idaratul Ma'arif al-Qur'an 2007); Muhammad Taqi Usmani, 'Causes and Remedies of the Recent Financial Crisis: From an Islamic Perspective' (Reshaping Economic Growth to Include the Spiritual, London, 28 November 2014).

78 See eg Muhammad Akram Khan, 'The Future of Islamic Economics' (1991) 23 Special Issue Islam and the Future 248.

79 See M Umer Chapra, 'Is It Necessary to Have Islamic Economics?' (2000) 29 Journal of Socio-Economics 21, which surveys the work of leading thinkers in this field.

80 See eg Max Weber, *The Protestant Ethic and the Spirit of Capitalism* (Talcott Parsons tr, Routledge 1930).

characteristically 'business atmosphere'[81] which expressly recognises private property, business enterprise, risk, profit, and reward.

The function of *ijtihad*, according to the Legalists, is to arrive at solutions to problems not explicitly covered by the Quran and *sunna*. Legalists believe that 'the Quran and *sunna* lay out a complete way of life whose sanctity and purity should not be tarnished by new interpretations influenced by time and circumstances'.[82]

Even though both Moralists and Legalists have been influential in shaping modern Islamic thought, it is the Legalist approach—namely that all bank interest is prohibited *riba*—that has come to dominate IBF. This is because the conservative Middle Eastern states preferred the Legalist approach when they decided to utilise their newfound oil riches to establish Islamic banks and research centres on a large scale in the 1970s.[83] This led to what Monzer Kahf calls 'a new alliance between wealth and *shariah* scholarship'.[84]

The Legalist's domination was further solidified by the fact that many IBF theorists and practitioners from the 1960s onwards appear to have been sympathisers of the two highly influential groups who preferred the Legalist approach—namely Egypt's Muslim Brotherhood and Pakistan's *Jamaat-e-Islami*. These groups placed emphasis on the permanence and immutability of the instructions given in the Quran and *sunna*, which further discouraged IBF theorists and practitioners from pursuing any initiatives in favour

81 See eg Charles Cutler Torrey, *The Commercial-Theological Terms in the Koran* (Brill 1892) 3; Ghislaine Lydon, 'A Paper Economy of Faith without Faith in Paper: A Reflection on Islamic Institutional History' (2009) 71 Journal of Economic Behavior & Organization 647.

82 Muzaffar (n 9) 10–12.

83 See eg Tripp (n 5) 134–39; Warde, 'Status of Global Islamic Finance Industry' (n 1) paras 1.10, 1.17.

84 Kahf (n 53).

of re-examining the interpretation of *riba*—even when conceptual and practical difficulties arose with the Legalist interpretation.[85]

The Legalist approach meant Islamic banks could not accept any pre-determined return on capital that involved an explicit interest element.[86] The IBF theorists had envisaged that profit-and-loss sharing (PLS) structures such as *musharakah* and *mudaraba* would become the mainstay of Islamic banks and any other business would be merely subsidiary.[87]

In practice, however, it was soon realised by Islamic bankers that PLS was too uncertain for commercial viability. This meant that methods that were PLS in name only were used for short-term commercial operations in a way that was functionally equivalent to capital-guaranteed fixed-return financing and achieved the same economic outcome under the guise of 'fees', 'commissions', and 'profit'.[88] The Moralists have protested that the Legalist approach has led to a proliferation of mechanisms devised by Islamic banks to circumvent *riba* that are modern versions of *hiyal* (stratagems).[89]

Moralists believe that the traditional interpretation of all bank interest as *riba*—which is the cornerstone of the Legalist approach—is incompatible with today's financial and

85 Saeed (n 10) 1–2.

86 For a survey of dissenting voices see Vogel and Hayes (n 27) 44ff.

87 Maurer (n 59) 30 states that Muhammad Nejjatullah Siddiqi is responsible for the popularity of PLS structures and believes that the enduring legacy of Siddiqi is that countless new books and media reports on IBF begin by mentioning the prohibition of interest and then immediately jump to a description of PLS contractual forms, without lingering over the finer points of *fiqh*.

88 Saeed (n 10) 1–2.

89 *Hiyal* (sing. *hila*) literally means 'ruse' and refers to traditional stratagems and legal fictions developed since the advent of Islamic law to bridge the gap between theory and practice to achieve otherwise prohibited results in many areas of Islamic law, including the laws related to *riba*. For discussions on *hiyal* from the early tenth century see Muhammad al-Ghazali, *Ihya ul-Ulum al-Din [The Revival of the Religious Sciences]*, vol 8 (Dar ul-Ihya al-Kutub al-Arabiyya 1957) 225–68. For a more recent example see Saeed (n 10) 4, 37–40, 142; Vogel and Hayes (n 27) 39–41; El-Gamal (n 53) 44–45; Ercanbrack (n 70) 88ff.

economic realities and is not practicably implementable or morally justifiable. Moreover, the mechanisms that the Islamic banks devised out of necessity to implement this interpretation—due to the inadequacy of PLS structures—do not appear to be any better than the transactions they have rejected as *riba*. The *murabaha* and *tawarruq* structures, which at one point claimed an 80-95% share of all investments made by Islamic banks[90] but were branded by many IBF commentators as an interest-bearing loan in all but name,[91] can be cited as prominent examples of such mechanisms.

The proliferation of such deceptive stratagems in IBF was seen as unacceptable, leading senior religious authorities such as Sheikh Tantawi, the former Grand Mufti of Egypt, to state that conventional banks were closer to Islam than Islamic banks.[92] As a result, Moralists have argued that IBF as currently practised lacks economic merit and is a political project aiming to foster a sense of collective Islamic identity at best; and a marketing ploy merely mimicking conventional finance at worst.[93]

2.4.2 Practical Experiments with Islamic Banking

When Muslim countries achieved independence after World War II, the colonisation of the banking system was disrupted and replaced by national banking. However, this national banking, which was mostly a nationalisation of foreign banks with the addition of some new

90 Tripp (n 5) 143.

91 See eg Saeed (n 10) 144, ch 5; Al-Omar and Abdel-Haq (n 6) 14–18; Tarik Yousef, 'The Murabaha Syndrome in Islamic Finance: Laws, Institutions and Politics' in Clement Henry and Rodney Wilson (eds), *The Politics of Islamic Finance* (EUP 2004); Warde, *Islamic Finance* (n 2) 140–44; Craig Nethercott, 'Murabaha and Tawarruq' in Craig Nethercott and David Eisenberg (eds), *Islamic Finance: Law and Practice* (OUP 2012).

92 Samer Soliman, 'The Rise and Decline of the Islamic Banking Model in Egypt' in Clement Henry and Rodney Wilson (eds), *The Politics of Islamic Finance* (EUP 2004).

93 See eg Mahmoud El-Gamal, 'An Economic Explication of the Prohibition of Riba in Classical Islamic Jurisprudence', *Proceedings of the Third Harvard University Forum on Islamic Finance: Local Challenges, Global Opportunities* (CMES, Harvard 1999); Kuran, *Islam and Mammon* (n 53); Muhammad Saleem, *Islamic Banking – A $300 Billion Deception* (Xlibris Corp 2006); Ercument Aksak and Mehmet Asutay, 'The Maqasid and the Empirics: Has Islamic Finance Fulfilled Its Promise?', *Islamic Finance: Political Economy, Values and Innovation*, vol 1 (Gerlach 2015).

indigenous banks, was in effect a 'neo-colonial' banking system as it continued to function on the interest-based operating systems left behind by the colonisers.[94] In response to this, in the mid-twentieth century, Derivationists began to undertake modest experiments in interest-free banking,[95] hoping that IBF would became the economic phase of independence following the political phase.[96]

The first experiments with interest-free financial institutions were inspired by Islamic economic rationale of benefiting Muslim societies as well as making profits.[97] Thus they were aimed at providing financial services to the less prosperous, propagating the ideas of a just and equitable society. The first experiments were undertaken in the 1950s and 1960s in rural areas of Pakistan, Malaysia, and Egypt.[98] Although modest in outcome, these experiments demonstrated the existence of what Charles Tripp calls 'a ready imaginative framework for distinctive forms of Islamic economic activity, resting on the mutually reinforcing grounds of Islamic values and the general welfare of the Islamic community'.[99]

The highest profile experiment was started in Egypt by Ahmed al-Najjar.[100] Al-Najjar's religious background and interest in economics are said to have been inspired by his uncle, Mohammad Abdullah al-Arabi, a renowned professor of economics in Egypt. Al-Najjar earned his PhD in social economics in West Germany, where he also gained experience with the German co-operative banking and saving schemes.[101] Discovering similarities between

94 Chachi (n 23).

95 See Vogel and Hayes (n 27) 4–5; Iqbal and Molyneux (n 19) 36–38.

96 Kahf (n 53).

97 Soliman (n 92).

98 For details of Pakistan's short-lived experiment with interest-free banking see Rodney Wilson, *Banking and Finance in the Arab Middle East* (Palgrave Macmillan 1983); Delwin Roy, 'Islamic Banking' (1991) 27 Middle Eastern Studies 427; Chachi (n 23); Tripp (n 5) 136.

99 Tripp (n 5) 137.

100 Also spelled Ahmad El-Naggar.

101 Warde, *Islamic Finance* (n 2) 71.

the schemes and Islamic economic principles,[102] al-Najjar returned to Egypt eager to replicate the German model in the land of the Nile.

With support and capital from the Germans, al-Najjar contacted the Egyptian authorities. He was introduced to high-ranking officials in the Ministry of Economy through family contacts at the State Intelligence Agency.[103] Such government contacts would have been key to getting the project off the ground, as during the early 1960s the Non-Derivationists were ultra-sensitive to any Islamic political activity[104] and suspicious of independent initiatives, 'especially if they sought to project themselves as more virtuous and worthy of support than the institutions of the state-run economy'.[105]

After a protracted negotiation process, during which al-Najjar never made any reference to Islam for fear that the initiative would be rejected, he finally managed to get official approval from the Nasser government and the Mit Ghamr Savings Bank was formed in July 1963. Named after the small town where it was established, the bank was registered as a public entity benefiting from a German grant of 780,000 Deutsche marks (equivalent to around US$3 million) and an Egyptian government contribution of 60,000 Egyptian pounds (equivalent to around US$120,000).[106]

Although the bank neither charged nor paid interest, its charter made no reference to Islam. To conceal its Islamic identity, even the *zakah* fund was named the 'social service account'. Al-Najjar himself describes the experience as follows:

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102 Some of these similarities have been enumerated in Johannes Engels and Rüdiger Litten, 'Islamic Banking in the German Socio-Legal Context' (Islamic Law and Society Discussion Group, CSLS, Oxford, 30 April 2014).

103 Soliman (n 92).

104 Kahf (n 53).

105 Tripp (n 5) 136.

106 Soliman (n 92).

> We started [the Mit Ghamr Saving Bank] in disguise of a saving bank using the name of a European country so that this step might succeed amid usurious banks, in an era when hostility to the Islamic tendency was at its peak, without making explicit its Islamic nature, something which was exposed anyway. It was a great success, and its success revealed its Islamic identity. We had no other way. [107]

In the absence of interest, the bank made money through trade and industrial endeavours as well as financing businesses on a profit-and-loss sharing basis in conformity with generally accepted injunctions of Islamic financial transactions.[108] Egypt's Ministry of Economy also provided a subsidy through which the bank covered its costs.[109] Although al-Najjar was primarily an academic, he managed the bank and handpicked the bank's staff from among enthusiastic devout Muslims with some banking experience, who were key in attracting the confidence of the conservative rural communities.[110]

The Mit Ghamr experiment proved quite successful. It spread from one small town to another, mobilising savings from Egypt's poorest communities. These communities typically had no collateral to offer the banks and were thus considered unbankable. Moreover, many also believed that interest-based banking was prohibited by Islam. Mit Ghamr was especially successful in creating and encouraging small-scale entrepreneurs.[111] The moral pressures of the close-knit local Islamic community ensured borrowers met their financial obligations and thus, there were few payment defaults. At the height of its activity, the bank operated nine branches and had a quarter of a million depositors and close to 2 million Egyptian pounds in deposits.[112]

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107 Ahmed Al-Najjar, *Harkat al-Bunuk al-Islamiyah: Haqa'iq al-Asl wa Awham al-Surah (Islamic Banks: The Truth of Origin and the Myth of Image)* (Sprint 1993) 32.

108 Michel Galloux, *Finance Islamique et Pouvoir Politique: Le Cas de l'Egypte Moderne* (PUF 1997) 24.

109 Rodney Wilson, 'Arab Government Responses to Islamic Finance: The Cases of Egypt and Saudi Arabia' (2002) 7 Mediterranean Politics 143.

110 Wilson, *Banking and Finance* (n 98) 76.

111 See Kahf (n 53); Tripp (n 5) 136ff; El-Ashker and Wilson (n 4) 355.

112 Warde, *Islamic Finance* (n 2) 71. For tables comparing the performance of the Mit Ghamr Savings Bank against the rest of Egypt's banking system see Chachi (n 23).

The experiment did not last long and was ended in February 1967. After only three and a half years of operation, it was taken over and incorporated into the National Bank of Egypt. The circumstances of its closure are somewhat obscure.[113] Certain accounts suggest the bank was unsuccessful and closed due to financial problems.[114] Others suggest that former Muslim Brotherhood members infiltrated the bank as clients, depositors, and employees. Al-Najjar himself had no political affiliations and was never associated with the Muslim Brotherhood. He maintained reasonable relations with the Egyptian government until his death in Cairo in the early 1990s. Another account claims that the relative success of the bank provoked the ire of leftist members of the Arab Socialist Union, who were worried that it would strengthen the hand of Islamists in rural areas and undercut the party's own secularist socialist programme.[115] The official government line regarding the bank's closure was that it had violated procedures of registration and licensing, lacked the ability to efficiently invest accumulated funds, and had committed other financial irregularities.[116] Al-Najjar denied these charges and the authorities never investigated them.

Another significant and successful experiment with Islamic finance was Malaysia's Tabung Haji (Pilgrims' Fund).[117] Established by the newly independent government of Malaysia in 1963, it was designed to help Malays—the Muslim and often poor majority who

113 For varying accounts see eg Timur Kuran, 'The Economic Impact of Islamic Fundamentalism' in Martin Marty and R Scott Appleby (eds), *Fundamentalisms and the State: Remaking Polities, Economies, and Militance* (UCP 1993) 313; Al-Omar and Abdel-Haq (n 6) 21; Galloux (n 108) 35–36; Tripp (n 5) 136; Warde, *Islamic Finance* (n 2) 71.

114 See eg Soliman (n 92).

115 Wilson, 'Arab Government Responses to Islamic Finance' (n 109). This also accords with al-Najjar's own assessment as to why the experiment was discontinued, see Ahmed Al-Najjar, *Al-Madkhal li al-Nadhariah al-Iqtisadia fil-Manhaj al-Islami (Introduction to the Economic Theory within the Islamic Methodology)* (Dar al-Fikr 1974) 230–32 cited in Chachi (n 23).

116 Kahf (n 53).

117 See Tabung Haji, 'About Us - Background' (*Tabung Haji*) <https://www.tabunghaji.gov.my/en/corporate/corporate-information/about-us> accessed 24 March 2018. See also Mohamed Ariff, *Islamic Banking in Southeast Asia: Islam and the Economic Development of Southeast Asia* (Institute of Southeast Asian Studies 1988); Nasr (n 14) 123ff; Mervyn Lewis and Latifa Algaoud, *Islamic Banking* (Edward Elgar 2001) 5–6; Warde, *Islamic Finance* (n 2) 70–71.

had newfound political influence—save for the *hajj* pilgrimage to Mecca. It was based on the recommendations of Royal Professor Ungku Aziz, who, in his working paper entitled 'Plan to Improve the Economy of Prospective Pilgrims', set out a system whereby rural Malays could finance their *hajj* without having to take imprudent steps such as selling land or breeding animals.

The government-sponsored fund started from humble beginnings with only 1,281 members and a total deposit of 46,600 Malaysian ringgits inventing procedures of Islamic financing on its own, without any interaction with the Middle East.[118] It became immensely successful and now collects small deposits from its more than 9 million depositors and invests its 62 billion Malaysian ringgits (US$16 billion) fund in a diverse range of investment portfolios in accordance with *shariah* principles, avoiding *riba* and *haram* products.[119]

2.5 STATE SPONSORSHIP OF IBF (1971-1990)

The period between 1970 and 1990 was of critical important to IBF's development. During this period, state sponsorship helped IBF take steps towards potentially becoming a viable model of financial intermediation. Building on the practical experiments of the 1960s and the seminal theoretical work of the Derivationists, Muslim states used their newfound oil wealth to promote the industry domestically and internationally. Victories of Islamic movements in the political sphere translated into Islamic advancements on the economic one.

During this period, the 'visible hand' of the state[120] could be seen propping up the sector with its oil wealth, outlawing interest through its laws, and supporting the Islamic

118 Chachi (n 23).

119 Tabung Haji, 'About Us - Corporate Profile' (*Tabung Haji*) <https://www.tabunghaji.gov.my/en/corporate/corporate-information/about-us> accessed 24 March 2018.

120 Soliman (n 92).

Development Bank internationally and private Islamic banking initiatives domestically. At this time, several Muslim states adopted the Legalist approach that equated all forms of bank interest to prohibited *riba*. This prohibition of interest found its expression in the civil and commercial codes of some Muslim states and the attempted Islamisation of the entire banking systems of Iran, Pakistan, and Sudan.[121]

2.5.1 Oil Wealth

By the early 1970s, the balance of power between oil-producing states and international oil companies had shifted. Uninterrupted economic growth and the increased reliance on fossil fuels had led to strong global demand for oil. High inflation and a declining dollar meant that the real income of oil producers was steadily dwindling. This realisation led them to be more assertive and demand a greater share from the oil companies.[122] The price of oil per barrel, which was US$1.27 in 1969, had reached US$2.90 by June 1973. The Arab-Israeli War of October 1973 and the ensuing oil embargo against countries supporting Israel (including the United States) caused a four-fold jump in oil prices, pushing them to US$11.65. OPEC's oil revenues went from US$23 billion in 1973 to US$96 billion in 1974. A second shock came with Iran's revolution in 1979, which saw OPEC's oil income jump from US$124 billion in 1978 to US$272 billion in 1980. In the case of Saudi Arabia, this meant its oil earnings jumped from a mere US$36 million in 1960 to US$4.3 billion in 1973, and US$55.5 billion in 1979, reaching US$104.2 billion in 1980.[123]

Emboldened by this sudden change in their financial fortunes, the Muslim oil-exporting countries began experimenting with financial institutions which not merely reflected the dominant capitalist order, but were an alternative to it.[124] This initiative had

121 See eg Civil Code of Kuwait 1980 arts 543–51; Qanun Amaliyat Banki Bedoon-e Riba (Bahre) [Iran's Usury/Interest-free Banking Law] 1983.

122 Warde, 'Status of Global Islamic Finance Industry' (n 1) paras 1.10, 1.17.

123 Dankwart Rustow, *Oil and Turmoil* (WW Norton & Company 1982) 278–79.

124 Tripp (n 5) 134.

modest beginnings but with the support of the Saudi royal family and a number of other Middle Eastern businessmen, it attracted a sufficient number of wealthy depositors for the idea of an Islamic bank to begin to take shape.[125] Although the earliest IBF experiments were not related to Arab oil wealth, the oil boom was responsible for the accelerated growth of IBF at national and international levels, with almost all Islamic banks established in the Middle East in the 1970s being partly, and in most cases fully, funded by oil wealth.[126]

2.5.2 Establishment of the Islamic Development Bank

Following the Six Day War of 1967, Nasser's pan-Arabism cause was greatly discredited and replaced by a Saudi-supported pan-Islamism.[127] Muslim states rallied together to create a united Islamic front in the face of a perceived danger from Israel to the sovereignty and dignity of Muslim countries. Thus, in 1970, the year Nasser died, 44 Islamic states created the Organisation of the Islamic Conference (OIC).[128]

OIC was established to allow Muslim countries to cooperate 'with a view to promoting mutual assistance in the economic, scientific, cultural, and spiritual fields, inspired by Islamic teachings'.[129] Under the OIC's auspices, the idea of IBF was brought under serious study. OIC encouraged the clarification of Islamic financial principles and the establishment of an organisation to put them into practice. This led to the creation of the Islamic Development Bank (IsDB) in 1975 with 40 members. Nearly 70% of IsDB's US$2

125 ibid 137.

126 See eg Saeed (n 10) 10, which provides that Dubai Islamic Bank, Kuwait Finance House, Bahrain Islamic Bank, Qatar Islamic Bank, Faisal Islamic Banks of Bahrain, Niger and Senegal, banks of the Al-Baraka group of Sheikh Saleh Kamil, and Dar al-Mal al-Islami of the Saudi Prince Faisal are fully funded by oil wealth, while the Faisal Islamic Banks of Egypt and Sudan, and most other Islamic banks in non-oil-exporting countries, are partly funded by oil wealth.

127 Ibrahim Warde, 'Global Politics, Islamic Finance and Islamist Politics Before and After 11 September 2001' in Clement Henry and Rodney Wilson (eds), *The Politics of Islamic Finance* (EUP 2004).

128 Later renamed the Organisation of Islamic Cooperation in 2011.

129 Saeed (n 10) 12–13.

billion capital was supplied by four major oil-producers: Saudi Arabia, Libya, UAE, and Kuwait.

The founders had initially envisaged IsDB as a bank for the Islamic *umma* (people), rather than an Islamic bank.[130] IsDB was specifically charged with providing development funding to projects in poor Muslim countries through *shariah*-compliant structures such as interest-free loans and PLS vehicles. It was to also deepen training and expertise in IBF and, most importantly, show the world that the interest-based capitalist system was not the only way of financing economic development.[131] When IsDB's articles of agreement were being drafted in 1973 and 1974, there was no clarity on how an Islamic bank would function in practice and no precedents, procedures, or manuals for *shariah*-compatible large-scale banking activities.[132] These would soon be developed through government support of private Islamic banking initiatives.

2.5.3 Support of Private Islamic Banks

During the 1970s, the Game of Islamic Bank Bargains was such that Islamic banking was as much a public sphere of operation as a private one. Muslim governments began promoting Islamic banking domestically through special laws or by becoming themselves shareholders in the newly formed Islamic banks.[133] Islamic banks were established as a result of private initiatives of a few visionary personalities such as Prince Muhammad al-Faisal (son of the

130 For more details on OIC/IsDB functions and organs see Iqbal and Molyneux (n 19) 59–61; El-Ashker and Wilson (n 4) 330–34.

131 See Tripp (n 5) 137ff; SA Meenai, *Islamic Development Bank: A Case Study of Islamic Co-Operation* (Routledge 2009) 1–22, 190–98, 210–11.

132 Kahf (n 53).

133 Saeed (n 10) 13–14 provides that a decree by the Emir of Dubai established the Dubai Islamic Bank in 1975, a decree by the Emir of Kuwait established the Kuwait Finance House in 1977; the Faisal Islamic Bank of Sudan and of Egypt were both established by special laws in 1977. In terms of shareholdings, the Nasser Social Bank (1971) was wholly government-owned, Kuwait Finance House (1979) was 49% owned by Kuwaiti ministries, and Bahrain Islamic Bank (1979) was 37% owned by IsDB, Kuwait, and Bahrain. Bank Islam Malaysia (1983) was 80% owned by the Malaysian federal government and state religious bodies.

Saudi King Faisal, who created the Dar al-Maal al-Islami (DMI) Group and a network of 'Faisal Banks' throughout the Islamic world), Sheikh Saleh Kamel (a prominent Saudi businessman who founded the Dallah al-Baraka Group, which at one time had a presence in 34 countries), Sheikh Ahmad al-Yaseen (founder of Kuwait Finance House and chairman of its *shariah* board), Saeed al-Lootah (an Emirati businessman who founded the Dubai Islamic Bank), Sami Hamoud (who developed the *murabaha* product and established the Jordan Islamic Bank), and Abdul Halim Bin Ismail (the first managing director of Bank Islam Malaysia Berhad).[134] This trend has continued to this day, whereby Islamic finance is shaped more by the strengths and interests of the visionary individuals involved than any of the industry's institutions.[135]

Learning from the Mit Ghamr experience, Islamic bankers relied from the outset on good working relationships with their host governments. Islamic banks thus either entered into some kind of partnership with their governments or kept close contact with the authorities while avoiding or terminating any employment or business relations that could have annoyed the ruling class.[136] For example, the Egyptian state's security apparatus 'convinced' Saudi Prince Faisal, head of the administration board of Faisal Islamic Bank of Egypt, to expel some members of the Muslim Brotherhood who had 'infiltrated' the administration board of the bank.[137]

Between 1971 and 1985, over 30 Islamic banks were established in Bangladesh, Bahrain, Egypt, England, Denmark, Guinea, Jordan, Kuwait, Luxembourg, Malaysia,

134 Kahf (n 53).

135 See section 8.3.1 (*Individual-driven*).

136 Kahf (n 53).

137 Interview with Fouad Alam, 'Interview with Director of State Security Office' (13 December 2001) cited in Soliman (n 92).

Mauritania, Qatar, Saudi Arabia, Senegal, Sudan, Switzerland, Tunisia, and Turkey.[138] Below are three examples of banks established during this period.

Nasser Social Bank (NSB) was established by the Egyptian government in 1971 on an interest-free basis as a social bank to serve the unbankable poor. This was the first time that the government of a Muslim country showed interest in establishing an interest-free bank.[139] Commentators cite various reasons for NSB's incorporation. Some believe it was part of the Egyptian government's policy of co-opting Islamic groups in its struggle with the leftists,[140] empowering the Islamic movement to counterbalance the Nasserites and the Marxists.[141] Others believe it was a project in Arab socialism[142] intended to fill the vacuum left from discontinuing the Mit Ghamr experiment that was so successful in mobilising savings from the lowest income strata of Egyptian society and enabling small-scale entrepreneurs.[143] NSB's official goals were to 'broaden the base of social solidarity' and 'provide aid to needy citizens'.[144] As with Mit Ghamr, while there was no direct reference to Islam in NSB's charter, the bank's operations were based on PLS and the collection and distribution of *zakah*.[145] NSB was owned and financed by the Egyptian state, which required public sector companies to donate 2.5% (in accordance with *zakah*) of their profits to NSB to build its capital reserves. NSB would also collect *zakah* from depositors willing to pay it and would distribute it to deserving categories as stipulated by the *shariah*. This allowed NSB to create a

138 El-Ashker and Wilson (n 4) 337 provides a list of these banks in chronological order.

139 Iqbal and Molyneux (n 19) 37.

140 See eg Warde, *Islamic Finance* (n 2) 70–71.

141 Soliman (n 92).

142 ibid.

143 See eg Kahf (n 53).

144 See eg Warde, *Islamic Finance* (n 2) 71.

145 Galloux (n 108) 28–29.

sizable *zakah* distribution network[146] and maintain relations with local charities and the poor.[147]

State involvement in interest-free banking sent an important signal to wealthy Muslims with surplus funds.[148] In Dubai, Saeed al-Lootah, a pious, innovative and well-known businessman with close connections to the ruling family of Dubai, came forward in 1975 to establish and finance the Dubai Islamic Bank (DIB).[149] This was the first private initiative to gain financial benefit from this new trend in IBF and led to the establishment of the first private commercial Islamic bank. DIB also benefited from state support, with the UAE and Kuwait contributing 20% and 10% of its capital, respectively.[150]

Faisal Islamic Bank of Egypt (FIBE) was created at the initiative of Prince Muhammad al-Faisal by a special law (No. 48 of 1977), which extended many advantages to the new institution.[151] Some opposition members objected to this special treatment when the law was discussed in Egypt's parliament. They also objected to the fact that the Minister of Awqaf (trusts) presented the law to parliament as part of its mandate on Islamic law matters, rather than the Minister of Economy, who would typically be in charge of banking regulation. Despite many reservations and objections, the law was eventually passed

146 See Mehmet Asutay, 'A Political Economy Approach to Islamic Economics: Systemic Understanding for an Alternative Economic System' (2007) 1 Kyoto Bulletin of Islamic Area Studies 3 for a description of the importance of *zakah* as an instrument of the Islamic economic system.

147 Kahf (n 53).

148 Iqbal and Molyneux (n 19) 37.

149 Kahf (n 53).

150 Iqbal and Molyneux (n 19) 37.

151 Soliman (n 92) states that some of these advantages were the protection of FIBE and its assets from nationalisation or confiscation, exemption from foreign currency control laws, 15-year exemption from many taxes, complete secrecy for FIBE's accounts, exemption from customs duties, and accounting the *zakah* paid by the bank as its costs.

unanimously, as it seems the parliamentarians considered voting against the law as akin to voting against Allah.[152]

FIBE is also significant because it marked the beginning of a new alliance between *shariah* scholars and bankers, being the first bank to have a formal *shariah* board. This tradition continued in the Jordan Islamic Bank (1978), the Faisal Islamic Bank of Sudan (1978), the Kuwait Finance House (1979), and went on to almost all IFIs in the Arab world, Turkey, and Bangladesh.[153] However, in Iran and Malaysia *shariah* interpretation has been centralised in national regulatory bodies and have remained largely outside the reach of global *shariah* scholars.[154]

2.6 CONCLUDING REMARKS

Modern IBF is an 'invented tradition'. Having emerged in the 1970s as the economic phase of post-colonial independence, it was not a link in an unbroken chain dating back to traditional pre-modern Islamic commercial practices. Non-Derivationists and secular governments had left Muslim populations feeling deeply humiliated by Western dominance and defeats such as those suffered in the Six Day War. On the economic front, the Non-Derivationists had also failed their Muslim populations, offering nothing more than neo-colonial interest-based banking systems that deemed the majority of the rural and poor population unbankable and were incompatible with the Muslim population's religious beliefs.

The population's disappointment with the Non-Derivationists led to the rise of the Derivationists. These Derivationists produced significant theoretical work on an Islamic

152 ibid.

153 Kahf (n 53).

154 David Bassens, Ben Derudder and Frank Witlox, 'Setting Shari'a Standards: On the Role, Power and Spatialities of Interlocking Shari'a Boards in Islamic Financial Services' (2011) 42 Geoforum 94.

economy and sought to imbue the secular neo-colonial banking sector with an Islamic identity. To this end, these Islamic economic institutions were not merely profit-seeking banks aimed at the economic elite, but also pursued social development and community support projects tailored to the previously unbankable poor. The Mit Ghamr Savings Bank, the Nasser Social Bank, and Faisal Islamic Bank, with their vast *zakah* distribution networks, can be cited as examples in this regard.

Despite the theoretical work and small-scale experiments conducted by the Derivationists in the 1960s, meaningful practical achievements were not attained without the state support and sponsorship of the 1970s. Given the massive popularity of Derivationist movements, they were able to encroach on the power of the Non-Derivationists (and, in the case of Iran, overthrow them completely). This power shift was conducive to reaching an accommodation between the two sides regarding economic matters.

At a time of Islamic re-awakening, the promotion of IBF was, for most Muslim states, a low-cost and low-risk method of avoiding being branded as insufficiently Islamic. The Non-Derivationists would use their new-found oil wealth to promote the IBF industry domestically and internationally, while also making appropriate accommodations in their legal systems. For their part, the Derivationists would avoid business relationships with elements that challenged the Non-Derivationist governments.

Whilst there was a wide spectrum of debate about Islamic economic principles—ranging from the Moralists' argument that bank interest is not prohibited *riba* to the Traditionalists' claim that banking, Islamic or otherwise, has no place in Islam—it was the Legalist approach, which equated all bank interest to *riba*, that became the beneficiary of this partnership between Derivationist thought and Non-Derivationist wealth.

This was helped by the fact that the Legalist approach was most favoured by the prominent Derivationist movements (such as the Muslim Brotherhood and *Jamaat-e-Islami*). Whilst the state provided the support and funds to help the IBF industry emerge, the Derivationists helped increase awareness among the masses at the grassroots level that formed the core of IBF customers and depositors that enable the IBF industry to survive and grow.

CHAPTER 3: CURRENT STATE

3.1	**ERA OF GLOBALISATION (1991-2001)**	**3.3**	**FINANCIAL CRISIS YEARS (2008-2013)**
3.1.1	TRIUMPH OF CAPITALIST LOGIC	3.3.1	WEATHERING THE CRISIS
3.1.2	PRODUCT DEVELOPMENT	3.3.2	LIQUIDITY IN THE MIDDLE EAST
3.1.3	ISLAMIC WINDOWS & INDICES	3.3.3	ETHICAL BANKING
3.1.4	REGULATORY & RESEARCH INSTITUTIONS	**3.4**	**CURRENT STATE OF IBF**
3.2	**POST-9/11 PERIOD (2001-2008)**	3.4.1	SIZE & GROWTH
3.2.1	DEMONISATION OF ISLAM	3.4.2	IBF & CAPITALISM
3.2.2	FINANCIAL WAR ON TERROR	**3.5**	**CONCLUDING REMARKS**
3.2.3	ARAB & MALAYSIAN CONVERGENCE		

'Islamic finance has a "such bad food, and in such small portions" problem. People complain that it is mimicking discredited capitalist finance, and also complain that it has not done so closely enough.'

– Prominent Islamic banker

This chapter discusses the evolution of Islamic banking and finance (IBF) during the post-Cold War 'New World Order', the post-9/11 'New New World Order', and the global financial crisis of 2008. Each period was marked by different ways in which various global stakeholders cooperated and competed in the Game of Islamic Bank Bargains as the global political landscape was shifting in profound ways.

Since its inception in the mid-1970s, IBF was embedded within the US-centred international economic order, supported by a Saudi-led pan-Islamism. When the Cold War ended and globalisation began, new rules, norms, and institutions emerged. The position of IBF was paradoxical. On one hand, IBF thrived, albeit by succumbing to capitalist logic and developing products and institutions to fit in with the global capitalist order, not challenge it. On the other hand, political Islam came to succeed Communism as the West's main enemy of the post-Cold War era.

The September 11th attacks strengthened the 'Islam is the new enemy' view just as it fostered an Islamic revival. As the 'Global War on Terror' came to dominate world politics,

Islamic institutions were attacked, but demand for Islamic products grew as Muslims rallied around the flag and Arab and Malaysian models of IBF converged. The financial crisis also provided IBF with paradoxical opportunities for growth as Islamic finance institutions (IFIs) weathered the storm better than conventional banks and were boosted by the drive towards ethical banking.

3.1 ERA OF GLOBALISATION (1991-2001)

Globalisation is a catch-all concept encompassing a broad range of phenomena, including: the end of the Cold War and the emergence of a unipolar world, deregulation and increased openness of markets, the growing role of finance, and the acceleration of technological change.[1] The collapse of the Soviet Union in 1991 was interpreted as 'the end of history'—the victory of capitalism over socialism, of the market economy over central planning.[2] This New World Order also brought about what has been called 'new finance'.[3]

The steady expansion of IBF was the hallmark of the Muslim world's financial landscape during the 1990s. During this period, Islamic banks rapidly gained market share in their domestic economies. IBF's market share in several Muslim countries grew from around 2% during the 1970s to around 15% during the 1990s.[4]

In the 1990s, IBF enjoyed double-digit growth,[5] developed a network that spanned more than 60 countries, and amassed an asset base of more than US$166 billion.[6] As the

1 For a detailed definition of globalisation see Hossein Askari, Zamir Iqbal and Abbas Mirakhor, *Globalization and Islamic Finance: Convergence, Prospects and Challenges* (John Wiley & Sons 2010) 1.

2 See eg Francis Fukuyama, 'The End of History?' [1989] The National Interest, later expanded into a book, Francis Fukuyama, *The End of History and the Last Man* (Free Press 1992).

3 See Askari, Iqbal and Mirakhor (n 1) 79–80.

4 Rajesh K Aggarwal and Tarik Yousef, 'Islamic Banks and Investment Financing' (2000) 32 Journal of Money, Credit and Banking 93.

5 Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects* (Palgrave Macmillan 2005) 51.

6 M Kabir Hassan, 'Determinants of Islamic Banking Profitability' in Munawar Iqbal and Rodney Wilson (eds), *Islamic Perspectives on Wealth Creation* (EUP 2005).

IBF sector grew, many of the original intentions faded from view, or diminished in importance compared to the profit-seeking priorities of the banks. Through vigorous efforts of mainly private business ventures, IBF became a respectable way of doing business in international circles.

As the oil boom of prior decades had driven IBF's expansion, the collapse of oil prices in the 1980s also transformed the industry.[7] The sudden drop in oil prices and subsequent economic downturn in oil-exporting countries meant state support and sponsorship was not as generous as before.[8] The early years of IBF were dominated by pan-Islamism promoted by Saudi Arabia (and to a lesser extent Pakistan and Egypt).[9] Globalisation highlighted the wide range of diversity within the Islamic world and its new geo-economics.[10] Malaysia and the Islamic communities living in the West became increasingly important.[11] Non-bank financial institutions also gained increased relevance. These included investment funds and *takaful* (Islamic insurance) companies.[12] This was later followed by new products such as *tawarruq*, *sukuk*, and *tahawutt* (Islamic hedging).[13]

7 See eg Kiren Aziz Chaudhry, *The Price of Wealth: Economies and Institutions in the Middle East* (Cornell University Press 1997) 2, 7, which states that oil revenues of major exporters dropped from a high of US$243 billion in 1980 to US$67 billion by 1988, with the dimensions of the crisis being described as 'legendary' for Saudi Arabia whose its oil revenues dropped from US$120 billion in 1981 to US$17 billion in 1985.

8 See eg Ibrahim Warde, *Islamic Finance in the Global Economy* (2nd edn, EUP 2010) 98.

9 See Peter Wilson, *A Question of Interest: The Paralysis of Saudi Banking* (Westview Press 1991).

10 See Warde, *Islamic Finance* (n 8) 10–11, for an excellent summary of the diversity of Islam's geo-economics.

11 Ibrahim Warde, 'Global Politics, Islamic Finance and Islamist Politics Before and After 11 September 2001' in Clement Henry and Rodney Wilson (eds), *The Politics of Islamic Finance* (EUP 2004).

12 See eg Iqbal and Molyneux (n 5) 50–51.

13 See eg Askari, Iqbal and Mirakhor (n 1) 139ff, for an overview of the development of Islamic funds, *takaful*, *sukuk*, and other examples of financial engineering.

However, the IBF sector was somewhat discredited in the aftermath of financial scandals, such as those of Egypt's Islamic Money Management Companies (IMMCs)[14] and the collapse of Bank of Credit and Commerce International (BCCI). Though not itself an Islamic bank, BCCI did have an Islamic unit, and enjoyed close links to Islamic banks.[15] It was viewed that religious considerations had taken a backseat to the pursuit of profits by Islamic banks.

3.1.1 Triumph of Capitalist Logic

As IBF expanded it soon succumbed to the logic of the capitalist global order.[16] The performance of the first Islamic banks in the 1970-80s was 'disastrous'.[17] The profit-and-loss sharing (PLS) model proved to be unworkable.[18] The global economic recession and the drop in oil prices devastated the balance sheets of banks that were heavily invested in

14 See Samer Soliman, 'The Rise and Decline of the Islamic Banking Model in Egypt' in Clement Henry and Rodney Wilson (eds), *The Politics of Islamic Finance* (EUP 2004), which explains how IMMCs damaged Islamic finance, first by stealing away its customers by offering a 26% return at a time when the return offered by Islamic banks did not exceed 11% and second by discrediting all economic projects working under the banner of Islam when they crashed in the late 1980s. After the crash of Islamic investment companies, long queues of accountholders were to be seen in front of Islamic banks to withdraw their money. It was rumoured that Prince Muhammad Al-Faisal loaded planes with billions of US dollars, with orders that they be sent directly from Cairo airport to Faisal Bank branches in order to meet the withdrawal demands of depositors. See also Warde, *Islamic Finance* (n 8) 77–80.

15 See Michel Galloux, 'The State's Responses to Private Islamic Finance Experiments in Egypt' (1999) 41 Thunderbird International Business Review 481, for a comprehensive report of BCCI's collapse. See also Warde, *Islamic Finance* (n 8) 80.

16 Charles Tripp, *Islam and the Moral Economy: The Challenge of Capitalism* (CUP 2006) 141.

17 Warde, *Islamic Finance* (n 8) 80.

18 See eg Aggarwal and Yousef (n 4); Mehmet Asutay, 'Conceptualisation of the Second Best Solution in Overcoming the Social Failure of Islamic Finance: Examining the Overpowering of Homoislamicus by Homoeconomicus' (2007) 15 IIUM Journal of Economics and Management 167; Thorsten Beck, Asli Demirgüç-Kunt and Ouarda Merrouche, 'Islamic vs. Conventional Banking: Business Model, Efficiency and Stability' (2013) 37 Journal of Banking & Finance 433, who explain this as 'a rational response by IFIs to the weak contractual framework prevalent in most countries with Islamic banks, which call for debt-like rather than equity-like instruments'.

physical assets.[19] A 'new *ijtihad*' gradually emerged to cater for the changing role of IBF in the new global political economy and the world of deregulated finance.[20]

There was a departure from IBF's original ideals of harmonising the material and spiritual dimension of people's lives and reinforcing the bonds of Islamic communities (eg through *zakah* distribution networks). IFIs became more pragmatic and diverse. They turned their focus on replicating conventional finance within the frameworks set by *shariah* scholars and under *shariah*-compliant contracts.[21] Their idealism gave way to their need to survive and thrive in a competitive globalised economy.[22] As Charles Tripp puts it, 'an ideal that had been heralded as radical and transformative was itself transformed … far from challenging the dominant system of global capitalism, the institutions were seeking a distinctive niche within international financial markets'.[23] Mehmet Asutay states in this regard:

> It is now a fact that Islamic finance opted out of the identity politics of IME [Islamic Moral Economy] in the 1990s following the influence of internalisation and globalisation. In addition to the impact of globalisation, particularly choosing 'commercial banking' as a model, the IBF sector now focuses on efficiency and profitability rather than 'social justice' and 'growth with harmony,' representing a convergence to conventional finance. … IBF has now become a 'hybrid' or 'heterogeneous' product of global financial systems rather than the product of a particular value system, namely Islam. Thus, Islamic finance no longer has the claim of being an 'alternative' system, but rather now provides alternative financial products within the existing global financial system.[24]

For some observers and customers, these developments were a significant discredit to the IBF industry. IFIs had accepted the logic of *riba*, in substance if not in form, and had

19 Ibrahim Warde, 'Status of the Global Islamic Finance Industry' in Craig Nethercott and David Eisenberg (eds), *Islamic Finance: Law and Practice* (OUP 2012) para 1.15.

20 ibid para 1.20.

21 ibid para 1.18.

22 Tripp (n 16) 141–42.

23 ibid 141–42.

24 Mehmet Asutay, 'Islamic Banking and Finance and Its Role in the GCC and the EU Relationship: Principles, Developments and the Bridge Role of Islamic Finance', *The EU and the GCC: Challenges and Prospects under the Swedish EU Presidency* (Gulf Research Center 2010).

become participants in the very capitalist financial system that they were meant to transform.[25]

The detractors were in two broad camps. First, those who were disappointed that 'capitalist materialism' had become the dominant framework of IBF and IFIs had not lived up to their original moral purpose of presenting Islamic economic principles as a genuine alternative framework.[26] Second, those who believed that IFIs used the 'Islamic' label as a marketing ploy to attract a pious captive customer base and get a leg up on their conventional rivals—with whom they only had cosmetic differences in substance. For example, by 1990, there were 62 Islamic branches of 23 conventional banks in Egypt. These branches did not have separate identities and their funds would be commingled with those of their conventional parents.[27]

3.1.2 Product Development

'The imitate vs innovate debate has been firmly settled in favour of imitation.'

– Islamic banker

By the 1990s, IFIs had developed instruments that differed significantly from the original PLS products such as *mudaraba* and *musharaka*.[28] It is estimated that *musharaka* and *mudaraba* structures constituted only 5% of total global IBF activity by 2000.[29] Why did PLS structures

25 Tripp (n 16) 145. See also Mahmoud El-Gamal, *Islamic Finance: Law, Economics, and Practice* (CUP 2006); Muhammad Saleem, *Islamic Banking – A $300 Billion Deception* (Xlibris Corp 2006).

26 See Bill Maurer, 'Engineering an Islamic Future' (2001) 17 Anthropology Today 8.

27 Tripp (n 16) 146.

28 For an explanation of how *mudarabah* and *musharakah* structures were used from early Islamic history all the way to modern business contexts (including reasons for its failure as a versatile IBF instrument) see Zubair Hasan, 'Islamic Banking at the Crossroads: Theory versus Practice' in Munawar Iqbal and Rodney Wilson (eds), *Islamic Perspectives on Wealth Creation* (EUP 2005).

29 See Abdel-Rahman Yousri Ahmad, 'Islamic Banking Modes of Finance: Proposals for Further Evolution' in Munawar Iqbal and Rodney Wilson (eds), *Islamic Perspectives on Wealth Creation* (EUP 2005). See also Shinsuke Nagaoka, 'Beyond the Theoretical Dichotomy in Islamic Finance: Analytical Reflections on Murabahah Contracts and Islamic Debt Securities' (2007) 1

fall out of favour in this way, despite being considered the ideal form of Islamic finance? From the Islamic bank side, bad experiences with PLS during the early and optimistic years of IBF led them to suffer significant losses.[30]

The picture was not much better from the depositor side. The more established depositors (eg companies and businesses) were unsettled by the insecurity and unpredictability of PLS—where their deposits could fluctuate and even suffer a loss. The less-established depositors (eg the entrepreneurs) were also unhappy to pay a share of their profits, typically agreed when they were in a weak bargaining position vis-à-vis the bank, instead of just servicing a loan as a fixed cost. In other words, entrepreneurs were not willing to share their upside with their Islamic banks and businesses were not willing to take a risk on the bank's downside.[31]

This led Islamic banks to develop products that would yield a fixed return for the bank and provide predictability and security for the customer. In what was an inversion of the role initially envisaged for Islamic banks, instead of trying to formulate products that reflected the economic principles of Islam, Islamic banks began scouring Islamic texts to justify and legitimise the transactions they needed to undertake to function in the global financial system. This form of 'reverse-engineering' or what Mahmoud El-Gamal calls '*shariah* arbitrage'[32] became the hallmark of IBF's product development. El-Gamal explains this process as follows:

> Interactive discussions between bankers, lawyers, and jurists commonly start with an existing conventional product for which no Islamic alternative is available. The three

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Kyoto Bulletin of Islamic Area Studies 72, cited in Asutay (n 24), where it is stated that from 1988 to 2006, *mudarabah* and *musharakah* instruments remained on average about 1.7% for the Bank Islam Malaysia Berhad and 9.3% for the Dubai Islamic Bank.

30 Tripp (n 16) 142–43.

31 Timur Kuran, 'The Economic Impact of Islamic Fundamentalism' in Martin Marty and R Scott Appleby (eds), *Fundamentalisms and the State: Remaking Polities, Economies, and Militance* (UCP 1993) 308–12, 316–17; Warde, *Islamic Finance* (n 8) 145–49.

32 El-Gamal (n 25) 20–21.

> groups then engage in a process of financial reengineering of the product, replacing its various conventional components that are deemed un-Islamic with others that can be presented to the public and defended as Islamic. In the later stages of product development and marketing, the vehicle of choice has been modification and adoption of premodern nominate financial contract names. Coverage of the premodern contracts in classical jurisprudence texts thus makes the new products identifiable as Islamic. To maintain credibility, industry practitioners insist on using Arabic names of contracts, for instance, '*ijara*' instead of the equivalent 'lease,' or '*murabaha*' instead of the equivalent 'cost-plus sale'. In many cases, the contemporary practice marketed under some premodern Arabic name bears only very superficial similarity to the premodern financial practice discussed in classical jurisprudence.[33]

Of course, this product development was not happening in a vacuum. The rampant deregulation of global finance in the 1990s meant that numerous new and exotic products were being churned out of conventional financial institutions. IFIs felt compelled to replicate these products as best they could to keep up and remain relevant in the new world of globalised finance.[34] The most widespread of these products were the *murabaha* and *tawarruq* structures.[35] Just as deregulation had given financial engineers free rein to design products to structure around various financial, legal, and tax considerations, the religious considerations of IFIs became just another consideration to be structured around.[36] Indeed, many of the most innovative Islamic finance products were developed at conventional banks.[37]

Deregulation also helped Islamic product development in an additional, unexpected way. With deregulation, the reign of 'net interest income' (ie the difference between interest charged to borrowers and interest paid to depositors) as the almost exclusive avenue of revenue generation for the banks came to an end. Now banks could earn profits in all sorts

33 ibid 11–12.

34 Tripp (n 16) 143–44.

35 See section 2.4.1 (*The Question of Riba: Legalist & Moralist Approaches*) for a discussion of the criticisms of the *murabaha* and *tawarruq* structures.

36 See eg David Eisenberg, 'Derivatives and Islamic Finance' in Craig Nethercott and David Eisenberg (eds), *Islamic Finance: Law and Practice* (OUP 2012).

37 See eg Harris Irfan, *Heaven's Bankers: Inside the Hidden World of Islamic Finance* (Constable 2014) ch 4.

of ways, such as fees and commissions.[38] These profits were not directly linked to interest and thus easier for Islamic banks to replicate.

3.1.3 Islamic Windows & Indices

Before the era of globalisation, Islamic banks lacked quality investment opportunities where they could utilise the funds collected from their depositors to earn a profit. So the Islamic banks turned to Western conventional banks to invest their funds in accordance with the guidelines they would provide. The conventional banks soon realised they were leaving money on the table by only playing this intermediary role and decided to enter this space in their own right. Thus, Islamic windows were born.[39] American Citibank created Citi Islamic in Bahrain, British HSBC created HSBC Amanah in Dubai, and were later joined by the French BNP and the Swiss UBS.[40]

These 'windows' were in effect portals through which the conventional banks provided *shariah*-compliant products and services, while the rest of the bank operated on a conventional basis. Through these windows, the conventional banks attracted deposits from wealthy clients in the Muslim world, as well as Islamic communities in the West. Furthermore, Islamic windows also provided an avenue through which conventional banks could participate in *shariah*-compliant projects in the Muslim world.

These Islamic windows represent a further convergence between Islamic and conventional finance and helped integrate IBF in the mainstream of global finance—but also provided ammunition to those decrying IBF as a profit-seeking marketing ploy. This development was so significant that it has been suggested that Islamic windows would

38 Warde, 'Status of Global Islamic Finance Industry' (n 19) para 1.19.

39 Askari, Iqbal and Mirakhor (n 1) 15.

40 See Clement Henry and Rodney Wilson, *The Politics of Islamic Finance* (EUP 2004) 5–6.

survive and prosper in global financial markets even if existing Islamic banks stagnated or failed.[41]

Another significant development in the convergence of Islamic and conventional finance was the creation in the late 1990s of *shariah*-audited international indices, namely Islamic Dow Jones and Islamic FTSE.[42] Subsequently, Bursa Malaysia, Standard & Poor's, Morgan Stanley Capital International and Thomson Reuters/IdealRatings also introduced Islamic indices of their own.[43]

These indices apply a *shariah* screen, which is a series of tests to determine if the company is eligible to be added to the index. The tests usually consist of three parts: business/income screening, financial screening, and purification requirements. The tests have a tolerance for diversion from strict and absolute *shariah*-compliance. The reasoning being that almost all companies in the world have some degree of exposure to non-compliant activity—whether through contact with some form of prohibited business activity, payment of interest on their debt, or receipt of interest from investments or deposits.[44] If a strict screen were to be applied, there would be no companies left on the indices. Thus, the *shariah* scholars took a view that as a matter of *dharurah* (necessity) and *maslaha* (expediency) a measure of 'impurity' and divergence from absolute *shariah*-compliance would need to be allowed.

For example, in accordance with the AAOIFI screening guidelines for the business/income screen, while the core business must be in compliance with the *shariah*, as

41 Monzer Kahf, 'Islamic Banks at the Threshold of the Third Millennium' (1999) 41 Thunderbird International Business Review 445.

42 For detailed descriptions see Askari, Iqbal and Mirakhor (n 1) 143.

43 Warde, 'Status of Global Islamic Finance Industry' (n 19) para 1.20. See also Warde, *Islamic Finance* (n 8) 152–53.

44 Michael McMillen, 'Shari'a Compliant Project Finance: A Structural Overview' in Humayon Dar and Umar Moghul (eds), *The Chancellor Guide to the Legal and Shari'a Aspects of Islamic Finance* (Chancellor Publications Ltd 2009).

much as 5% of the company's income can be generated from prohibited activities. These activities are anything deemed forbidden by the index's *shariah* board and typically includes adult entertainment (which can come up in the music and film industries), pork and alcohol (which can come up in the food industry, but also in hotels and airlines), and dealing in *riba* and *gharar* (which can come up in conventional banking and insurance). Tobacco and arms are also typically screened out.[45] For the financial screen, interest-bearing debt-to-assets ratio of one-third would be allowed and the ratio of physical (non-financial) assets to total assets would also need to be greater than one-third.[46] This criteria creates significant overlap between Islamic finance and ethical investments. As an Islamic bank manager in London said, 'All ethical finance is not *shariah*-compliant, but all *shariah*-compliant finance should be ethical'.[47]

These impurity allowances are accompanied by 'purification' or cleansing requirements. These requirements are designed to address the consequences of the transaction that would be prohibited but for the 'impurity allowance'. For example, if some income was derived from prohibited sources as part of the 5% impure income allowance, that amount can be donated to charity to purify the remainder of the transaction.[48]

In this way, Islamic windows and indices served to create further convergence between Islamic and conventional finance in the era of globalisation on the one hand, and—as critics claim—distance IBF from its initial moral objectives on the other.

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45 Mehmet Asutay and Shehab Marzban, 'Alternative Ways of Developing GCC Islamic Funds Industry: Entrepreneurial Development', *Islamic Finance: Political Economy, Values and Innovation*, vol 1 (Gerlach 2015);

46 Rodney Wilson, 'Capital Flight through Islamic Managed Funds' in Clement Henry and Rodney Wilson (eds), *The Politics of Islamic Finance* (EUP 2004). For a thorough explanation of the evolution of the *shariah* screening methodology and criteria see Kamal MA Mian, 'Sharia Screening and Islamic Equity Indexes' in Rahail Ali (ed), *Islamic Finance: A Practical Guide* (2nd edn, Globe Business 2014).

47 Interview with Islamic Banker52, 'CEO of Islamic Bank in London' (21 February 2018).

48 McMillen (n 44).

3.1.4 Regulatory & Research Institutions

During this time, IBF became a proper industry in need of proper institutions. As IBF started to play an increasingly significant role in the domestic economies of various Muslim nations, it also gained international recognition as a viable way of doing business.[49] It became untenably strenuous to try and regulate interest-free Islamic banks within a conventional framework.[50] Such a framework put Islamic banks at a comparative disadvantage and was not geared towards the way they conducted their business.[51]

Generally speaking, Islamic banks are regulated by the central banks and monetary authorities responsible for a country's entire banking and finance sector. However, with the advent of global regulation, the autonomy of domestic regulators has been somewhat eroded. This means that central bankers in the Muslim world must also comply with international rules and regulations issued by bodies such as the World Bank, the International Monetary Fund (IMF), and the Basel Committee on Banking Supervision of the Bank of International Settlements (BIS).[52] These international organisations had almost no regard for the specific needs of IFIs.

This situation led to the establishment of two regulatory bodies aimed specifically at IBF, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB).[53] AAOIFI was established in 1991 with its headquarters in Bahrain, through close interaction with the International Accounting

49 Askari, Iqbal and Mirakhor (n 1) 15.

50 See Warde, 'Global Politics' (n 11), where the attitude of many conventional regulators is summed up in a famous statement by Robin Leigh-Pemberton, the former governor of the Bank of England, to the effect that Islamic banking is 'a perfectly acceptable mode of investment, but it does not fall within the long-established and well-understood definition of what constitutes banking in this country'.

51 See eg Warde, *Islamic Finance* (n 8) 210–11, where the difficulties of regulating banks without the tool of interest are explained.

52 Warde, 'Global Politics' (n 11).

53 Sandra Abboud and Abdel-Maoula Chaar (eds), *Islamic Finance Qualification (IFQ): The Official Workbook* (3rd edn, CISI/ESA 2009) 20.

Standards Board (IASB), and formulates and issues accounting, auditing, ethics, governance and *shariah* standards for the IBF industry.[54] IFSB was established in Malaysia in 2002 with the active involvement of the IMF and IsDB and support from the Bahrain Monetary Agency, Bank Negara Malaysia, and other central banks. IFSB's mission is to promote a regulated and transparent IBF industry.[55] The IBF industry is also supported by IsDB and its affiliated institutions.[56]

Interest in IBF was not limited to the realm of practice alone. IBF had its niche following in academic circles since the 1970s.[57] There was, however, a mushrooming of educational institutions and universities—both in the Muslim world and further afield—offering courses and degrees in the subject during the 1990s.

In the US, perhaps the most ambitious research on IBF was conducted at Harvard University, which started the Harvard Islamic Finance Information Program (HIFIP) in 1995—later renamed the Islamic Finance Project (IFP)—and until recently operated as part of the Harvard Law School. IFP's annual Harvard Forum on Islamic Finance was initiated in 1998 to 'provide a forum for academic discourse to scholars coming from all over the

54 For a full overview of AAOIFI's objectives and activities see Iqbal and Molyneux (n 5) 60–61; AAOIFI, 'About AAOIFI' (*AAOIFI*) <http://www.aaoifi.com/en/about-aaoifi/about-aaoifi.html> accessed 18 November 2014.

55 For a full overview of IFSB's objectives and activities see Iqbal and Molyneux (n 5) 62–63.

56 For further details of these institutions and their activities see ibid 59, 61–66, and the websites of the relevant institutions. See also 'About IDB' (*Islamic Development Bank*) <http://www.isdb.org/irj/portal/anonymous/idb_faq_ar> accessed 11 May 2017; Islamic Development Bank, 'Islamic Development Bank Group in Brief' <http://www.isdb.org/irj/go/km/docs/documents/IDBDevelopments/Internet/English/IDB/CM/Publications/IDBGroupBrief2013.pdf> accessed 11 May 2017.

57 For intellectual developments that occurred in the 1970-80s, see Ahmed Abdel-Fattah El-Ashker and Rodney Wilson, *Islamic Economics: A Short History* (Brill 2006) 338–46, which discusses the First International Conference on Islamic Economics (Mecca, 1976), International Centre for Research in Islamic Economics (ICRIE) (Jeddah, 1977), IsDB's Islamic Research and Training Institute (IRTI) (Jeddah, 1981), International Institute of Islamic Thought (IIIT) (Virginia, 1981), the Islamic Foundation (Leicester, 1973), International Islamic University (Islamabad, 1980), and International Islamic Universities Malaysia (IIUM) (Kuala Lumpur, 1983).

world'.[58] In the UK, several universities, including Durham University and Reading University, provide specialist graduate degrees in Islamic finance and are engaged in serious research in the field.

There has also been an explosion of professional qualifications in the sector, such as the Islamic Finance Qualification (IFQ) offered by the Chartered Institute for Securities & Investment (CISI) and the l'Ecole Supérieure des Affaires (ESA), the Certified Islamic Finance Executive (CIFE) offered by the Ethica Institute of Islamic Finance, and the various diplomas offered by the Institute of Islamic Banking and Insurance (IIBI).[59] The Chartered Institution of Management Accountants (CIMA) also offers a certificate in Islamic finance, the first to be offered by a professional chartered accountancy body.[60]

These developments during the era of globalisation show that IBF, through its bodies and products, education, and regulation, began to develop the trappings of a respectable specialisation within the mainstream of global finance.

3.2 POST-9/11 PERIOD (2001-2008)

The September 11th attacks and the subsequent 'Global War on Terror' had a significant but paradoxical effect on IBF. The misguided suspicion that IFIs were funding terrorism halted the growing integration of IBF in the global economic system. This setback was temporary, as soon afterwards IBF experienced significant transformations and remarkable growth. Criticisms of IBF from the West prompted stakeholders to make a serious effort at rationalising and streamlining the industry. In addition, the feeling amongst Muslims that Islam as a whole was under threat rallied them around the Islamic flag and drove up

58 Iqbal and Molyneux (n 5) 65.

59 Further details about degrees and certificates (from basic to the doctorate level) can be found at 'Islamic Finance Training Programs & Certifications 2.0' <http://islamic-finance-resources.blogspot.co.uk/2010/02/islamic-finance-training-programs.html> accessed 19 November 2014.

60 Askari, Iqbal and Mirakhor (n 1) 22ff.

demand for Islamic products whether due to greater religiosity or greater expression of Islamic identity.[61] Notable developments of this period include countless new commercial and regulatory initiatives as well as the convergence of the Arab and Malaysian models of IBF.

3.2.1 Demonisation of Islam

Even before the September 11th attacks, Islam was vilified in a number of academic and foreign policy circles as fundamentally incompatible with Western values.[62] Fears about Islam had started with Iran's Islamic revolution of 1979. With the collapse of the Soviet Union, many theorists filled the threat vacuum with Islam and—as the successor of Communism—placed it on a collision course with the West.[63]

The 9/11 attacks seemed to solidify and justify the designation of Islam as the 'single greatest threat' to the 'New World Order'.[64] As the 'clash of civilisations' argument went mainstream post-9/11, 'Islam is the new enemy' became the commonly accepted policy position.[65] The writings of anti-Islamic academics, policy wonks, and journalists influenced public opinion and foreign policy, particularly in the United States.[66] Prominent politicians would make pronouncements such as, '*Shariah* is a mortal threat to the survival of freedom

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61 Warde, 'Status of Global Islamic Finance Industry' (n 19) para 1.21;

62 See Warde, 'Global Politics' (n 11).

63 Most prominent among these was Samuel P Huntington, 'The Clash of Civilizations?' [1993] *Foreign Affairs* later expanded into a book, Samuel P Huntington, *The Clash of Civilizations and the Remaking of World Order* (Simon & Schuster 1996), which argued that future conflicts would break out along civilisational lines, with Islam and Confucianism epitomising those civilisations that were inherently hostile to the West.

64 For a more detailed discussion of the Islamic 'threat' in the New World Order, see Warde, *Islamic Finance* (n 8) 227–29.

65 See Bob Woodward, *Bush at War* (2nd rev edn, Pocket Books 2003).

66 See eg Daniel Pipes, *Militant Islam Reaches America* (WW Norton & Co 2002); Bernard Lewis, *What Went Wrong?: Western Impact and Middle Eastern Response* (W&N 2002); Stephen Schwartz, *The Two Faces of Islam: The House of Sa'ud from Tradition to Terror* (Random House 2003); Steven Emerson, *American Jihad: The Terrorists Living Among Us* (Free Press 2003), cited in Warde, 'Global Politics' (n 11).

in the United States and in the world as we know it'.[67] Voices friendly to Islam, like that of Iranian President Mohammad Khatami who instead of a 'clash' called for a 'Dialogue of Civilisations',[68] were ignored and dismissed.[69]

This demonisation of Islam led to the ban of the *hijab* (head scarves) in schools and the *niqab* (face veil) in public in France and elsewhere in Europe; a ban on minaret construction in Switzerland; a ban on the use of *shariah* in the courts of over ten US states; and a leading Dutch politician seeking to ban the Quran from the Netherlands, calling it Islam's *Mein Kampf*.[70]

Islamic finance did not escape this demonisation unscathed.[71] In this environment, IBF was found guilty by association of a wide array of misdeeds,[72] including: financing terrorism;[73] committing fraud;[74] infiltrating capitalism in order to destroy it from within;[75]

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67 Newt Gingrich, 'America at Risk: Camus, National Security, and Afghanistan' (American Enterprise Institute, Washington, DC, July 2010).

68 Mohammad Khatami, 'Speech of Seyed Mohammad Khatami President of the Islamic Republic of Iran' (The United Nations General Assembly on The United Nations Year of Dialogue among Civilizations, New York, 9 November 2001) <http://www.dialoguefoundation.org/?Lang=en&Page=22&TypeId=5&NewsId=32&Action=NewsBodyView>.

69 See also Martin S Kramer, *Ivory Towers on Sand: The Failure of Middle Eastern Studies in America* (Washington Institute For Near East Policy 2001).

70 Geert Wilders, 'Enough Is Enough: Ban the Koran', cited in Irfan (n 37) xii–xiii. For discussion of Islamophobia in the UK especially following the 7/7/2005 attacks see Jonathan Ercanbrack, 'The Law of Islamic Finance in the United Kingdom: Legal Pluralism and Financial Competition' (SOAS 2011) para 6.1.2.

71 A trend also seen in anti-Semitic writings on Jewish finance, discussed in Brad A Greenberg, 'An Ugly Bias Is Back: Blaming Jews for Financial Woes' [2009] *Christian Science Monitor*.

72 See generally Warde, *Islamic Finance* (n 8) 229.

73 See eg Marieke DeGoede, *Speculative Security: The Politics of Pursuing Terrorist Monies* (University of Minnesota Press 2012).

74 Alex Alexiev, 'Playing by Islamofascist Rules' *The Washington Times* (26 January 2007), explains that 'Islamo-fascist rules' of finance 'were little more than a hoax perpetrated on its clients through a series of deceitful ruses'. See also Alex Alexiev, 'Islamic Finance, or Financing Islamism?' (*The Center for Security Policy*, 22 October 2007).

75 See eg Alyssa A Lappen, 'A Caliphate of Toxic Assets' (*FrontPageMag.com*, 29 June 2009).

opening a backdoor way of imposing *shariah* on the West; and financing Islamism aimed at the overthrow of Western civilisation.[76]

This discourse also played a role in claiming financial compensation for the 9/11 attacks.[77] On 15 August 2002, relatives of more than 600 victims, along with firefighters and rescue workers, filed 'the lawsuit of the twenty-first century'.[78] This was a US$116 trillion lawsuit against Osama bin Laden, the Saudi Bin Laden Group, three Saudi princes, the government of Sudan, seven international banks, and eight Islamic foundations and charities.[79] Leading IBF figures—such as Prince Mohammad Al-Faisal and his Dar al-Maal al-Islami, Sheikh Saleh Kamel and his Dallah al-Baraka Group—and Al-Rajhi Bank were among 80 defendants of the lawsuit. In November 2002, the defendants were increased to 186 and the plaintiffs increased to over 2,500, but the amount claimed was reduced to US$1 trillion.[80] Other copycat suits followed and they all included deep-pocketed IFIs among their defendants.[81] The fear-mongering around IBF that was common in the post-9/11 period continued during the subsequent financial crisis.[82]

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76 David J Jonsson, *Islamic Economics and the Final Jihad: The Muslim Brotherhood to the Leftist/Marxist – Islamist Alliance* (Xulon Press 2006), suggests an apocalyptic confrontation, a 'final jihad', between the West and 'the Leftist/Marxist-Islamist Alliance'.

77 Warde, *Islamic Finance* (n 8) 227.

78 See Warde, 'Global Politics' (n 11).

79 See Susan Schmidt, 'September 11 Families Join to Sue Saudis' *Washington Post* (16 August 2002); '$116 Trillion Lawsuit Filed by 9/11 Families' (*CNN*, 16 August 2002).

80 See Milo Geyelin, 'Sept.11 Suit to Add Defendants, Including Saudi Bank, Minister' *Wall Street Journal* (22 November 2002). For further details on what has come to be known as the '9-11 Lawsuit' see the website of the law firm progressing the case 'Seeking Justice for 9/11 Families: In Re Terrorist Attacks on September 11, 2001' (*Motley Rice*).

81 See Warde, 'Global Politics' (n 11).

82 See eg Catherine Herridge, 'AIG Bailout Promotes Shariah Law, Lawsuit Claims' (*FoxNews.com*, 22 December 2008), explaining the lawsuit brought in 2008 to stop a $40 billion bailout of AIG because it had a *shariah*-compliant unit. For a summary of the facts and issues in question in the case see Zulkifli Hasan and Mehmet Asutay, 'An Analysis of the Courts' Decisions on Islamic Finance Disputes' (2011) 3 ISRA International Journal of Islamic Finance 41.

3.2.2 Financial War on Terror

Demonising Islam in people's hearts and minds was accompanied by policy positions, which were also aimed against Islamic finance—whose *raison d'être* was portrayed as funding terrorism.[83] Given the magnitude of the 9/11 attacks, 'sophisticated financial networks' must have been behind them, the reasoning went.[84] In this 'New Kind of War', the uniforms would be, as US Defence Secretary Donald Rumsfeld put it, 'bankers' pinstripes and programmers' grunge just as assuredly as desert camouflage'.[85]

Indeed, the first shots of the War on Terror were fired on the financial front. On 23 September 2001, then-US President George W. Bush announced, 'We have launched a strike on the financial foundation of the global terror network'.[86] The strike was to add 27 individuals and entities to the asset-freeze list.[87] Since then many more persons, sometimes due to only tangential links to Islamic charities or IFIs, have been blacklisted without formal charge or explanation.[88]

The rationale for this 'financial war on terror' was threefold: first, 'following the money' would reveal a web of relationships between terrorists and their supporters. Second, financial punishments and asset freezes would starve the terrorists and their supporters of their financial resources and take the 'profit out of crime'. Third, financial scrutiny could

83 See eg Ibrahim Warde, *The Price of Fear: Al-Qaeda and the Truth Behind the Financial War on Terror* (IBTauris 2007).

84 Warde, 'Global Politics' (n 11).

85 Donald Rumsfeld, 'A New Kind of War' *The New York Times* (27 September 2001).

86 The White House, 'President Freezes Terrorists' Assets' (24 September 2001).

87 Arabinda Acharya, *Targeting Terrorist Financing: International Cooperation and New Regimes* (Routledge 2009) 9–11.

88 See eg Giles Fraser, 'Yassin Kadi's Ordeal at the Hands of the US Security Services Is Kafka Incarnate' *The Guardian* (8 November 2013). See also DeGoede (n 73).

help 'frame the guilty' through a host of derivative crimes, such as tax evasion and money laundering.[89]

In a climate of generalised suspicion, IBF had woken up to find a massive target on its back, and suffered a devastating blow.[90] In the initial post-9/11 panic, Islamic banks—and more broadly banks from the Islamic world—were considered guilty until proven innocent.[91] With the blacklisting of several IFIs and Islamic charities, a lull fell over the IBF industry, which felt that any one of their number could be next. Such trepidation was heightened by the US Treasury asking foreign regulators, including the Saudi central bank, to place Islamic banks on a watch list.[92] Islamic charities also came under close surveillance on the grounds that their funds could find their way to the pockets of terrorists. IFIs were implicated in this scrutiny, given their role in the collection and distribution of *zakah*—a practice that has since subsided significantly.

Ironically, IBF had been, until then, viewed as 'a moderating element in Islam'[93] and 'a useful way of countering Islamic extremism'.[94] Not well-known or well-understood by the general Western public, IBF felt unfairly targeted by smear campaigns. Having just barely become a well-integrated part of the global economy and the status quo, protecting its reputation mattered greatly to it. Speaking out against this trend at an Islamic banking conference in Bahrain in November 2001, Prince Muhammad Al-Faisal a leader of the IBF industry said:

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89 Warde, *Islamic Finance* (n 8) 227. For a more detailed discussion of these issues, see Warde, *The Price of Fear* (n 83).

90 Warde, *Islamic Finance* (n 8) 84–85.

91 ibid 227.

92 Warde, 'Global Politics' (n 11).

93 See eg Clement M Henry, *The Mediterranean Debt Crescent: Money and Power in Algeria, Egypt, Morocco, Tunisia and Turkey* (UPF 1996) 22.

94 Henry and Wilson (n 40) 1.

> We all condemn the September 11th attack[s] … as a heinous crime, which has nothing to do with Islam or Muslims as a whole. The West is raising various questions. But these questions are not raised with us, but with 'experts' who do not know anything about [IBF].[95]

Another IBF leader, Sheikh Saleh Kamel, founder of the al-Baraka Group and chairman of the Council of Islamic Banks, protested that:

> The concept of Islamic banking is one of the creative methods of Islam to serve the economic and social welfare of Muslims. But some circles tried to use the September 11th attacks to launch a campaign under the false pretext that these Islamic banks are the source for financing terrorism.[96]

The general level of ignorance on the subject was epitomised by a statement made by former National Security Adviser, Sandy Berger, the top official in charge of surveillance over Osama Bin Laden's financial networks during his tenure at the White House (1996-2000). He stated that tracking Bin Laden's money would be difficult because it was hidden in 'underground banking, Islamic banking facilities'.[97] Only after meetings in Saudi Arabia, Kuwait, and Bahrain, did US Treasury Secretary Paul O'Neill, the man spearheading the financial war on terror, learn that Islamic banking was 'a legitimate way of doing business'.[98]

It has since become clear that there was no credible evidence of any connection between IBF and terror networks.[99]

3.2.3 Arab & Malaysian Convergence

The fallout of the financial war on terror led to a significant slowdown in the integration of IFIs in the global economy.[100] Leaders of the IBF industry called for a repatriation of Islamic funds, declaring that, 'The West has always been hostile to Islamic banking … it is

95 Latheef Farook, 'Islamic Institutions Flay West' *Gulf News* (12 November 2001).

96 ibid.

97 Gene J Koprowski, 'Islamic Banking Is Not the Enemy' *Wall Street Journal Europe* (1 October 2001).

98 Warde, 'Global Politics' (n 11).

99 Warde, *Islamic Finance* (n 8) 228.

100 ibid 85.

time Muslim financial institutions and individuals bring back their money from the West to invest in Muslim countries and develop this industry in our region'.[101] These calls did not go unheeded.

What felt like a witch-hunt against IFIs and Islamic charities, as well as prominent Muslim businesspeople, served to scare away Muslim investors and much of their investments from the US. Malaysia emerged as the destination of choice for a substantial portion of these assets. Malaysia's stature had grown in the Muslim world as its Prime Minister, Mahathir Mohammed, took a strong stand in denouncing the Global War on Terror's excesses against Muslims. This also got Malaysia noticed as a Muslim country that had achieved an impressive level of economic growth and had developed a domestic IBF industry—ripe for attracting these newly released investments looking for a new home. For a whole host of these economic and political reasons, Middle Eastern Arabs started to choose Muslim Malaysia rather than Europe or the US as their holiday and trade destination.[102]

Malaysia also saw this as an opportune moment to reach a common ground with Arab IBF, which had until then expressed misgivings about the Malaysian model. As part of this rapprochement, when Malaysia issued sovereign *sukuk* in 2002, it targeted both Arab and Malaysian investors and had it blessed by *shariah* scholars from both jurisdictions.[103] Closer cooperation on IBF ensued between Malaysia and Arab regulators, such as those of Bahrain and the UAE. Bank Negara, Malaysia's central bank, also spent millions of dollars to invite scholars from all over the world to partake in a '*shariah* dialogue' programme.

101 Farook (n 95).

102 See Warde, 'Status of Global Islamic Finance Industry' (n 19) para 1.23.

103 ibid para 1.24.

A new web of institutions linking Arab and Malaysian institutions emerged. Malaysian IBF products became increasingly popular in the Persian Gulf just as Gulf-based products found a good market in Malaysia. This cross-selling helped IBF take strides towards a more consistent set of rules and practices in hopes of becoming a coherent, albeit pluralistic, industry.[104]

The post-9/11 fall-out had also invigorated efforts at international coordination and standardisation. Being placed on the back-foot had sounded the alarm and greatly concentrated the minds of Islamic bankers and their regulators. In the scramble that followed, the sovereign *ijara sukuk* was launched, IFSB was established as a standard-setting body, along with the International Islamic Financial Market (IIFM), the Liquidity Management Center (LMC), and the Islamic International Rating Agency (IIRA)—all of this in 2002 alone.[105]

So after suffering a blow in the aftermath of 9/11, IFIs and their customers rallied around the IBF industry leading to a period of unprecedented expansion on the back of accelerated growth both inside and outside the Islamic world.[106]

3.3 FINANCIAL CRISIS YEARS (2008-2013)

In the years preceding the financial crisis of 2008, the paradigm of global finance—as epitomised by Wall Street's 'greed is good' mentality—enjoyed the near-unanimous allegiance of the financial community. Financial markets, with their fixation on financial innovation, were overcome by hubris and thought themselves to be all-knowing and self-correcting. This mindset was reflected in the statements of the high priests of unfettered capitalism, such as Alan Greenspan, Chairman of the Federal Reserve (1987-2006). In the

104 ibid para 1.26.

105 ibid para 1.22.

106 See Warde, *The Price of Fear* (n 83).

run-up to the system's collapse, the man dubbed a 'rock star' and the 'maestro',[107] said 'increasingly complex financial instruments have contributed to the development of a far more flexible, efficient, and hence resilient financial system'.[108] With the meltdown, Goldman Sachs, the world's most powerful investment bank, was branded as 'a great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money'.[109] Lloyd Blankfein, CEO and Chairman of Goldman Sachs since 2006, provoked the ire of many when he retorted that he was just a banker 'doing God's work'.[110]

At this time, IBF was a small part of the mainstream of global finance. This was not to be taken as a recognition of the merits of IBF by the global financial system. Indeed, in those years IFIs were often on the receiving end of lectures essentially telling them how to better do 'Allah's work' and become more like mainstream finance.[111]

With the onset of the crisis, IFIs were offered unlikely opportunities to expand and grow for the reasons set out below.

3.3.1 Weathering the Crisis

Dividing the financial crisis into three phases, the first was a drop in US real estate prices. Damaging in its own right, it wrought devastation to the financial system when it became clear that millions of bad subprime loans were—through the miracle of securitisation—sitting on the balance sheets of many of the world's major financial institutions.[112] Second

107 Ambrose Evans-Pritchard, 'Greenspan Was More a Rock Star than a Feared Fed Sage' *The Telegraph* (16 September 2007).

108 Alan Greenspan, 'Economic Flexibility' (12 October 2005) cited in Warde, *Islamic Finance* (n 8) 88.

109 Matt Taibbi, 'The Great American Bubble Machine' [2009] *Rolling Stone*.

110 John Arlidge, 'I'm Doing God's Work. Meet Mr Goldman Sachs' *The Sunday Times* (8 November 2009).

111 Warde, 'Status of Global Islamic Finance Industry' (n 19) para 1.47.

112 For views on the causes of the crisis see Askari, Iqbal and Mirakhor (n 1) 94. See also Abbas Mirakhor and Noureddine Krichene, 'The Recent Crisis: Lessons for Islamic Finance' (2009).

was a credit freeze. The financial institutions, through groupthink, had placed bets in the form of 'credit default swaps' that these products would never default. When the unexpected default happened, they were utterly unprepared to pay up. Immediately it became clear that any of the big Wall Street firms could be insolvent with these toxic assets on their books. Trade between the banks froze and the global financial system went into free-fall, threatening to take with it the real economy. The third phase of the financial crisis was, thus, a global economic recession. A full-blown global depression was only averted because governments around the world stepped in and pumped billions of dollars into their economies.[113]

IFIs managed to escape the first two phases relatively unscathed, as many of the practices that caused the crisis would not pass muster with their *shariah* boards—who were in effect playing a checks and balances role against the groupthink of mainstream finance.[114] The securitisation of subprime loans in phase one would be prohibited as a sale of debt and the credit default swaps of phase two would be a derivative rife with prohibited *gharar*.[115] Moreover, *shariah* boards also frowned upon or outright prohibited short-selling (as the *shariah* does not permit transacting in something you do not own). Though not implicated as a cause of the financial crisis, short-selling played a damaging role in its aftermath, and had to be curtailed by many financial centres.

These old-fashioned principles of avoiding excessive leverage and speculation vindicated the IFIs—who were criticised for not being more like mainstream finance, but

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For an Islamic perspective on the crisis see Muhammad Taqi Usmani, 'Causes and Remedies of the Recent Financial Crisis: From an Islamic Perspective' (Reshaping Economic Growth to Include the Spiritual, London, 28 November 2014).

113 See Warde, 'Status of Global Islamic Finance Industry' (n 19) para 1.48.

114 Maher Hasan and Jemma Dridi, 'The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study' (IMF 2010) IMF Working Paper WP/10/201.

115 Warde, 'Status of Global Islamic Finance Industry' (n 19) para 1.49.

ended up being saved by that very fact.[116] At a time when the financial tsunami caused a meltdown and cast a mood of soul-searching over the financial industry, a sense of self-confident triumphalism overtook Islamic finance.[117] Some presented IBF as a panacea for all the economic ills of the world and turned the tables to lecture conventional banks to be more like Islamic ones to get out of their predicament.[118]

But such self-righteous gloating was short-lived, as once the financial crisis spilled into the real economy IFIs too started to feel the pinch. Being mostly asset-backed, IFIs were much more vulnerable to the effects of the downturn in the real economy. They suffered primarily as a result of the 'drop in real estate prices in the GCC countries, a sharp correction in regional stock markets, and deteriorating asset prices in US and European financial and real estate markets'.[119]

So while not a panacea after all, the Islamic sector still weathered the crisis better than the conventional.[120] If nothing else, conventional circles came to acknowledge that IBF principles were not without merit and should not be dismissed out of hand. This put the winds in the sails of the IBF sector, who now had the confidence to try and withstand blind imitation of conventional products (if they so chose).[121]

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116 Askari, Iqbal and Mirakhor (n 1) 24–25. See also Usmani (n 112).

117 Warde, 'Status of Global Islamic Finance Industry' (n 19) para 1.51.

118 See eg PK Abdul Ghafour, 'Islamic Finance Panacea for Global Crisis: Chapra' *Arab News* (23 October 2008); Robin Brant, 'Is Islamic Finance the Answer?' *BBC News* (11 May 2009); Askari, Iqbal and Mirakhor (n 1) 183ff.

119 RatingsDirect, 'Rated Gulf Islamic Financial Institutions and Takaful Companies Have Shown Resilience to Global Market Dislocation, But They Are Not Risk Immune' (*Standard & Poor's*, 20 February 2009), cited in Askari, Iqbal and Mirakhor (n 1) 24–25.

120 See eg Mehmet Asutay, Ahmet Faruk Aysan and Cenk C Karahan, 'Reflecting on the Trajectory of Islamic Finance: From Mit Ghamr to the Globalisation of Islamic Finance' (2013) 2 Afro Eurasian Studies 5; Ercument Aksak and Mehmet Asutay, 'The Maqasid and the Empirics: Has Islamic Finance Fulfilled Its Promise?', *Islamic Finance: Political Economy, Values and Innovation*, vol 1 (Gerlach 2015).

121 Warde, 'Status of Global Islamic Finance Industry' (n 19) para 1.53.

3.3.2 Liquidity in the Middle East

With the credit crunch in the US and Europe, global financial institutions became keen to tap the wealth of the Islamic world, especially the wealth accumulated in the oil-rich countries of the Middle East due to record oil prices in the lead-up to the financial crisis.

Between January 2002 and July 2008, the price of oil rose from US$20 to US$145 a barrel. This meant a large part of the current account balance of oil importers was being transferred to oil exporters. 'Between 2002 and 2006, net capital outflows from oil exporters grew by 348%, becoming the largest global source of net capital outflows in 2006.'[122]

With the credit crunch significantly freezing liquidity in the West and the impressive oil wealth amassed in the Middle East, many companies and sovereigns turned to the Middle East for funds. These funds were often extended through Islamic finance instruments. Traditionally risk-averse when managing their liquidity,[123] IFIs would have typically extended funds on a short to medium term basis of three to seven years. But due to the increased levels of liquidity they had accumulated in the oil boom, the IFIs were able to provide funds on longer tenors of 10+ years typical of their conventional counterparts.[124]

Of course, the oil boom did not last. Prices fell from a peak of US$145 in July 2008 to US$30.28 a barrel in December 2008 and traded at between US$35 and US$82 a barrel in

122 Diana Farrell and others, 'The New Power Brokers: How Oil, Asia, Hedge Funds, and Private Equity Are Shaping Global Capital Markets' (McKinsey & Co 2007) cited in Lucas Chancel and Thomas Spencer, 'Greasing the Wheel: Oil's Role in the Global Crisis' (*Vox CEPR Policy Portal*, 16 May 2012).

123 See eg Andrew Wood, 'Islamic Finance Escapes Worst of Crisis' *Financial Times* (7 June 2009).

124 Shibeer Ahmed and Sajjad Khoshroo, 'Islamic Project Finance' in Rahail Ali (ed), *Islamic Finance: A Practical Guide* (2nd edn, Globe Business 2014).

2009.[125] But still, at the outset, IFIs in the Middle East had healthier balance sheets than many of their conventional counterparts in the West.

3.3.3 Ethical Banking

With the financial crisis throwing the global economy into disarray, the conventional financial system and its addiction to debt and leverage came under intense scrutiny. Research showed that the conventional financial system is unstable and crises are 'inherent in a financial system where the predominant mode of financing is interest-based debt contracts and credit'.[126]

The financial crisis of 2008 and events such as the bonuses scandal of 2009 and LIBOR-rigging scandal of 2012 all served to erode public trust in the financial system.[127] When massive taxpayer bailouts had averted a disastrous collapse of the entire economy, mistrust gave way to public anger.[128] People were outraged that their taxes were being used to keep afloat a system that privatised profits and socialised losses.[129] Calomiris and Haber capture this mood, by saying that the losers of this game were:

> Taxpayers who did not benefit from the weakening of underwriting standards and who would have to pay for a cleanup in the event of widespread mortgage defaults. Those individuals were effectively subsidising everyone else, but most of them did not understand the game as it was being played, or even realise that the house had dealt them in. The subsidies they provided were not explicitly recognised in the government's budget: they were sets of implicit guarantees—hidden taxes—that would become visible only once

125 U.S. Energy Information Administration, 'Cushing, OK WTI Spot Price FOB' <http://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=RWTC&f=D> accessed 14 December 2014.

126 Askari, Iqbal and Mirakhor (n 1) 79–80. See also Charles W Calomiris and Stephen H Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit* (PUP 2015).

127 See eg Colin Mayer, *Firm Commitment: Why the Corporation Is Failing Us and How to Restore Trust in It* (OUP 2013).

128 See Paola Sapienza and Luigi Zingales, 'A Trust Crisis' (2012) 12 International Review of Finance 123.

129 See eg David Feige, 'Socializing Risk, Privatizing Profit' (*Huffington Post Blog*, 26 October 2008). See also Adam Ng, Mansor H Ibrahim and Abbas Mirakhor, 'Ethical Behavior and Trustworthiness in the Stock Market-Growth Nexus' (2015) 33 Research in International Business and Finance 44.

> the other players stood up from the gaming table and the house presented the taxpayers with a bill for charges that they had unwittingly agreed to pay.[130]

All of this set many thinkers on a quest for discovering or devising a more stable and ethical alternative to the prevailing financial system that—with its risk-misaligned compensation and moral hazard—had destabilised the global economy.[131] Islamic finance, at least in theory, could be one such alternative.

Islamic finance was eager to be touted as the answer. Islamic finance had shown it was immune to some of the worst offences that brought about the financial crisis. It made lofty claims about putting an end to the 'slavery of debt' and providing for a fair distribution of risk between financiers and customers. Even the Vatican pointed banks to the rules of Islamic finance as a means of restoring confidence amongst their clients.[132] The Vatican's official newspaper stated, 'The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service'.[133]

In this environment, IBF was quick to claim ethical superiority and subtly shift its marketing strategies 'toward the "ethical" and "socially responsible" labels and away from the "faith-based" and "Islamic" labels'.[134] This approach had a dual effect of distancing IBF from the cloud of suspicion that had hung over its head since 9/11 and also broadening its appeal to an investor base disenchanted by the misdeeds of conventional finance.[135] This

130 Calomiris and Haber (n 126) 212.

131 Martin Cihák and others, 'Benchmarking Financial Systems Around the World' (2012) World Bank Policy Research Working Paper No 6175.

132 Lorenzo Totaro, 'Vatican Says Islamic Finance May Help Western Banks in Crisis' (*Bloomberg*, 4 March 2009).

133 Loretta Napoleoni and Claudia Segre, 'Dalla finanza islamica proposte e idee per l'Occidente in crisi (Islamic finance proposals and ideas for the West in crisis)' *L'Osservatore Romano* (Vatican, 3 March 2009) 3.

134 Bill Maurer, 'Articulating Islamic Knowledge to an American Dream: Islamic Home Financing Alternatives after September 11, 2001' (2003) 26 PoLAR 196.

135 Hans Visser, *Islamic Finance: Principles and Practice* (2nd edn, Edward Elgar 2013) para 1.4.

struck a chord with non-Muslims who felt that IBF could be the answer to their desire to move away from the discredited conventional financial system and find an ethical way of investing their money.[136]

It was not to be. Despite a temporary bump in interest, Islamic finance never caught on as an alternative to the conventional financial system. The promise was that, in IBF, unlike in the debt-based system, you would have 'one-to-one mapping of financial structures onto the underlying real sector assets';[137] risk of loss would be 'shared between the surplus fund holder and the entrepreneur';[138] and there would be no opportunity to 'expand credit and leverage beyond what can be supported by the real sector output'.[139]

The reality, however, was that IBF's ethical underpinnings were mostly in the realm of business practices (ie the vice industries they avoided) and they were no ethically-superior when it came to debt-addiction or corporate social responsibility.[140] So while the worst offences of the conventional financial system did not take place in IFIs, this was not due to a lack of desire but rather a lack of sophistication for devising a suitable *shariah*-compliant equivalent or lack of market depth for the product to thrive in the markets in which Islamic banks operated.[141] It was not because of some moral objection to debt and interest, which, we have seen, had pervaded IBF in all but name (eg through debt-based products like the

136 ibid para 1.5. See also Warde, *Islamic Finance* (n 8) 107–08, on how 'Morality and ethics may have always been the Achilles' heel of the market economy'.

137 Mirakhor and Krichene (n 112).

138 ibid.

139 Noureddine Krichene and Abbas Mirakhor, 'Resilience and Stability of the Islamic Financial System – An Overview' (IFSB 2008).

140 See eg Salma Sarially, 'Evaluating the "Social Responsibility" of Islamic Finance: Learning from the Experiences of Socially Responsible Investment Funds', *Islamic Economics and Banking in the 21st Century* (2005).

141 Irfan (n 37) 197.

tawarruq).[142] If IFIs suffered a less devastating loss in the aftermath of the financial crisis, it was because they were less competent and more conservative by nature.[143]

Researchers found that, despite the significant theoretical differences between conventional and Islamic banks, when controlling for time-variant country-fixed effects, there is little real difference in their business practices. As Islamic banks mimic the products of the conventional banks, they are exposed to the same risks. If Islamic banks are better able to withstand crises, it is because they are better capitalised and often have higher-quality assets.[144] So while post-crisis analysis demonstrated that Islamic banks were more stable and resilient to exogenous shocks,[145] they had their own set of deficiencies and were less cost-effective than their conventional counterparts.[146] These issues made IBF inadequate as a viable alternative for conventional finance.

3.4 CURRENT STATE OF IBF

Islamic banking and finance is now a recognised niche in global finance, with legions of bankers, lawyers, accountants, consultants, and scholars specialising in the sector from East to West, Malaysia to America. IBF is playing an increasingly important role in the financial systems and economies of many Muslim countries. In Iran, the entire banking system is

142 Asutay (n 24).

143 'Global Islamic Finance Report (GIFR) 2017' (Edbiz Consulting 2017) 42.

144 See Beck, Demirgüç-Kunt and Merrouche (n 18), which 'compares the business model, efficiency, asset quality, and stability of Islamic and conventional banks, using an array of indicators constructed from balance sheet and income statement data across a sample of 22 countries with both Islamic and conventional banks'. See also Hela Miniaoui and Gaston Gohou, 'Did the Islamic Banking Perform Better During the Financial Crisis? Evidence from the UAE' (2011), which uses balance sheet data for 37 UAE banks and a compensating differential framework to assess the performance gap between the conventional and Islamic banking systems.

145 Askari, Iqbal and Mirakhor (n 1) 113ff.

146 Beck, Demirgüç-Kunt and Merrouche (n 18). See also Seif I Tag El-Din, 'Towards Optimal Risk Management for Profit-Sharing Finance' in Munawar Iqbal and Rodney Wilson (eds), *Islamic Perspectives on Wealth Creation* (EUP 2005), where it is stated that 'fix-return engineering has already exhausted all the potential juristic support, but with little hope of attaining the efficiency standards of conventional banking'.

shariah-compliant, to the exclusion of conventional banking. In countries where Islamic banking coexists with conventional banking in a dual system, it has achieved systemic importance in Brunei, Kuwait, Malaysia, Qatar, Saudi Arabia, the UAE, and Yemen. Islamic banking also accounts for around 5% of total banking assets in Turkey, Egypt, and Indonesia.[147] It is not only Muslim countries that have an interest in IBF. With the globalisation of finance, countries such as the United Kingdom, Hong Kong, and Singapore are also vying for a seat at the table of this increasingly significant industry.[148]

IBF going global is further evidenced by the broad range of Muslim and non-Muslim *sukuk* investors. '*Sukuk* issued by institutions based in Malaysia, Saudi Arabia, and the UAE are held in significant portions by investors in Asia, Europe, and the United States.'[149] Non-Muslim customers have also shown some interest in the ethical underpinnings of Islamic finance, especially in the aftermath of the financial crisis where the Sustainable Development Goals (SDGs) and responsible finance have gained significance.[150]

Against this backdrop, conventional banks are also engaged in IBF—both as a means of doing business with Muslims and as a growth opportunity for themselves. However, similar to the post-9/11 environment in which Islamophobia was rampant, the fallout of the atrocities committed by the so-called Islamic State in Europe and around the world has been that some Western banks and financial institutions have become wary of getting involved in IBF.[151] While this has surely slowed the growth of IBF, it has also been an opportunity for

147 TheCityUK, 'The UK: Leading Western Centre for Islamic Finance' (2015) 21.

148 For an overview of the IBF's presence in Europe and Asia (particularly Hong Kong and Japan) see Askari, Iqbal and Mirakhor (n 1) 23–24.

149 ibid 146.

150 S&P Global Ratings, 'Islamic Finance Outlook 2018 Edition' (S&P 2017) 4.

151 'GIFR 2017' (n 143) 43.

IFIs in the Muslim world to target their products and services to an ever-expanding Muslim population living in the West.[152]

At the state level, Islamic finance has become an important policy tool for governments. IBF can be used to implement policy approaches ranging from empowering Islamists to disenfranchising them.[153] The approach of the state is often correlated with the desires of its people who have turned to Islamic finance—whether it be after the demonisation of Islam in the wake of the September 11th attacks or in the aftermath of the contraction that followed the financial crisis of 2008. As part of these considerations, when Muslim countries have been awash with liquidity during boom years they would often seek to utilise their funds on the international stage—frequently through their sovereign wealth funds—in a *shariah*-compliant manner.

More and more Muslims, with a renewed sense of religious devotion, are seeking greater conformity between their faith and their lives in the modern world.[154] Islamic finance is the form this takes in the realm of commerce—especially for wealthy individuals who have the financial means to back this desire. Islamic finance has emerged as an avenue for Muslims wanting to reassert their Islamic identity.

3.4.1 Size & Growth

Despite the hype of recent years surrounding the breakneck speed of IBF's growth, in reality the industry had stagnated around the US$2.3 trillion mark at the end of 2016.[155] Predictions for the industry's future growth have varied wildly, from as low as US$3

152 See ibid, where it is explained how Kuwait Finance House set up a *shariah*-compliant bank in Germany and Habib Bank's plans for the UK. See also Askari, Iqbal and Mirakhor (n 1) 22, for other IFIs targeting European Muslims. For analysis of Muslims as a growing population segment in Europe see 'Europe's Growing Muslim Population' (Pew Research Center 2017).

153 See section 7.1 (*Policy Approaches*).

154 Frank Vogel and Samuel Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Kluwer Law International 1998) 5.

155 'GIFR 2017' (n 143) 37.

trillion[156] to as high as US$6.7 trillion by 2020.[157] The reality has been that 2016 was the third consecutive year in which the industry experienced single-digit growth.[158] The days in which the industry experienced growth rates of over 20% seem to be gone.[159]

Growth potential: Despite its lacklustre performance of late, most observers believe that Islamic finance is far below its true potential. Currently estimated at just over 1% of global financial assets,[160] Islamic finance is considered to be the preferred way of banking for just under a quarter of the world's population.[161] Significant portions of the Muslim population are currently excluded or under-served by conventional finance. This underscores the significant growth potential for Islamic finance and the opportunity to achieve greater financial inclusion for Muslims.

Moreover, Muslim populations are forecast to grow at about twice the rate of non-Muslim populations over the next 20 years. This means, by 2030, Muslims will make up over 26% of the world's projected population of 8.3 billion.[162] This is while less than a quarter of adult Muslims have a bank account and only 7% have access to formal financing.[163] Only about a quarter of banked Muslims do their banking on a *shariah*-compliant basis. This means that roughly 300 IFIs around the world have approximately 100 million customers.[164] Over 80% of Muslims do not have access to *shariah*-compliant

156 ibid.

157 S&P Global Ratings, 'Islamic Finance Outlook 2017 Edition' (2016).

158 Growth rates have been 7% for 2016, 7.3% for 2015 and 9.3% for 2014 according to 'GIFR 2017' (n 143) 36.

159 Growth rates were 28.6% for 2008, 26% for 2009, 19.1% for 2011 and 20.2% for 2012 according to ibid 37.

160 TheCityUK (n 147) 6.

161 PricewaterhouseCoopers, 'Shariah-Compliant Funds: A Whole New World of Investment' (2009).

162 TheCityUK (n 147) 17–18.

163 ibid 18.

164 'GIFR 2017' (n 143) 45.

banking.[165] This demographic statistic demonstrates that financial inclusion will be the key to IBF's growth.[166] It is estimated that 'by doubling the pool of Muslim customers to 200 million, the size of the industry will increase by 2.5 times to US$5.732 trillion'.[167]

Factors hampering growth: The flip-side of being integrated into the global economy is that IBF is impacted by the same factors. The global economy is faced with new challenges emerging from a changing political landscape, new monetary policy and financial regulations, continued downward pressure on oil prices, high regional tensions in the Middle East, and a general uncertainty in global economic outlook.[168]

An unpredictable administration in the United States has taken steps to move away from multilateralism towards unilateralism and 'America First' protectionism. Withdrawal of the US from the Paris climate accord (signed by 194 nations), the 12-nation Trans-Pacific Partnership, and the seven-nation Iran nuclear deal have all been triggered or threatened. In Europe, 'Brexit' discussions are formally underway between the UK and the EU. Germany only managed to form a coalition government after months of uncertainty. Anti-immigration and anti-Muslim sentiment is strong throughout Europe, and there is concern that this could lead to far-right parties gaining further political power and advancing protectionist policies.[169]

These developments are bad for the global economy in general, but hit the IBF industry particularly hard. Given the atrocities of the so-called Islamic State both in Europe and elsewhere, Islam is again demonised and vilified in the West and many Western

165 TheCityUK (n 147) 17.

166 See also Sami Ben Naceur, Adolfo Barajas and Alexander Massara, 'Can Islamic Banking Increase Financial Inclusion?' (IMF 2015) IMF Working Paper WP/15/31.

167 'GIFR 2017' (n 143) 45.

168 See eg ibid 42; Islamic Financial Services Board, 'Islamic Financial Services Industry Stability Report 2017' (2017).

169 IFSB Report 2017 (n 168).

financial institutions that were active in the IBF space in previous years are no longer showing any interest.[170]

Another factor impacting the growth of the IBF industry is the ongoing military conflicts and political tensions engulfing the Middle East. The unrest in places like Libya, Iraq, Syria, and Yemen has made any meaningful growth in these places impossible. Moreover, ever-escalating tensions between countries like Iran, Qatar, and Lebanon on the one hand and Saudi Arabia, UAE, Egypt, and Bahrain on the other are also not conducive to growth and prosperity in the region. An emerging trend away from pan-Islamism towards pan-Arabism in the politics of the region has made the cooperation between the Arab model of IBF and the various other centres of Islamic finance (such as Iran and Malaysia, and to a lesser extent, Turkey and Pakistan) more difficult.

The growth of IBF has also been hindered by the continued low price of oil. Over 80% of the world's Islamic finance assets are concentrated in ten oil-exporting countries.[171] Malaysia is the only significant player in the IBF market whose economy is not heavily dependent on oil prices.[172] The drop in oil prices has impacted public sector finances and related development projects. These projects have often incorporated IBF as a way of supporting an industry that has been viewed as indigenous with many local stakeholders.[173]

A final factor worth mentioning regarding the slowdown of IBF is that it has matured in key markets in which it is present. This means any further growth in those countries will depend on IBF's ability to attract those not willing to pay the 'piety premium' of Islamic finance and need further incentives to opt out of the superior returns and risk profiles of

170 See 'GIFR 2017' (n 143) 36.

171 ibid 40.

172 Samir Hijazi, 'Islamic Finance & Oil Prices: Where to Now?' [2016] *Business Islamica*.

173 ibid.

conventional banking.[174] Another important factor will be the general pace of economic growth in OIC countries. As the tide rises in these countries, it will lift IBF as well.[175]

3.4.2 IBF & Capitalism

'From the alphabet of Islamic symbols and beliefs can be fashioned a vocabulary of accommodation with a capitalist order.'

– Charles Tripp[176]

An issue that started with globalisation but still plagues IBF is its uncomfortable relationship with capitalism. The industry has not come to a defensible position that is convincing to the majority of Muslims. Indeed, in my experience, almost no Islamic finance conference or event takes place without someone (usually in the Q&A session) asking how Islamic finance is any different from the conventional.

While the expectation seems to be for IBF to be a distinct and genuine alternative to the capitalist financial system, the reality has been that IBF has become a niche part of it.[177] Indeed what is often cited as a symptom of this is bankers moving back and forth between conventional and Islamic banks, and most Islamic bankers receiving their initial training at conventional banks.[178] Mehmet Asutay says in this regard:

> Considering the original nature of IBF as an ethical financing system, it would have been expected that the direction of the convergence should have been from conventional finance and banking towards IBF, with the objective of moderating the excessive capitalist practices and financial as well as the economic crisis inclination inherently existing in the conventional banking and finance system. This is due to the fact that the value proposition of IBF is important for the establishment of a sound financial architecture.[179]

174 Vogel and Hayes (n 154) 6.

175 Askari, Iqbal and Mirakhor (n 1) 24–25. See also Aksak and Asutay (n 120).

176 Tripp (n 16) 149.

177 See Bill Maurer, *Mutual Life, Limited: Islamic Banking, Alternative Currencies, Lateral Reason* (PUP 2005) 39–42, on how IBF and conventional finance are 'densely interconnected' and an 'anthropology of entanglement' exists between the two.

178 See eg Irfan (n 37).

179 Asutay (n 24).

This situation has led to frustration and disappointment amongst those who were looking to IBF for a serious alternative to the dominant capitalist order. The adherents to this view had hoped IBF would not only 'reconstitute the financial power of Muslim communities, but would also restore the moral economy of Muslims, serving as the engine of equitable development for resource-poor regions of the Islamic world'.[180]

These hopes have not materialised. To the adherents, the fundamental logic that drives IBF is secular, materialistic capitalism and the sector's Islamic character is nothing but a sham. Although in technical compliance with *shariah*, IBF has done little to 'promote a distinctively Islamic ethos in contradistinction to the imperatives of capitalism'.[181] An Islamic scholar complains in this regard that:

> There is a total disregard for morality. The behaviour of Islamic banks should be shaped by morality—it is not an additional consideration as it is for conventional banks. Debt-based financing will not take us anywhere good. There is plenty of data to support this. The largest data is the financial crisis.[182]

Partly in response to such views, IFIs have sought to maintain charitable contributions and development assistance as part of their activities. Even if admittedly small, these charitable activities are important for IFIs as a means of reassuring people of IBF's religious merit and integrity.[183]

3.5 CONCLUDING REMARKS

Through globalisation, Islamic banking and finance has more or less been subsumed in the global financial order. As part of the global economy, IBF goes up and down with the global economic tide.

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180 Tripp (n 16) 148–49.

181 ibid 148–49.

182 Mehmet Asutay, 'Islamic Finance's Overreliance on the Banking Model' (How Ethical is Islamic Finance?, London, 21 February 2018).

183 Fuad Al-Omar and Muhammad Abdel-Haq, *Islamic Banking: Theory, Practice and Challenges* (Zed Books 1996) 109–14.

There are, however, certain trends that have a more significant impact on IBF compared to conventional finance. Oil prices are an example of this. With over 80% of global IBF assets concentrated in ten oil-exporting countries, oil price drops are acutely felt in the sector. This usually takes the form of cuts in public infrastructure spending in these oil-exporting Muslim countries. The flip-side of this is when oil prices are booming (eg during the lead up to the financial crisis) IBF also enjoys a boost as the overflowing coffers of IFIs allows them to participate in bigger projects with longer tenors. As a general trend, high oil prices lead to higher public spending and infrastructure expenditure which often involves IBF.

Another factor which particularly impacts IBF is heightened Islamophobia in the West following geopolitical events. For example, in the aftermath of the atrocities committed on 9/11 and by the so-called Islamic State, Islam—and IBF as a subset—found itself on the back-foot. This led to a cooling off of interest in the West and by Western institutions towards anything to do with Islam and IBF. But also led to a boost to IBF from a 'rallying around the flag' effect as a matter of increased religiosity or expression of Islamic identity during a time when it was felt that the faith was subject to Islamophobic vitriol. Coming under attack in this way has also had the effect of sharpening the minds of industry stakeholders in a focused effort towards rationalising and streamlining IBF.

IBF is also impacted by turmoil in the Middle East, which more broadly saps investor confidence in the stability and prosperity of the region. An emerging trend away from pan-Islamism towards pan-Arabism in the politics of the region has made the cooperation between the Arab model of IBF and the various other centres of Islamic finance (such as Iran and Malaysia) more difficult.

It appears that the greatest challenge faced by IBF in its current state is its struggle for authenticity. Despite its obvious overlap with ethical finance, it appears that IBF needs to

do more to genuinely earn its ethical stripes. The reality is that IBF and capitalism have emerged as strange bedfellows. As a result, IBF has not inspired a mass following amongst Muslim populations where a political push is absent. The general view is that religious considerations have taken a backseat to the pursuit of profits by Islamic banks.

A symptom of this is that product development at IFIs is in the hands of financial engineers—not Islamic economists or *shariah* scholars—who reverse-engineer them from the conventional. Islamic texts are later scoured for legitimisation. Religious considerations—like a tax inefficiency—are just another set of obstacles to be structured around. IFIs generally do not start by looking at Islamic economic principles then seek to formulate products that manifest them in practice. In addition to this form of product development, convergence between Islamic and conventional finance has been hastened through Islamic windows of conventional banks.

This approach has led to serious frustration amongst many industry observers who complain that IBF should not be striving to be a less-efficient version of the conventional banks contributing to a discredited global capitalist system which, in their eyes, has shown itself to be broken in the financial crisis.

In the following chapters I will look in more detail into the relative strengths and weaknesses in the bargaining positions of each of the stakeholders that has brought about this system.

CHAPTER 4: ISLAMIC PROJECT FINANCE

4.1	**PROJECT FINANCE SECTOR OVERVIEW**	**4.4**	**ISLAMIC PROJECT FINANCE INSTRUMENTS**
4.2	THE EMERGENCE OF IPF	4.4.1	*ISTISNA-IJARA* & *WAKALA-IJARA*
4.2.1	ENERGY INVESTMENT NEEDS	4.4.2	PROJECT *SUKUK*
4.2.2	OPTICS	4.4.3	*MURABAHA* & *TAWARRUQ*
4.2.3	LIQUIDITY SOURCE	**4.5**	**LEGAL ISSUES & RISKS**
4.2.4	DIVERSIFICATION OPTION	4.5.1	INTERFACE WITH CONVENTIONAL FINANCE
4.2.5	PRODUCT AVAILABILITY	4.5.2	GOVERNING LAW & DISPUTE RESOLUTION
4.2.6	*SUKUK* COMING ON-STREAM	4.5.3	TAX
4.3	**PROJECT OVERVIEW**	**4.6**	**CONCLUDING REMARKS**
4.3.1	SPONSORS & STRATEGIC IMPORTANCE		
4.3.2	FINANCING		

'Customers pay a piety premium to put a scholar between themselves and the hellfire. Similar to halal meat. You pay a premium for a sausage that has been stamped as halal, but no one wants to know how the halal sausage was made.'

– Islamic finance specialist in London office of international law firm

This chapter shows how the *halal* sausage is made. To provide practical insight into the Islamic project finance sector, I use an actual project to demonstrate what tensions arise in the sector and how stakeholders cooperate and compete to resolve them in line with their interests.

The chapter provides an overview of the project finance industry, its historical context, and how it came into interaction with Islamic finance. It explores the factors that have led to the emergence of Islamic project finance and have helped it grow. It then provides details of the particular project I am focusing on and discusses its strategic importance and how it was financed. To maintain business confidentiality and ensure candid responses from my interviewees, the transaction has been anonymised and is only referred to as the 'Project'.

The chapter provides insight into the Islamic finance instruments and techniques used to extend *shariah*-compliant funds to the Project. I demonstrate the practical steps industry

stakeholders take—and the lengths to which they go—to make the conventional compliant. I also highlight how certain activities have raised questions regarding Islamic finance's authenticity. The final section of the chapter examines some of the legal issues and risks that arise when Islamic and conventional financing is used in a single project financing.

4.1 PROJECT FINANCE SECTOR OVERVIEW

Prior to the 1970s, large-scale projects in many developing countries were often funded through official sources, such as governments, development institutions, and export promotion agencies. By the 1970s there was less public sector money available for these projects and private sector participation became more important.[1] As a consequence, countries turned to flexible financing techniques to develop the large-scale and capital-intensive energy, infrastructure, and industrial projects aimed at supporting their economic development. Project finance was one such technique.

But what is project finance?[2] Defining it has been a somewhat moving target, as the term's meaning has evolved over the years to adapt to macro-economic changes.[3] In 2015, John Dewar, a leading project finance lawyer, defined it as:

> The financing of a specific asset in which lenders look principally to the revenues generated by the operation of that asset for the source of funds from which loans will be repaid. The primary security for the loans consists of the assets of the project including,

1 Hossein Razavi, *Financing Energy Projects in Developing Countries* (2nd rev edn, PennWell Books 2007) ch 1.

2 For a full definition, which also cites a vast body of relevant work see Michael McMillen, 'Shari'a Compliant Project Finance: A Structural Overview' in Humayon Dar and Umar Moghul (eds), *The Chancellor Guide to the Legal and Shari'a Aspects of Islamic Finance* (Chancellor Publications Ltd 2009) para 2.2.

3 See eg Frank Fabozzi Peter Nevitt, *Project Financing* (7th rev edn, Euromoney Books 2000) 1; Scott L Hoffman, *The Law and Business of International Project Finance: A Resource for Governments, Sponsors, Lawyers, and Project Participants* (3rd edn, CUP 2007) para 1.01; Stefano Gatti, *Project Finance in Theory and Practice: Designing, Structuring, and Financing Private and Public Projects* (2nd rev edn, Academic Press Inc 2012) para 1.1; John D Finnerty, *Project Financing: Asset-Based Financial Engineering* (3rd edn, Wiley 2013) 1–2; ER Yescombe, *Principles of Project Finance* (2nd rev edn, Academic Press Inc 2013) para 2.2.

> most notably, the cashflow the project generates and the contracts that assure the stability of both its costs and its revenues.[4]

Benjamin Esty of Harvard Business School explains that 'project finance involves the creation of a legally independent project company financed with non-recourse debt (and equity from one or more sponsors) for the purpose of financing a single purpose, industrial asset'.[5] While each project financing is unique to the requirements of the parties involved, Esty's explanation highlights certain features shared by most projects. A legally independent special purpose vehicle (SPV)—referred to as the 'project company'—is set up to own the assets and liabilities of the project. This legal independence causes a financial separation between the sponsor(s) and the project company. Sponsors raise funds for their project on the basis of the project itself, rather than the assets of the sponsors. This means there will be no recourse to the sponsors for the liabilities of the project company (except where certain limited sponsor assurances, such as completion guarantees, are provided). As a result, capital providers will need to look solely to the cashflow and assets of the project for their repayment, not the balance sheet of the sponsors. The project's assets will be pledged as security to the financiers so they can have a clear claim on them without concern for the financial condition of the sponsors.

The downsides of project finance are said to be that it costs more, takes longer to arrange, restricts managerial flexibility, and requires greater disclosure.[6] In his book, Esty recounts a conversation with Bill Young, Head of BP Amoco's Specialised Finance Unit, who stated that 'the only people who prefer project finance are the ones who've never done

4 John Dewar (ed), *International Project Finance: Law and Practice* (2nd edn, OUP 2015) 1.

5 Benjamin C Esty, *Modern Project Finance: A Casebook* (John Wiley & Sons 2003) 25.

6 ibid 144.

a deal using project finance'.[7] But project finance remains the best available option for many capital-intensive projects that cannot be financed on their sponsor's balance sheet.

While there are claims that project finance actually predates corporate finance and dates back to Roman times and earlier still, it only really took off in the 1980s and 1990s.[8] In the 1990s, modern project finance spread rapidly from the United States to Europe and on to emerging markets in Asia, the Middle East, Africa, and Latin America. This growth continued and peaked just before the financial crisis of 2008.[9] By then, project finance was a well-established part of modern finance, with many of the world's leading international commercial banks and law firms setting up departments dedicated to it.[10]

The financial crisis had a significant impact on the project finance industry. In the ensuing 'credit crunch' several banks that were until then very active in the project finance space significantly reduced their involvement or withdrew from the market completely. The crisis spilled over from the financial sector into the wider economy and precipitated a prolonged recession. This prompted governments to intervene in the markets—through regulatory measures and massive quantitative easing—to stabilise the economy. This put project finance in dire straits. There were no public funds, as most governments were trying to manage growing public deficits and could not invest in capital-intensive infrastructure projects. There were no private funds, as commercial banks, who historically provided most of the capital for project finance, were dealing with the aftermath of the credit crunch. So, from a peak of US$4.5 trillion in 2007, the market for project finance and syndicated loans

7 ibid.

8 See eg DentonWildeSapte, 'A Guide to Project Finance' para 1.1 (2004).

9 Yescombe (n 3) para 2.3.

10 *Project Finance International* and *Infrastructure Journal* are two trade publications that are dedicated to the sector and rank law firms and banks active in the project finance space.

dropped to US$1.5 trillion in 2009. The project finance portion of the market declined from US$220 billion in 2004 to US$138 billion in 2009.[11]

Despite the global economic downturn, project finance recovered remarkably. Buoyed by strong demand for infrastructure projects and a continued need to extract natural resources, the project finance market made up much of its lost ground and by 2011 was close to its pre-crisis levels.[12] This remarkable recovery was only made possible by relying on sources of funding that had previously played only a marginal role in project finance transactions. In emerging markets, but in some cases even in OECD countries, these funds were provided by national, bilateral, and multilateral development institutions as well as export credit agencies (ECAs).[13]

4.2 THE EMERGENCE OF IPF

From different growth trajectories, project finance and Islamic finance began to converge—slowly at first in the mid-90s and rapidly post-9/11. Prior to this, Islamic finance did not have the bandwidth to be extensively used in large-scale long-term infrastructure project financings. This situation has now changed to such an extent that Islamic finance is a significant source of funds for the Middle East's growing project finance sector. The use of Islamic finance within a project finance structure came to be known as Islamic project finance, or IPF for short.[14]

11 Gatti (n 3) xv.

12 ibid.

13 John Dewar (ed), *International Project Finance: Law and Practice* (OUP 2011) v–vi.

14 Shibeer Ahmed and Sajjad Khoshroo, 'Islamic Project Finance' in Rahail Ali (ed), *Islamic Finance: A Practical Guide* (2nd edn, Globe Business 2014).

Project finance has socio-developmental potential and focuses on real assets, and is thus well-suited to Islamic finance.[15] Clear risk sharing structures and contractual certainty are key features of both project finance and Islamic finance.

In the 1970s and 1980s project finance in the Islamic world was done by governments, often with the help of the AAA-rated Islamic Development Bank (IsDB).[16] The focus shifted from public to private funds in the mid-1990s. The first IPF transaction—where Islamic and conventional funds were used in a single project-financed deal—was Pakistan's US$1.8 billion Hub River Power Project which had a US$92 million *istisna* tranche provided by Al-Rajhi Bank.[17] This deal proved the feasibility of co-financing a project with Islamic and conventional funds and was named *Euromoney*'s 'Deal of the Year' in 1994.[18] This was followed in 1996 with the US$2 billion Equate Petrochemical Project in Kuwait, which included a US$200 million *ijara* tranche provided by Kuwait Finance House.[19]

Between 2002 and 2008—following the September 11th attacks and prior to the financial crisis—there was an unprecedented growth in the project finance market in the GCC. The GCC turned to project finance to develop its natural resources and meet its infrastructure needs, thus becoming the world's biggest project finance market.

The desire by states to mobilise private finance (both conventional and Islamic) to develop public infrastructure created considerable opportunities for IPF. In the GCC,

15 Graham D Vinter, Gareth Price and David Lee, *Project Finance* (4th rev edn, Sweet & Maxwell 2013) 3–006. For a contrary view that says given project finance's 'Western orientation', with its fundamental debt-leverage principle, it takes 'no cognisance of certain Islamic principles', namely the *shariah* prohibitions against *riba* and *gharar*, see McMillen, 'Shari'a Compliant Project Finance' (n 2).

16 Ibrahim Warde, *Islamic Finance in the Global Economy* (2nd edn, EUP 2010) 185.

17 Esty (n 5) 416.

18 ibid 417.

19 See Benjamin Esty, 'The Equate Project: An Introduction to Islamic Project Finance' (2000) 5 Journal of Project Finance 7; Esty (n 5) ch 21.

Islamic finance made up nearly 40% of the total project finance market in 2015, compared to just over 12.5% in 2006.[20] These funds were offered by the Islamic windows of the conventional commercial banks as well as the local Islamic banks who extended funds in local currency, thus opening up an important new source of funds that had previously been untapped.[21] The convergence of Islamic finance and project finance was also helped by the entry of project finance powerhouses such as Citibank, Deutsche Bank, and HSBC into the Islamic finance market.

Today, in a majority of IPF transactions, the *shariah*-compliant tranche sits alongside a conventional finance tranche (which is usually larger). This is expected to remain the case for the foreseeable future as Islamic finance institutions (IFIs) often cannot (because of the size of the projects) or do not want to (because of diversification issues) finance projects in their entirety.[22]

IPF structures were used by the Abu Dhabi Water and Electricity Authority (ADWEA) in its integrated water and power plant (IWPP) projects such as Shuweihat S1 (UAE, 2001), Umm Al-Nar (UAE, 2003), and Taweelah A2 (UAE 2004). This model set a precedent for many of the IPF transactions that followed: Qatargas II (Qatar 2004), PetroRabigh (Saudi Arabia, 2006), and Al-Dur IWPP (Bahrain, 2009). This trend has continued for more recent deals such as Rabigh IPP (Saudi Arabia, 2009), SATORP Refinery and Petrochemical Project (Saudi Arabia, 2010), Riyadh PP11 (Saudi Arabia, 2010), Barzan Gas Project (Qatar, 2011), EMAL Aluminium (UAE, 2012), Sadara Refinery and Petrochemical Project (Saudi Arabia, 2013), and PetroRabigh II (Saudi Arabia, 2015).[23]

The rapid growth of IPF has been helped by a variety of factors as explored below.

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20 'Global Islamic Finance Report (GIFR) 2016' (Edbiz Consulting 2016) 259.

21 Vinter, Price and Lee (n 15) para 3–003.

22 McMillen, 'Shari'a Compliant Project Finance' (n 2) para 4.

23 Hamed Ghoddusi and Sajjad Khoshroo, 'Islamic Finance and the Energy Sector' (SSRN 2015) SSRN Scholarly Paper ID 2565812.

4.2.1 Energy Investment Needs

The International Energy Agency (IEA) estimates that the Middle East's energy demand will grow by 480 Mtoe (million tonnes of oil equivalent) by 2040. Despite electric cars claiming a growing share of the market, oil demand will continue to be fuelled by trucks, aviation, shipping, and petrochemicals.[24] Earlier estimates indicated that an annual investment of US$2 trillion was needed to meet the global energy demand. Out of this US$2 trillion, US$621 billion was needed in the oil sector and US$399 billion in the natural gas sector.[25] This makes the energy sector one of the largest receivers of global investments.

This creates an incredible opportunity for IPF, as a large portion of the world's oil and gas reserves are held by states with Muslim majorities.[26] For example, Saudi Arabia and Iran together hold over a quarter of the world's oil reserves and a fifth of its gas reserves. The populations of these two countries are almost exclusively Muslim and Islamic finance claims a 35% penetration rate in the Saudi banking sector and 100% penetration rate in Iran. These countries (as well as other resource-rich countries in the Middle East) are following aggressive plans to build midstream and downstream processing plants.[27] Additionally, the Middle East region will need to attract serious investments in the renewable energy sector.[28] Moreover, major Muslim populations live in low-income Asian and African countries. As

24 International Energy Agency, 'World Energy Outlook 2017' (2017).

25 International Energy Agency, 'World Energy Outlook 2014' (2014).

26 Hisham Khatib, 'Oil and Natural Gas Prospects: Middle East and North Africa' (2014) 64 Energy Policy 71.

27 Ghoddusi and Khoshroo (n 23).

28 See eg WE Alnaser and NW Alnaser, 'The Status of Renewable Energy in the GCC Countries' (2011) 15 Renewable and Sustainable Energy Reviews 3074.

the wealth in these countries grows,[29] they will need to improve energy efficiency and access through a major overhaul of their infrastructure.[30]

Given the capital-intensive nature of these energy infrastructure projects and locations in which they are needed, IPF is set to play an increasing role in energy investments going forward.

4.2.2 Optics

IPF's growth has been assisted in large part by the commitment of governments in the Middle East (and, to a lesser extent, Asia) to promote their domestic Islamic finance industry.[31] This commitment stems in part from the broader consumer demand in many Muslim countries for *shariah*-compliant financial services and products.

According to a banker working on IPF projects in the Middle East, a deal's 'optics' become important when the project is in a Muslim-majority country and a state entity is one of the sponsors.[32] There is a political and cultural desire in certain Middle Eastern projects, especially mega-projects with national significance, to promote Islamic finance.

IPF also enhances the credibility of projects by demonstrating the government's support for the transaction. Moreover, project sponsors who are looking to the IPO markets as a possible exit route, can enhance the attractiveness of their share offering by catering to the public's appetite and preference for *shariah*-compliance.[33]

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29 John Dewar and Mohammad Munib Hussain, 'Islamic Project Finance' in John Dewar (ed), *International Project Finance: Law and Practice* (2nd edn, OUP 2015) para 11.01.

30 See eg Tommi Ekholm and others, 'The Effect of Financial Constraints on Energy-Climate Scenarios' (2013) 59 Energy Policy 562 where the impact of financial constraints on the access to electricity in Sub-Saharan Africa is discussed. See also IEA Outlook 2017 (n 24).

31 See eg section 7.2 (*Policy Drivers*).

32 Esty (n 5) 416–17.

33 'Global Islamic Finance Report (GIFR) 2010' (Edbiz Consulting 2010).

4.2.3 Liquidity Source

Given their infrastructure and development needs, the projects undertaken in the GCC are often large and capital-intensive—requiring billions of dollars and sometimes in excess of US$10 billion.[34] In the past, these amounts were funded by the public sector or by the Western conventional project finance powerhouses (such as Citibank, Crédit Agricole, Deutsche Bank, HSBC, and Société Générale).

In the aftermath of the credit crunch, there was a retrenchment from Western banks who were no longer able to fund long-term project financings because of lack of liquidity and enhanced capital adequacy controls and restrictions.[35] So project sponsors in the Middle East had no choice but to tap their domestic banks and financial institutions. These domestic institutions had access to significant funds they had accumulated during the oil boom and could thus lend at relatively low rates because they had a lower cost of funds and did not have to worry about capital adequacy issues.[36]

Many of these domestic institutions are run on a *shariah*-compliant basis and can only participate in these projects through IPF. Thus, the Islamic tranche—though still often small, between 3% to 20% of the overall funding package—has become an indispensable piece of the finance puzzle for many Middle Eastern projects.[37]

Our Project was mentioned by a number of lawyers involved in the transaction as the perfect example of this, whereby sponsors needed to raise amounts in excess of US$10

34 Interview with Lawyer15, 'Partner with Islamic Finance Specialisation in London Office of International Law Firm' (30 April 2015) notes that the trend has been that projects are getting 'bigger and bigger' needing much more financing to be raised.

35 Dewar (n 4) para 11.01.

36 Interview with Government Official04, 'Legal Counsel at a Leading National Oil Company' (13 May 2015).

37 Interview with Islamic Banker26, 'Senior Islamic Banker' (14 October 2014).

billion which could not be done from conventional and foreign sources alone, so they tapped the domestic Islamic banks and capital markets for around 20% of the funds.[38]

Many lawyers I interviewed believed that the main benefit of using Islamic finance is to unlock the domestic liquidity that would otherwise be unavailable.[39] Indeed, some practitioners argue that given the 'bogus' structures often used in IPF—where pricing comes down to interest plus margin, thus 'making a mockery of the idea that interest is bad'—Islamic finance 'has merit only as a source of liquidity'.[40] In fact, Islamic bankers state that many of the new structures developed for IBF have been 'devised as ways of getting access to the red-hot pot of cash sitting in the Middle East'.[41]

Observers watched to see if IBF would be effected by the crash in oil prices in early 2015 (when prices fell from around US$100 to US$40 per barrel), but prices have since somewhat recovered to around US$60 per barrel and are on an upward trend, albeit modestly so. Given this recovery, my sources in the Saudi government did not believe that oil prices would have an effect on the liquidity of the domestic banks, or on the broader IBF industry. However, they agreed that a sustained price depression would impact liquidity and consequently IBF.[42]

4.2.4 Diversification Option

Besides providing an additional source of funds, IPF also helps with diversification. Research has shown that conventional and Islamic banks show different risk profiles and

38 Interview with Lawyer06, 'Partner at London Office of International Law Firm' (3 February 2015).

39 See eg ibid; Interview with Lawyer01, 'Senior Partner at London Office of International Law Firm' (3 February 2015); Interview with Lawyer13, 'Senior Associate and Islamic Finance Specialist in London Office of International Law Firm' (31 March 2015).

40 Interview with Lawyer01 (n 39).

41 Interview with Islamic Banker11, 'Prominent Islamic Banker' (22 April 2015). See also 'Global Islamic Finance Report (GIFR) 2017' (Edbiz Consulting 2017) 37.

42 Interview with Regulator03, 'Senior Regulator in Saudi Arabia' (14 May 2015).

exposures to global crises.[43] Thus, when one source of financing becomes limited (eg in the aftermath of the financial crisis), sponsors can raise more funds from the alternative source. Again, our Project is a perfect example this. This is what the head of finance at the project company had to say about raising the required funds from a diverse range of sources during a difficult time:

> [During the financial crisis,] market conditions impacted lending capacity for Saudi banks as they became reluctant to lend in US dollars due to high funding costs. While I wanted to maximise ECA funding, this tranche was very much reliant on eligible content. To overcome this challenge, the sponsors developed a funding strategy whereby mandated lead arrangers (MLAs) were asked to commit at high levels at the beginning of the process to cover potential shortfalls from other tranches. Down the road, and as other tranches developed, the sponsors made a massive scale back to the banks' commitments—to as low as US$50 million. … The *sukuk* also helped scale back bank commitments. As a result of our [diversification] strategy, we were able to achieve a fully-funded finance plan.[44]

The fact of diversification is clear, what is less clear is the intention behind it. Excluding the *sukuk*, the other three Islamic tranches raised only 5% of the funds. These tranches were documented across over 30 documents spanning hundreds of pages—as, contrary to the conventional facilities which are documented as a loan in a single document, the Islamic facilities are structured as procurement and leasing arrangements across at least six documents (but often more). These documents were not only drafted, but were also reviewed, commented on, and revised by six law firms (operating out of London and Saudi Arabia), as well as in-house counsel at each of the sponsors and the banks acting as documentation banks and facility agents; not to mention the *shariah* scholars, who required the documents for the *wakala-ijara* tranche to be translated into Arabic for their review. There are also numerous other ancillary documents that need to be entered into with the Islamic banks such as various fee letters, process agent appointment letters, and so on.

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43 Maher Hasan and Jemma Dridi, 'The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study' (IMF 2010) IMF Working Paper WP/10/201; Hossein Askari, Zamir Iqbal and Abbas Mirakhor, *Globalization and Islamic Finance: Convergence, Prospects and Challenges* (John Wiley & Sons 2010).

44 Interview with Government Official48, 'Head of Finance Division at Leading National Oil Company' (4 November 2013).

Moreover, there are numerous knock-on effects across the entire suite of documents to ensure this group of participants is dealt with on a *pari passu* basis with all others. One example of this is the change in terminology required to all documents (even the conventional ones), whereby the entire group of financiers are not to be called 'lenders' as the Islamic banks are not, strictly speaking, 'lending' money, but have rather leased an asset in exchange for rental income. Thus, more generic terms such as 'participant' or 'financier' are used in all the documents, which are departures from the LMA standard forms.

Practitioners believe this method of diversification is used by the project sponsors to bring in their relationship banks. Sometimes these relationship banks are domestic Islamic banks and can only be brought into the project via a *wakala* tranche.[45] This form of diversification also allows the sponsors to spread around their business to a large range of entities and in the process also make up their required funding package.[46]

4.2.5 Product Availability

IPF's growth was made possible by the emergence of dedicated Islamic finance institutions offering a broad range of products developed to utilise a project's underlying tangible and intangible assets in a *shariah*-compliant but conventional-compatible manner.[47]

With globalisation, it became clear that *shariah* compliance needed to be achieved in harmony with various secular legal systems.[48] Around the same time a significant number Western trained professionals such as lawyers, bankers, accountants, and asset managers entered the field of Islamic finance. Through close interaction with these professionals,

45 Interview with Lawyer49, 'Partner with Islamic Finance Specialisation in London Office of International Law Firm' (16 June 2015). For further explanation of this phenomenon see section 7.3.3 (*Using State-connected Entities)*.

46 Interview with Lawyer09, 'Partner and Head of Islamic Finance at London Office of International Law Firm' (9 February 2015).

47 Sajjad Khoshroo, 'Islamic Project Finance: Rapid Growth in the Middle East' (2013) 10 *Islamic Finance News* 31.

48 See section 3.1.2 (*Product Development*) for further details.

shariah scholars gained significant hands-on experience in a wide range of financial products of increasing complexity.[49] All of this led to a transformative move away from the historical rigidity of static nominate contracts towards using those contracts as building blocks for innovative new combinations and products.[50] An example of this is the development of the *tahawutt* (Islamic hedging) agreement in 2010.[51]

4.2.6 *Sukuk* Coming On-stream

Developments in *sukuk* generally and project *sukuk* specifically have been a huge boost for Islamic project finance. *Sukuk* has become a source of funds for project companies as well as a liquidity management tool for Islamic banks to allow them to invest in project financings.

The global financial crisis precipitated a slowdown in bank finance which was further exacerbated by Basel III capital adequacy rules.[52] This meant project companies were not adequately served by the wholesale bank sector and had to turn to other sources to meet their funding requirements. Capital markets became a viable option, whether in the form of conventional bonds or Islamic *sukuk*.[53]

Project *sukuk* specifically has been welcome as a key source for plugging the funding gap. Project *sukuk* is often cheaper to issue and a cheaper source of funds, making it an

49 See eg Harris Irfan, *Heaven's Bankers: Inside the Hidden World of Islamic Finance* (Constable 2014) ch 1.

50 McMillen, 'Shari'a Compliant Project Finance' (n 2).

51 Richard Fagerer, Michael Pikiel and Michael McMillen, 'The 2010 Tahawwut Master Agreement: Paving the Way for Shari'ah-Compliant Hedging' (SSRN 2012) SSRN Scholarly Paper ID 1670118.

52 Dewar and Hussain (n 29) para 11.63.

53 Yousif Haider, 'The Next Frontier: Project Sukuk' (*Zawya*, 2013).

attractive option for project companies looking to raise financing at the lowest possible cost.[54]

In addition to the better pricing, project *sukuk* has the added advantage that it subjects the project company to only limited managerial interference and oversight by the *sukuk*-holders, compared to the active managerial involvement and long list of restrictions imposed by project financiers.[55]

Sukuk are also quite versatile and attract a wider range of Muslim and non-Muslim investors from around the world. There is nothing inherent in the *sukuk* structure that would limit its appeal to Muslim investors. *Sukuk* can be issued by institutions anywhere in the world and purchased by investors anywhere in the world.[56]

In this way project *sukuk* has given project companies access to investors, such as pension funds, who need to match their long-term liabilities with long-term investments. This is while Islamic banks have been dependent on relatively short-term customer deposits, which in some cases discourages them from participating in projects with long-term tenors for fear of maturity mismatch. Indeed, liquidity management has been, historically, one of the biggest challenges faced by Islamic banks.[57] This fear has been exacerbated by the lack of mature capital markets in the Middle East on which Islamic banks could readily draw, in the absence of a liquid inter-bank lending market. In this environment, project *sukuk* has emerged as an effective tool for alleviating the liquidity and maturity mismatch concerns of Islamic banks.

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54 See ibid., where it is said that, 'the price of a *sukuk* can be as much as 20 basis points lower compared to the pricing on a conventional bond'.

55 Shibeer Ahmed, 'Project Sukuk' in Ali Rahail, *Sukuk and Islamic Capital Markets: A Practical Handbook* (Globe Business 2011). See also Dewar and Hussain (n 29) para 11.71.

56 Dewar and Hussain (n 29) para 11.23.

57 Ghoddusi and Khoshroo (n 23).

Another way in which *sukuk* indirectly helps the IPF sector is by providing Islamic banks with a high quality and *shariah*-compliant place to park some of their funds, which frees up other capital to invest in more risky project financings. This is why many of the Islamic banks are also heavily invested in *sukuk* and many issuances in the Middle East are heavily over-subscribed. While most Islamic banks are 'buy-to-hold' *sukuk* investors, a nascent secondary *sukuk* market is now emerging which will further help the development of this sector.

4.3 PROJECT OVERVIEW

To better demonstrate the intricacies of the IPF sector, I have chosen to focus on a major project finance transaction, incorporating a significant Islamic finance portion, recently undertaken in Saudi Arabia. The Project was a joint venture between Saudi Arabia's national oil company (NOC) and a major international oil company (IOC). I have chosen this transaction because it provides a great opportunity to study the interaction between *shariah* scholars, international lawyers and bankers, international businesspeople at the IOC, and government officials (at the Capital Market Authority of Saudi Arabia (CMA) and those setting policies for the NOC). Given the sheer size of the Project, Islamic banks worked alongside conventional banks to raise the necessary funds. This provided an excellent opportunity to study the interaction between conventional and Islamic finance.

4.3.1 Sponsors & Strategic Importance

As one of the largest project financings ever arranged in the international finance markets, and the largest project financing ever in the Middle East, the Project has key strategic importance for Saudi Arabia, the NOC, and the IOC.[58] Much planning went into the Project—more than six years spanned between the signing of the memorandum of understanding and financial close.

58 The NOC and IOC together are referred to as the Sponsors.

Saudi Arabia is the world's largest oil exporter and holds about a fifth of global oil reserves.[59] The country's economic policy is targeting a sustained, balanced economic growth, maintaining low levels of inflation, and achieving the best allocation of resources for all sectors. The Project will play a key role in the Kingdom's industrial and economic diversification and will create significant direct and indirect employment opportunities for Saudi citizens. At peak construction 50,000 workers will be on the ground. When completed, the complex will be one of the world's largest integrated chemical facilities.

The Project will leverage the Kingdom's competitive advantages in the production of petrochemical feedstocks and base chemicals to move further along the value chain towards finished goods. Total production will amount to approximately 3 million metric tonnes per year of high-value chemical products and performance plastics, which are expected to generate approximately US$10 billion per year in revenues.

The NOC and IOC offer world-class sponsorship of the Project, combining the NOC's strengths as a reliable feedstock supplier with the IOC's superior downstream product technologies and world-class operational and marketing capabilities. The NOC is a petroleum company wholly owned by the Saudi government. It has been a world leader in hydrocarbons exploration, production, refining, and shipping. It employs more than 50,000 people worldwide and manages some of the world's largest oil and gas reserves—used as feedstock for the Project. The IOC brings to the table cutting edge technology and project expertise as well as a global marketing and distribution network spanning 160 countries. It employs approximately 54,000 people worldwide, has 188 manufacturing sites in 36 countries, and produces approximately 5,000 products.[60]

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59 'Country Analysis Brief: Saudi Arabia' (US Energy Information Administration 2014) cited in 'Worldwide Look at Reserves and Production' [2015] Oil & Gas Journal.

60 The statistics for this section have been obtained from the Project's publicly available prospectus. This has not been cited to preserve the anonymity of the Project.

4.3.2 Financing

The funding for the Project was on a mammoth scale and was raised from a variety of sources. The debt-to-equity ratio of the Project was 65:35, meaning the Sponsors provided 35% of the overall funds by way of equity capital, subordinated shareholder loans, and equity bridge financing. The remaining 65%, which exceeded US$10 billion, was raised through banks and capital markets, conventional and Islamic, public and private sources.

For the bank financing, seven ECAs were involved, alongside 28 commercial banks. Three ECAs provided around 50% of the overall financing through direct loans. The remaining ECAs provided cover (by way of risk insurance) for 17% of the financing. This financing was provided by banks located throughout the world, from Japan to America.

The local versions of the international banks also participated in the conventional ECA-covered tranches, but provided the financing in the local currency, the Saudi Arabian Riyal (SAR). An additional 12% of the funds were provided by commercial banks (in SAR and USD) without ECA cover. A national development fund made up a further 12% by way of a direct loan at a favourable 'commission' rate—a euphemism used to avoid the term 'interest', similar to how 'financier' is used to avoid the term 'lender'.

A mere 5% of the bank financing was provided by the Islamic banks. The breakdown being 4% provided by the Islamic windows of the conventional banks (in SAR and USD under the *istisna-ijara* structure), and less than 1% provided by the local Islamic banks (in SAR only under the *wakala-ijara* structure).

The *sukuk* element was sizeable and was the equivalent of around 20% of the bank financing. The *sukuk* was issued on the Saudi stock exchange, the Tadawul, and was oversubscribed by just under three times. Three local banks and one Islamic window acted as the joint lead managers for the issuance. The minimum holding of the *sukuk* was SAR1

million (approximately US$267,000) and could only be purchased by Saudi institutions and investors. In reality, a small and select number of Saudi institutions purchased the entire offering.[61]

The Project also benefited from a whole host of advisors. There were two joint *shariah* advisory boards (representing more than one Islamic bank) and two independent ones, each issuing a *fatwa* confirming the *shariah*-compliance of the *sukuk* and the Islamic bank financing structures. Seven international and local law firms were involved, meaning over 150 lawyers billed time to the Project by the time it was closed.[62]

As typical of any Project of this size, technical, environmental, market, insurance, and financial advisors also played important roles advising the financiers on various aspects of the Project. The magnitude of the undertaking and the number of advisors involved gives an understanding of the size of the beast—as we will see, there was no way a handful of *shariah* scholars were going to be holding up this steamroller.[63]

On the finance side, the size, complexity, and cost of these projects necessitates the involvement of many participants—each of whom must gain commercial comfort on its level of risk exposure. Risks are typically allocated to participants according to their role in the transaction and by who is best placed to assume it.[64] Given the magnitude of the Project, the capital requirements exceeded the capabilities and exposure limits of any single

61 The significance of this is analysed in section 7.3.3 (*Using State-connected Entities*).

62 To provide a sense of scale, the Project and its financing arrangements were documented over around 25,000 pages across over 300 contracts.

63 See section 5.3.1 (*Lawyers*).

64 Dewar and Hussain (n 29) para 11.24.

institution, and thus required financing groups. The Project's international scope required compliance with multiple legal systems.[65]

All finance parties (in many cases through agents) signed up to a common suite of finance documents that regulated their relationship with the project company and with each other. These finance documents included the Common Terms Agreement (CTA), the Intercreditor Agreement, the Accounts Agreement, the Completion Guarantees, and the Security Documents (Onshore and Offshore).

The CTA sets out the overall framework for how the various sources of initial financing and (if needed) additional financing will be used and the conditions that need to be satisfied by the project company to draw on these funding facilities. It also regulates how the project company is to make its repayments and prepayments (on a voluntary or, in certain circumstances, mandatory basis).

The CTA provides for the payment of 'commission'—a common euphemism for 'interest' in documents where both Islamic and conventional financiers are present. Under the CTA the various finance parties all benefit from, among others, a package of: (i) common information undertakings; (ii) common positive and negative undertakings; and (iii) common events of default. Our Project's CTA is governed by English law and provides for arbitration under the ICC rules as the means of dispute resolution.

The Intercreditor Agreement coordinates the relationship between the finance parties, including on issues such as the ranking of 'debt',[66] voting and decision-making procedures among the finance parties, sharing in security over the Project and the proceeds of

65 As is typical in IPF transactions, see eg Michael McMillen, 'Islamic Project Finance' in Kabir Hassan and Mervyn Lewis (eds), *Handbook of Islamic Banking* (Edward Elgar 2007).

66 It is inappropriate to refer to funds raised from the Islamic banks as debt as they are structured as a lease, but this often occurs for ease of documentation.

enforcement against such security. The Accounts Agreement regulates the various onshore (denominated in SAR) and offshore (denominated in USD) bank accounts required for the Project and the 'cash-waterfall' that determines how the money flows in and out of the project company's accounts.

Pursuant to the Completion Guarantees, prior to the project completion date—ie the date that the construction of the project is completed and all relevant tests evidencing the same are satisfied—the NOC and IOC will guarantee (proportionate to their ownership share) the obligations of the project company to pay principal, commission, and other financing costs payable to the finance parties.

Pursuant to the suite of security documents, the project company will grant security over certain of its assets (including its contractual rights) to the onshore security agent and the offshore security agent, each of whom will hold such security for the benefit of the finance parties. To the extent that these security interests are enforced, each finance party is entitled to a *pro rata* share of the proceeds of such enforcement, subject to the priorities specified in the Intercreditor Agreement.

4.4 ISLAMIC PROJECT FINANCE INSTRUMENTS

To provide a better understanding of IPF and how this '*halal* sausage' is really made, I take a detailed look at the Islamic finance instruments used in the Project. I cover lease-sale arrangements (*istisna-ijara* and *wakala-ijara*), cost-plus sales (*murabaha* and *tawarruq*) and a participatory bond (*sukuk*).[67] I demonstrate how each instrument is structured through a diagram and step-by-step guide. I explore the legal, regulatory, and *shariah*-compliance issues that come up with such instruments and how the lawyers, bankers, and *shariah* scholars

67 Other structures, such as the *musharakah* and *mudarabah* are not frequently used in project finance and are not covered in this dissertation. For insight into these structures see eg Julian Johansen and Atif Hanif, 'Musharaka and Mudaraba' in Craig Nethercott and David Eisenberg (eds), *Islamic Finance: Law and Practice* (OUP 2012); Dewar and Hussain (n 29) paras 11.15–16, 11.73.

structure around these limitations. This provides a technical understanding of how these complex instruments work and why they are sometimes criticised as being 'form over substance'.[68]

But first things first. At the outset, before the Islamic finance instruments can be incorporated into the Project, certain general structuring issues must be resolved. These include determining the viability of the Project and its appropriate tax structures in each relevant jurisdiction, identifying the participating parties and advisors, negotiating the commercial terms and the relevant term sheets, and structuring to meet other regulatory (particularly bank regulatory), tax, legal and accounting requirements.[69]

Afterwards, the transaction's structure is presented to and discussed with the financiers and their lawyers. The main financiers include ECAs and commercial banks, both conventional and Islamic. The IFIs include both local Islamic banks and Islamic windows of conventional banks. There are usually two forms of presentations made to the financiers: first, a diagram setting out the structure and documentary relationships; and, second, a 'risk grid' focusing on underwriting factors and risk coverage.

The presentation provides an overview of some basic *shariah* principles, such as the prohibition of *riba* and *gharar*, noting that the IFIs can neither pay nor receive interest. It also lays out the manner in which the Islamic finance documents are constructed. This basically constitutes taking the key provisions from the conventional loan documents and replicating them for the Islamic documents in *shariah*-complaint terms (eg a lease rather than a loan, sale and purchase undertakings rather than voluntary and mandatory prepayments). These replicated provisions are incorporated into a 'skeleton structure' that is based on a

68 This section on IPF instruments is based generally on Ahmed and Khoshroo (n 14); Ghoddusi and Khoshroo (n 23).

69 For further details see eg McMillen, 'Islamic Project Finance' (n 65).

previous precedent Islamic finance transaction and thus broadly acceptable to the *shariah* board of the relevant IFI.

The risk grid is essentially a table that lists the key provisions contained in the suite of conventional finance documents on one side and how the provision is addressed in the suite of Islamic finance documents on the other. This is often not a straightforward exercise as what is typically covered in a single conventional loan agreement needs to be covered in numerous separate *shariah*-compliant agreements.

When a conventional loan is 'translated' into a *shariah*-compliant one through an *istisna-ijara* (lease-sale) arrangement, it is documented in the following contracts: (i) the procurement agreement (where terms for drawing down the facility are replicated); (ii) the forward lease agreement (where the repayment terms are replicated); (iii) the investment agency agreement (which regulates the relationship with the facility agent and between the IFIs); (iv) the purchase undertaking (which replicates the mandatory prepayment provisions for events such as total loss or illegality); (v) the sale undertaking (which replicates the voluntary prepayment provisions); and (vi) the service agency agreement (which replicates the insurance and maintenance provisions). Of course, it is common for there to be many additional side letters and undertakings associated with the suite of Islamic finance documents. It is also common for there to be more than one Islamic facility.[70]

This grid allows the credit and underwriting committees of each of the financiers—who are the ultimate gatekeepers who determine which transactions each bank gets involved with—to understand exactly how each risk typically covered in their suite of conventional finance documents is covered in the suite of Islamic finance documents. This is an important example of how bank regulators are steeped in the logic of conventional finance and need to understand the conventional equivalents before approving any *shariah*-

70 For reasons this may occur see Dewar and Hussain (n 29) paras 11.28.

compliant structure. This is why Islamic finance documents take conventional documents as a starting point and reverse-engineer them to eliminate the provisions that explicitly violate the *shariah* and replace them with provisions that achieve the same commercial outcome through *shariah*-complaint provisions.

The following sections demonstrate by way of diagrams and step-by-step guides the structures of the most commonly used instruments in Islamic project finance.[71] The numbers used in step-by-step guides correspond with the numbers in the diagrams. Solid lines denote contractual relationships and contract names respectively. Boxes with black names denote contractual parties. Dotted black lines and names denote transfers of funds or title. Detailed explanation of noteworthy considerations have been moved to the footnotes to assist with following the step-by-step description of the structure without the distraction of additional explanations. These explanations, however, provide important insights into why things are structured the way they are and should not be ignored.

The guides may appear complex and convoluted, but have been—believe it or not—simplified to demonstrate the multistep dance that occurs to make the conventional compliant. As mentioned, what is covered by each of these products over a number of documents, is typically achieved by a more or less standard facility agreement in conventional finance. This is part of the reason why an Islamic structure can never be as efficient as its conventional counterpart. The 'form over substance' concerns come up with the numerous hats the project company wears in each structure (eg the project company is the procurer, lessee, and service agent in the *istisna-ijara* structure). In a conventional financing, the project company is usually just the borrower.

71 These diagrams and guides have been previously published in slightly modified form in Ahmed and Khoshroo (n 14). More detailed descriptions can be found in McMillen, 'Islamic Project Finance' (n 65); Craig Nethercott and David Eisenberg (eds), *Islamic Finance: Law and Practice* (OUP 2012).

4.4.1 *Istisna-Ijara* & *Wakala-Ijara*

The *istisna* (procurement/construction) and *ijara* (lease) combination—and, to a lesser extent, the *wakala-ijara* combination—are the most commonly used Islamic finance structures in large long-term energy projects. These structures are well-suited to multi-sourced financings of capital-intensive energy projects. With these structures the Islamic financiers can match their inward and outward cashflows with that of their conventional counterparts. The IFIs do this by coordinating their phase payments under the *istisna* and *wakala* contracts with the drawdown schedules under the conventional loan facilities, and their rental payments under the *ijara* with the repayment schedules under the loan facilities.[72]

During a project's construction phase, the *istisna* is used as a forward sale contract for the construction (or procurement) of an asset. Once the asset constructed/procured by way of the *istisna* is completed, it is leased to the project company under the *ijara* contract. This *istisna-ijara* structure has been in frequent use since 2000 and has achieved a measure of standardisation. It has been used in some of the Middle East's major project financings such as PetroRabigh II (2015), Sadara (2013), Barzan (2011) and SATORP (2010).[73]

For some *shariah* boards (often attached to local banks in Saudi Arabia) the *wakala-ijara* structure is preferred to the *istisna-ijara.* This is because these *shariah* boards view the *istisna-ijara* arrangement, whereby the project company acts as the procurer of the assets and then leases those same assets to itself, as a bit too fictitious for their liking. Instead, in the *wakala* (agency) structure, the project company acts as the *wakil* (agent) of the Islamic financiers in arranging for the EPC contractor to construct the relevant assets. This structure was used (alongside an *istisna-ijara*) in Riyadh PP11 and Rabigh IPP as well as SATORP and Sadara.[74]

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72 Sajjad Khoshroo, 'Islamic Project Finance: Down but Not Out' [2015] *Islamic Finance News* 45.

73 Khoshroo, 'IPF: Rapid Growth in the Middle East' (n 47).

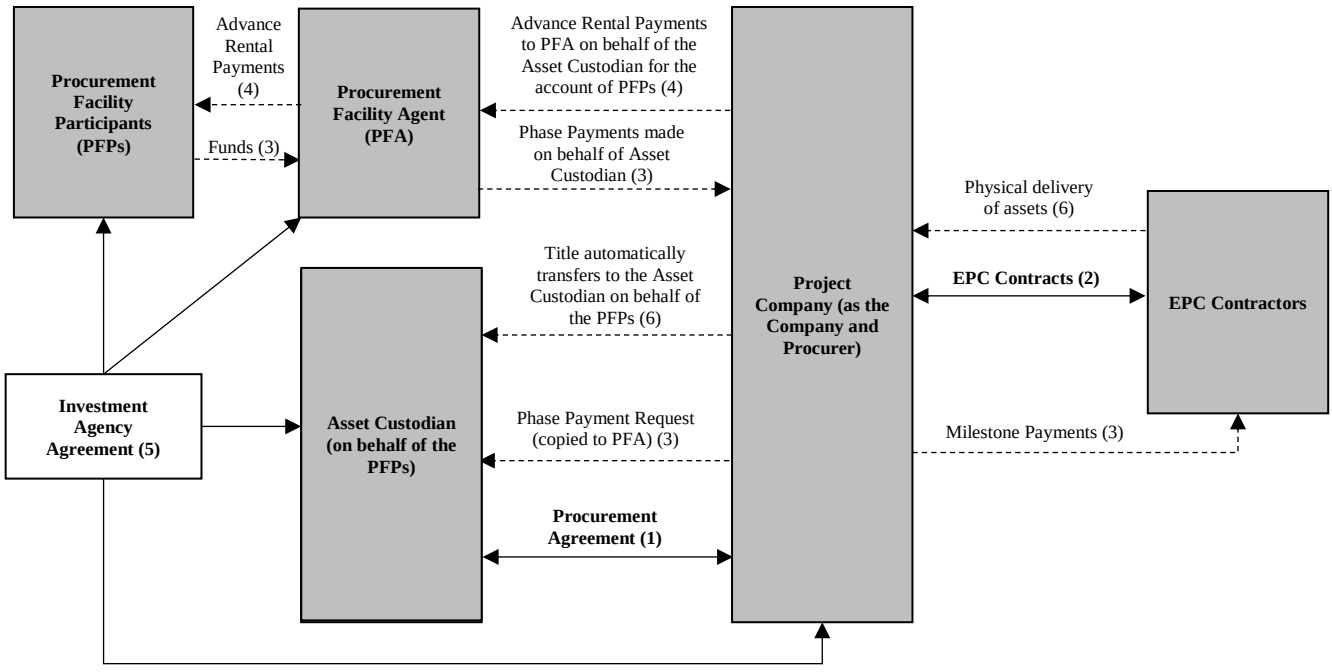
74 ibid.

As is typical in asset-based Islamic finance instruments, both the *istisna-ijara* and *wakala-ijara* structures require underlying assets to be financed. However, in practice, instead of making a genuine determination as to the assets the project requires and sizing the Islamic tranche accordingly, the process is reverse-engineered by determining the intended size of the proposed Islamic facility and then earmarking a matching portion of the project assets. In the *istisna-ijara* facility these are often expressed as a percentage of the overall project assets, or a short-form list of assets in bullet point format. The *wakala-ijara* facility usually provides a full list of assets accompanied by detailed technical specifications. Clearly identifiable assets are preferred and can include things like turbines, liquefaction and refrigeration units, storage tanks, and offshore oil and gas platforms.[75]

4.4.1.A Istisna-Ijara Structure

The *istisna-ijara* structure is best explained by looking at it over the construction period and the operation period.

Construction period:



75 Sajjad Khoshroo, 'Key Differences between Istisnah and Wakalah Structures' (2013) 10 *Islamic Finance News* 20.

Figure 2: Construction Phase of *Istisna-Ijara* Structure

1. Under the *istisna* contract, often referred to as the Procurement Agreement, the project company[76] (in its capacity as the 'procurer') agrees to procure the construction, development, and delivery of the procurement facility assets to the asset custodian.[77] The asset custodian will hold these assets, the value of which corresponds with the size of the procurement facility, on behalf of the procurement facility participants. The procurement facility participants are the Islamic finance institutions participating (ie providing the financing to the project company) under the procurement facility. The project company (as procurer) commits to deliver the procurement facility assets in accordance with the specifications of the EPC contracts and by the scheduled project completion date.[78]

2. The project company (as procurer) enters into the EPC contracts[79] to procure the construction, development, and delivery of the procurement facility assets.

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76 As set out in section 4.1 (*Project Finance Sector Overview*), the project company is a legally independent SPV set up to own the assets and liabilities of the project. This legal independence causes a financial separation between the sponsor(s) and the project company. The project company wears multiple hats (ie fulfils multiple roles) under each of the various documents. In reality it is the entity that 'borrows' the money from the various financiers.

77 It is common practice (particularly in Saudi Arabia) to establish a SPV to hold title to the Islamic financed assets. This entity is usually known as an 'asset custodian' or 'asset agent'. This arrangement has benefits for both the project company and the Islamic financiers. For the project company, it means that the assets are not held by the Islamic financiers directly—isolating the asset from the risk of insolvency of an Islamic financier. For the Islamic financiers, it serves to protect them from risks associated with asset ownership (such as environmental or third party liabilities).

78 If the asset is not delivered as scheduled or an event of default occurs causing the procurement facility participants to terminate the Procurement Agreement, then the project company will be obliged to pay liquidated damages to the procurement facility participants. This amount is often referred to as the 'termination sum' and is equal to: (i) in the case of delay, the lease payments the procurement facility participants would have received had the lease commenced as scheduled; and (ii) in the case of termination, all amounts paid by the procurement facility agent (including the phase payments and any refund of advance rental payments) to the project company to procure the assets. This is effectively the *shariah*-compliant method of acceleration during the construction period.

79 This is an example where *shariah*-compliance is 'fudged'. Construction contracts are usually highly standardised, and not *shariah*-compliant. It is economically impracticable to get an EPC

3. Upon receiving a phase payment request from the project company (as procurer), the asset custodian (acting through the procurement facility agent[80] who is acting on behalf of the procurement facility participants) makes phase payments to the project company (as procurer) in the amount of the milestone payments required to be made under the EPC contracts. These payments are structured to be the equivalent of loan drawdowns under the conventional facilities and will be subject to the same conditions precedent.

4. The project company (as the 'lessee' under the *ijara*[81] contract, commonly known as the Forward Lease Agreement)[82] will make advance rental payments to the procurement facility agent (on behalf of the asset custodian and for the account of the procurement facility participants) prior to the delivery of the asset.

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contractor to modify its standard form EPC contract to make them *shariah*-compliant, so this is not done. See McMillen, 'Shari'a Compliant Project Finance' (n 2).

80 A facility agent is used for ease of administration between multiple facility participants. As mentioned, given the size of these transactions it is common to see financing groups with multiple participants under each facility.

81 The full Arabic term is *ijara mawsufah fi al-dhimmah* (literally, lease of that which is described in the mind). For a comprehensive explanation of the religious rules underpinning this structure see Ahmed Nassar, 'The Parameters of Forward Ijarah and Its Application in Financing Services in Islamic Financial Institutions' (2010).

82 The forward lease structure can be viewed as an exception to the general *shariah* principle that one may not transact regarding assets that do not exist—as doing so would allow the Islamic financiers to gain a return on money itself and not assets. While the actual 'lease period' will only commence at the beginning of the operation phase, during the construction phase the project company will make 'advance rental payments' (structured to be equivalent to interest during construction under the conventional facilities) to cover any return expected by the procurement facility participants during the construction phase. *Shariah* scholars have justified such payments as 'payments on account' of the actual lease, which will commence during the operation phase. As a result, the advance rental payments must be returned to the project company (as lessee) if delivery of the asset does not occur. However, in such a scenario, to make the procurement facility participants whole commercially, the project company (as procurer) will be obliged to pay to the asset custodian a 'termination sum' equal to the aggregate of advance rentals which the asset custodian (as lessor) has to refund the project company (as lessee) under the Forward Lease Agreement. These two amounts are in practice netted off against each other in an enforcement scenario and no money changes hands. This process—where the project company as procurer owes money to itself in its capacity as lessee—can be viewed as an example of the acrobatics performed under the Islamic facility to achieve the same economic outcome as the conventional facilities, albeit in a *shariah*-compliant manner.

5. The relationship among the asset custodian, the procurement facility agent, procurement facility participants, and the project company is regulated by the Investment Agency Agreement. The Investment Agency Agreement sets out how phase payments are funded by each of the procurement facility participants and how rental income received under the Forward Lease Agreement is distributed among them. It also contains provisions relating to the appointment, duties, and resignation/replacement of the procurement facility agent. The terms of the Investment Agency Agreement essentially mirror the mechanical and payment terms of the conventional facilities.

6. Upon the EPC contractor's delivery of physical possession of the procurement facility assets to the project company (as procurer), title to and constructive possession of the procurement facility assets passes to the asset custodian. The asset custodian will then be responsible for all obligations associated with ownership of the procurement facility assets (such as settling ownership taxes, placing insurance, and bearing the risks associated with loss, environmental liability, and third party claims). The asset is then leased to the project company (as lessee) under the Forward Lease Agreement.

Operation period: Once the asset is leased to the project company (pursuant to step 6 above), the operation period commences as set out below.

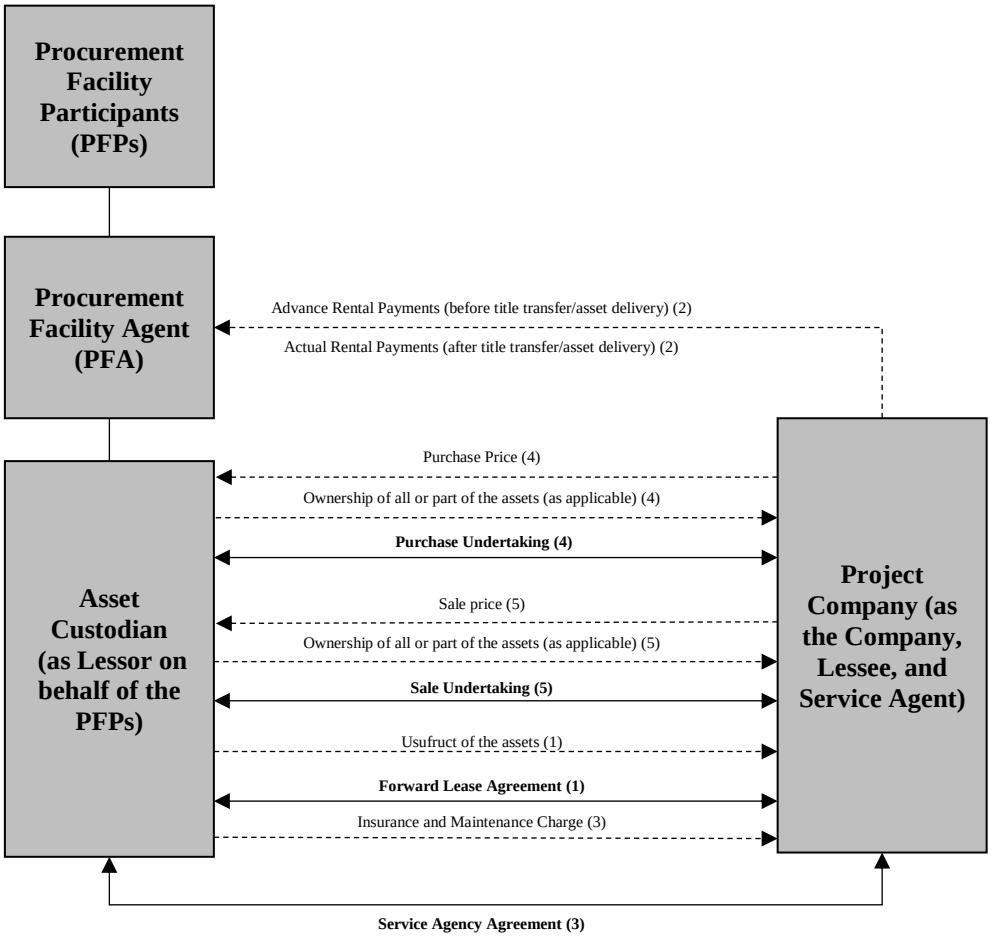

Figure 3: Operation Phase of *Istisna-Ijara* Structure

1. Under the Forward Lease Agreement, the asset custodian (as lessor on behalf of the procurement facility participants) leases the procurement facility assets (ie transfers the usufruct) to the project company (as lessee) in exchange for advance rental payments before the assets are delivered and actual rental payments after the assets are delivered. The phase payments made under the Procurement Agreement during the construction period are in essence 'repaid' by payment of rental payments under the Forward Lease Agreement during the operation period. In effect, under the *ijara* contract the project company will lease the assets from the asset custodian that it has itself procured the construction of for the asset custodian under the *istisna* contract.

2. Actual rental payments commence from the date on which physical possession of the procurement facility assets are delivered to the project company (as lessee). The rental payments are made to the procurement facility agent on behalf of the asset custodian and for the account of the procurement facility participants.[83]

3. Pursuant to the Service Agency Agreement, the asset custodian (as lessor on behalf of the procurement facility participants) appoints the project company as its service agent for maintaining and insuring the procurement facility assets and settling ownership taxes in return for an insurance and maintenance charge payable to the project company (as service agent).[84] [85]

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83 Rental payments are comprised of: (i) a fixed element (the equivalent of principal under a conventional loan); (ii) a variable element (the equivalent of interest) which is comprised of (A) a benchmark rate (such as LIBOR or SAIBOR), plus (B) a margin, plus (C) any mandatory costs; and (iii) the lease service amount or supplemental rental (equivalent to the insurance and maintenance charge paid under the Service Agency Agreement). The rental payments replicate the economics of conventional financing arrangements and are economically comparable to principal and interest payable under the conventional facilities and are payable at the same time. Commonly, a fairly wide minimum and maximum band is set in which the variable element is allowed to fluctuate. This is a *shariah* requirement to avoid *gharar*. For discussion on why using benchmark rates is not prohibited see Dewar and Hussain (n 29) para 11.49; Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Idaratul Ma'arif al-Qur'an 2007) 168–71.

84 There is a *shariah* requirement that the asset custodian (as lessor and owner of the leased assets) take responsibility for all major maintenance, insurance, and ownership taxes in respect of the asset. This is because for the structure to be plausible, it must seem that the asset custodian is the true owner of the assets, which it has leased to the project company. The asset custodian is not best placed to perform this role and will transfer this responsibility to the project company itself by appointing it as its 'service agent' under the Service Agency Agreement. So while—legally and from a *shariah*-compliance perspective—the ownership risk rests with the asset custodian (and ultimately the procurement facility participants), the commercial reality is that the project company will be responsible for any tax, insurance, and maintenance costs. Economically, the asset custodian (as lessor) is to pay the project company (as service agent) for any costs it incurs in performing its role as service agent, but the asset custodian is made whole—so that the project company (as lessee) ultimately bears the cost—by obliging the lessee to pay to it, by way of a lease service amount or supplemental rental payment under the Forward Lease Agreement, an amount equal to the service agency charges owed by the asset custodian under the Service Agency Agreement. In practice, the supplemental rental and the insurance and maintenance charges are netted off against each other. Again, this is an excellent example of how legal fictions are constructed so that the Islamic facilities create the same economic outcome as the conventional facilities in *shariah*-compliant terms.

85 In an *istisna-ijara* and *wakala-ijara* structure, one area of concern is the impact that a total loss (ie the asset being destroyed or damaged beyond repair) will have on the leasing arrangements.

4. Pursuant to the purchase undertaking, the project company agrees to buy all or part of the beneficial ownership interest of the asset custodian (as lessor on behalf of the procurement facility participants) in the procurement facility asset for the purchase price determined under the Purchase Undertaking. This will occur upon a mandatory prepayment event (such as illegality, expropriation, or change of control) or, more usually, upon enforcement/acceleration under the Forward Lease Agreement. For an enforcement action, the purchase price will be equal to all amounts outstanding under the procurement documents. For a mandatory prepayment event, the purchase price will be equal to the amounts that need to be prepaid.

5. Pursuant to the Sale Undertaking, the asset custodian (as lessor on behalf of the procurement facility participants) agrees to sell all or part of the beneficial ownership interest in the procurement facility asset to the project company for the sale price determined under the Sale Undertaking. This will occur upon a voluntary prepayment or on the final discharge date under the Forward Lease Agreement. The sale price for a voluntary prepayment will be equal to the amounts being prepaid. The sale price on the final discharge date will usually be a nominal amount equal to

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As far as the *shariah* is concerned, such total loss terminates the lease arrangements with immediate effect—you cannot lease a destroyed asset—and the project company (as lessee) will be exempt from making further rental payments (other than payments already accrued and outstanding as at the date of termination). As a result of the termination, any Purchase Undertaking also becomes ineffective. To mitigate this risk, the Islamic financiers require the project company (as service agent under the Service Agency agreement) to take out and maintain insurances in respect of the full replacement value of the asset. Upon occurrence of a total loss, the project company (as service agent) is obliged to pay the insurance proceeds received to the Islamic financiers. If the insurance proceeds are less than the full replacement value, the project company (as service agent) will have failed to comply with its strict obligations under the Service Agency Agreement and will be liable to indemnify the Islamic financiers for any shortfall. In this manner, the risk for total loss is effectively shifted from the Islamic financiers to the project company and the Islamic financiers are provided with a means of recouping their investment if the asset is destroyed.

the fee payable by the asset custodian (as lessor under the Service Agency Agreement) to the project company (as service agent).[86]

4.4.1.B Wakala-Ijara *Structure*

The *istisna-ijara* and *wakala-ijara* structures are substantially similar; however, the *wakala-ijara* structure is sometimes preferred by the *shariah* boards of local Islamic banks in Saudi Arabia. This is because, in a *wakala-ijara* structure, the project company does not act as the procurer of the assets, but instead acts as the agent (or *wakil*) of the *wakala* facility participants in arranging the construction of the assets by a third party EPC contractor.[87] Below I set out the structure of the *wakala-ijara* in a similar format to what was done for the *istisna-ijara* structure.

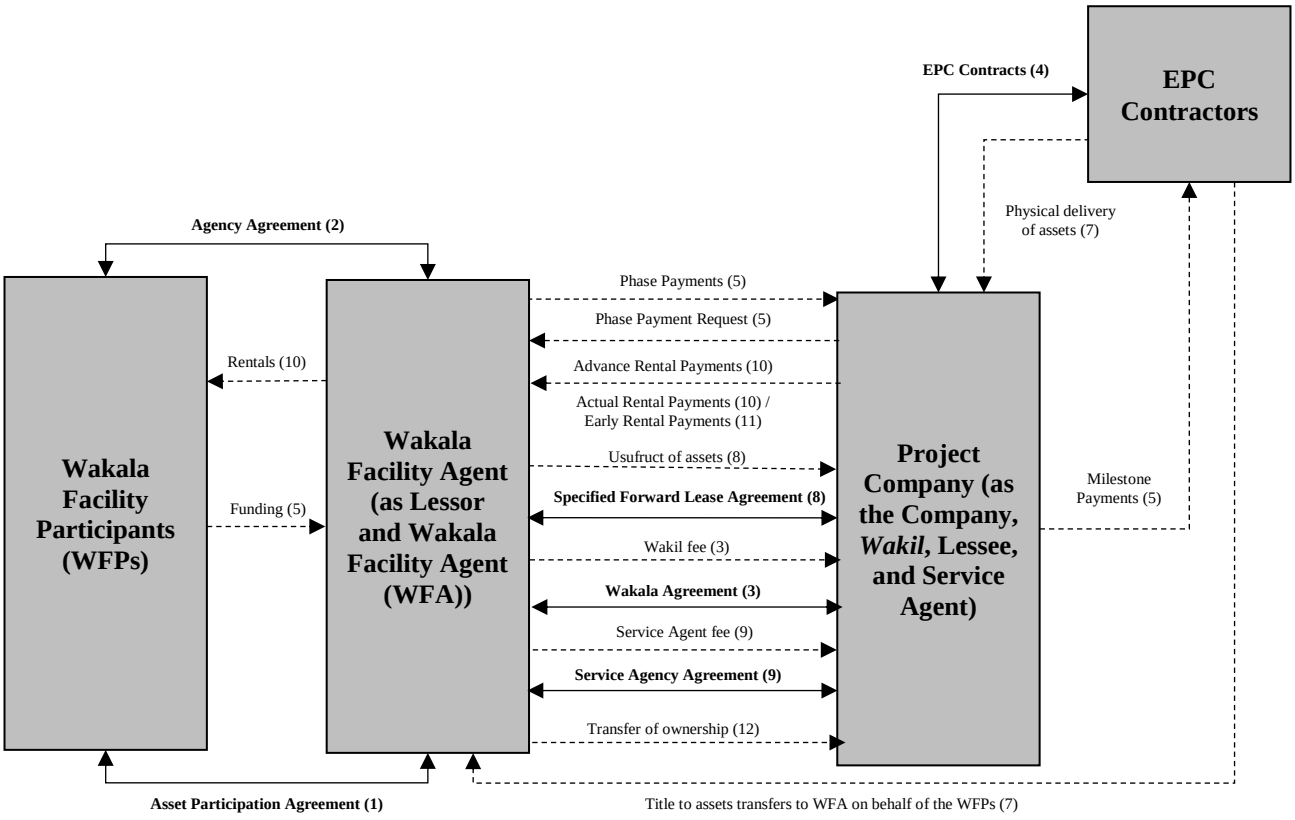

Figure 4: *Wakala-Ijara* Structure

86 Under the procurement facility, a nominal fee (eg US$100) is paid to the project company as 'procurer' and 'service agent' under the Procurement Agreement and Service Agency Agreement respectively. An amount equivalent to the commitment fee is also paid and documented under the Forward Lease Agreement.

87 For further details see Khoshroo, 'Key Differences' (n 75).

1. Pursuant to the Asset Participation Agreement, the *wakala* facility participants (ie the Islamic finance institutions participating and providing the financing to the project company under the *wakala* facility) agree to jointly participate in owning the *wakala* facility assets with the intention of leasing the *wakala* facility assets to the project company (as lessee) through the Specified Forward Lease Agreement.

2. Pursuant to the Agency Agreement, the *wakala* facility participants appoint the *wakala* facility agent as their agent for entering into the *Wakala* Agreement and the Specified Forward Lease Agreement.[88]

3. Pursuant to the *Wakala* Agreement, the *wakala* facility agent (acting on behalf of the *wakala* facility participants) appoints the project company as its *wakil* (agent) for the procurement of the *wakala* facility assets from the EPC contractor in exchange for a *wakil* fee payable to the project company (as *wakil*/agent).

4. The project company (as *wakil*/agent) enters into the EPC contracts to procure the construction, development, and delivery of the *wakala* facility assets.

5. The *wakala* facility agent will provide the project company with the phase payments as per the schedule set out in the *Wakala* Agreement. The funding will be provided to the *wakala* facility agent by the *wakala* facility participants pursuant to the Asset Participation Agreement. Once the phase payments are received by the project company, it will be provided to the EPC contractor as milestone payments.

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88 Typically, the EPC contracts are entered into before the financing arrangements are put in place. To allow the project company to enter into the EPC contracts prior to the execution of the finance documents (specifically, the *Wakala* Agreement), an 'Initial *Wakala* Agreement' is entered into between the project company (as agent) and an Islamic financier on behalf of the future *wakala* facility participants. This Islamic financier may be the project company's financial advisor or a bank that is likely to be involved in the *wakala* tranche or otherwise has a special relationship with the project or its sponsors. Under the Initial *Wakala* Agreement, the project company is appointed as the Islamic financier's undisclosed agent for entry into the EPC contracts. The Initial *Wakala* Agreement will automatically terminate upon the signing of the *Wakala* Agreement.

6. The project company (as *wakil*/agent) assumes the responsibilities for project execution and completion and supervision of the construction of the *wakala* facility assets.

7. Pursuant to the terms of the EPC contracts, as soon as physical possession of the *wakala* facility assets is delivered by the EPC contractor to the project company (as *wakil*/agent), title to the *wakala* facility assets will pass directly to the *wakala* facility agent (on behalf of the *wakala* facility participants) and the *Wakala* Agreement will terminate.

8. The *wakala* facility assets will be leased (ie their usufruct will be transferred) by the *wakala* facility agent (as lessor) to the project company (as lessee) pursuant to the Specified Forward Lease Agreement in exchange for rental payments.

9. Pursuant to the Service Agency Agreement, the *wakala* facility agent (on behalf of the *wakala* facility participants) appoints the project company as its service agent for maintaining and insuring the *wakala* facility assets and settling any ownership tax in return for a fee payable to the project company (as service agent).[89]

10. Pursuant to the Specified Forward Lease Agreement, advance rental payments are made prior to the date on which the *wakala* facility assets are delivered to the project company and actual rental payments commence thereafter. These rental payments

89 Under the *wakala* facility, the *wakala* facility participants are to pay the project company a '*wakil* fee' and 'services fee' for its role under the *Wakala* Agreement and Service Agency Agreement respectively. These amounts are usually set off against the first advance rental payment to be made by the project company to the *wakala* facility agent (on behalf of the *wakala* facility participants). The *wakala* facility participants are also paid an administration and management fee which tends to be equivalent to the commitment fee and upfront fee payable to the conventional facility participants.

are made to the *wakala* facility agent for the account of the *wakala* facility participants.[90]

11. Pursuant to the Specified Forward Lease Agreement, the project company (as lessee) may make voluntary or mandatory early rental payments before or after the delivery of the *wakala* facility assets. Upon making such early rental payment, the schedule of the rental payments will be adjusted.

12. Upon payment of the final rental payment or upon the termination of the *Wakala* Agreement by the *wakala* facility agent or the Specified Forward Lease Agreement by the *wakala* facility agent (as lessor) or the project company (as lessee), the *wakala* facility agent (as lessor) will transfer the ownership of the *wakala* facility assets to the project company and the project company shall pay the 'termination sum' which will be made up of the fixed element of the rental payments not yet paid (less any outstanding insurance and maintenance charge amounts to be paid to the project company (as service agent under the Service Agency Agreement)) plus the variable element of the rental payments accrued but unpaid up to that date and any other amount due but unpaid to the *wakala* facility participants.

4.4.2 Project *Sukuk*

As we saw in section 4.2.6 (Sukuk *Coming On-stream*), attractive pricing, lower cost of issuance, longer tenors, increased standardisation, less managerial interference compared to Islamic banks, strong demand from regional and domestic investors, and political

90 In the procurement facility the stage payments are made at the request of the project company (as procurer) and function similarly to a utilisation request under the conventional facilities. The advance rental payments and lease rental payments are paid by the customer in accordance with a formula which incorporates a benchmark (such as LIBOR or SAIBOR) plus a margin. The formula incorporates amounts which are equivalent to the commitment fee payable under the conventional facilities. Under the *wakala* facility, the stage payments and lease payments are made in accordance with a fixed schedule set out in the documents determining the exact date and amount to be paid. This is to achieve a higher level of certainty to avoid compromising the *shariah*-compliance of the facility due to *gharar*.

commitment to develop the region's capital markets have all contributed to the growth of *sukuk* in general, and project *sukuk* in particular.

Project *sukuk* has been added to the repertoire of Islamic project finance instruments only in the last decade. Project *sukuk* burst onto the world scene in 2011 with Saudi Arabia's issuance of the SATORP Refinery and Petrochemical Project *sukuk*—an issuance that was more than three times over-subscribed. The SATORP *sukuk* had a tenor of 14 years, which is typical for project financings, but longer than usual *sukuk* tenors of between five and seven years.[91]

This issuance was followed by other issuances to both refinance existing projects and as part of the initial financing plan for new projects. Large-scale financings now often pre-structure an option for project *sukuk* or bonds into the documentation even though there is no intention for them to be issued as part of the initial financing (eg PetroRabigh II (2015)).

Sukuk securities are certificates evidencing an undivided ownership share in tangible assets. The underlying asset is usually a fixed asset such as land, real estate, machinery, and facilities used in refineries, power plants, petrochemical plants, and pipelines. By purchasing a *sukuk* certificate the buyer attains a proportionate beneficial ownership interest in the underlying asset or revenue (which is often a share of rental payments derived from the *ijara* component of the *sukuk* structure). A subsequent purchaser of the *sukuk* acquires the rights and obligations of the original subscriber and replaces the seller in its portion of the ownership of the underlying assets.

Various types of *sukuk* are used to meet the short-term and long-term financing needs of existing and greenfield energy projects.[92] Below I demonstrate the *sukuk* structure used in the Project. This *sukuk* used a *musharaka* (partnership) structure overlaid on top of an *istisna-*

91 Haider (n 53).

92 For an overview of different types of *sukuk* see Dewar and Hussain (n 29) paras 11.64–67.

ijara arrangement. I will not cover the mechanics for the *istisna-ijara* in detail as it is the same as that described in section 4.4.1.A (Istisna-Ijara *Structure*).

4.3.2.A *Project* Sukuk *Structure*

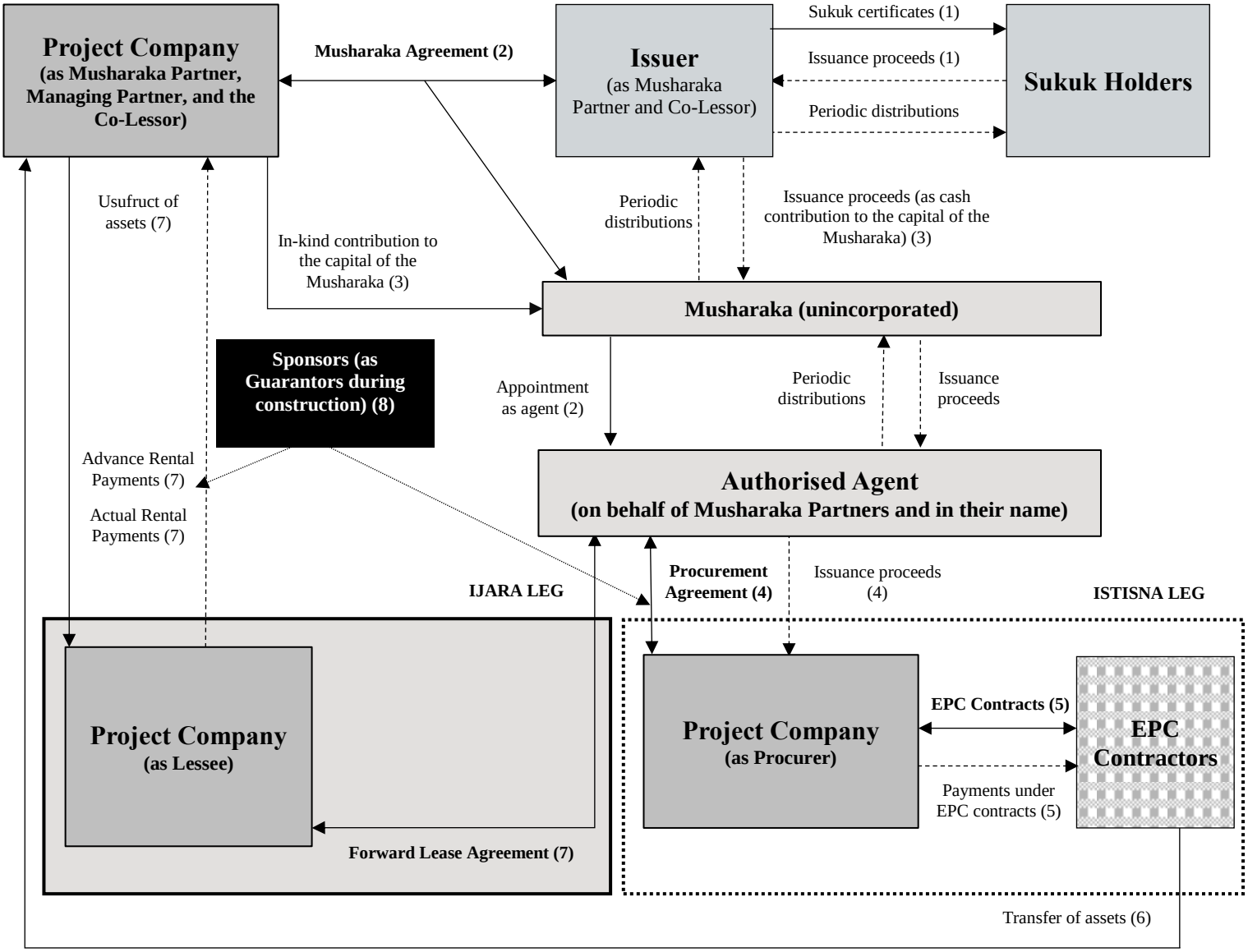

Figure 5: Project *Sukuk* Structure

1. The issuer issues *sukuk* certificates to the *sukuk*-holders in return for the issuance proceeds. The certificates constitute undivided beneficial ownership interests in the *sukuk* assets, representing direct, secured, unconditional, and unsubordinated obligations of the issuer, and rank *pari passu*, without any preference or priority, among themselves.

2. A Musharaka Agreement is entered into between the project company (as *musharaka* managing partner) and the issuer (as *musharaka* partner), whereby they form an unincorporated *musharaka* (partnership) and agree their rights and obligations thereunder and appoint the 'authorised agent' as their agent.[93]

3. Pursuant to the Musharaka Agreement, the issuer (as *musharaka* partner) makes a cash contribution of the issuance proceeds to the *musharaka* and the project company (as *musharaka* managing partner) makes an in-kind contribution (in the form of rights to land) to the *musharaka*.[94]

4. The authorised agent (on behalf of the *musharaka* partners) enters into a Procurement Agreement with the project company (as procurer) to procure the *sukuk* assets in return for the issuance proceeds.

5. The project company (as procurer) enters into the EPC contracts whereby it pays the issuance proceeds for the construction and delivery of the *sukuk* assets.

6. Upon the construction of the *sukuk* assets, the EPC contractors will deliver physical possession of the *sukuk* assets to the project company (as procurer). Title to the

93 The 'authorised agent' is a special purpose vehicle incorporated to enter into certain agreements on behalf of the *musharaka* partners. This is to address a *shariah* concern that does not approve of the project company entering into contracts with itself in different capacities or 'wearing different hats'. Without the authorised agent, the project company (as managing partner and lessor) would enter into a Procurement Agreement with itself (as procurer) and a Forward Lease Agreement with itself (as lessee) and a Service Agency Agreement with itself (as service agent). Instead, pursuant to the Musharaka Agreement, the *musharaka* partners appoint the authorised agent and authorise it to enter into the Procurement Agreement, the Forward Lease Agreement and the Service Agency Agreement on their behalf and in their name. The authorised agent is not a partner of the *musharaka* and does not hold any rights or assets for the benefit of the *musharaka*.

94 This in-kind contribution of tangible assets is to comply with the *shariah* prohibition against trading in debt (rather than assets) when the *sukuk* is issued. To ensure that the *sukuk* is tradable, the project company's in-kind contribution takes the form of tangible assets (such as land or lease rights). Tradability is a concern when the *sukuk* is being issued to finance the development of a greenfield project which does not yet have any tangible assets of its own. In this manner, each *sukuk* will be a certificate evidencing undivided ownership interest in the underlying asset and can be traded (at discount, par, or premium) from day one (provided no other contractual restrictions apply).

assets will be held by the *musharaka* managing partner (on behalf of the unincorporated *musharaka*).

7. The authorised agent (on behalf of the *musharaka* managing partner as co-lessor) and the issuer (as *musharaka* partner and co-lessor) enters into a Forward Lease Agreement with the project company (as lessee) whereby the issuer's undivided share of the *sukuk* assets is leased to the project company (as lessee) in exchange for periodic rental payments.

8. The sponsors (as guarantors during the construction period) will guarantee the obligations of the project company (as procurer under the Procurement Agreement) to procure the construction and delivery of *sukuk* assets and the obligations of the project company (as lessee under the Forward Lease Agreement) to make advance rental payments during the construction period.[95]

4.4.3 *Murabaha* & *Tawarruq*

Another structure that provides support in Islamic project finance transaction is the *murabaha*, also known as 'cost-plus financing'. The *murabaha*—and its sister structure, the *tawarruq*—change what is effectively a loan into a trade transaction. Compared to other Islamic finance products, the *murabaha*/*tawarruq* is simple, low-risk, predictable, and flexible.

In a *murabaha*, the Islamic financier purchases an asset and then sells the asset to the project company at cost plus a fixed profit. Payment by the project company is usually deferred and made in instalments. The project company requires the asset being purchased for its own use. In project financings, intangible assets (such as airtime) can be used as the *murabaha*'s underlying assets (as was the case for the Mobily Telecoms Project (Saudi Arabia 2007)).

95 This is in line with the completion guarantees typically provided by project sponsors under the conventional project financing.

In a *tawarruq* (which is a more versatile variation of the *murabaha*), the Islamic financier purchases an asset at market value for immediate delivery and spot payment, and immediately sells it on to the project company at a pre-agreed price for immediate delivery and on a deferred payment basis. On acquiring title to the asset, the project company immediately resells the asset on a spot payment and immediate delivery basis to a third party and receives cash. Unlike in a *murabaha*, in a *tawarruq* the project company does not require the asset for its own use and is only interested in its resale value.

The end result of a *tawarruq* looks very much like an interest-bearing loan, and thus the structure is often viewed as a synthetic form of Islamic finance and has been frowned upon by *shariah* scholars.[96] Those supporting the structure's use argue that the banks are entitled to the mark-up as compensation for the ownership risk they take upon acquiring the assets and for the service they provide. Most scholars find this argument unconvincing as they can see that the mark-up in fact reflects prevailing interest rates (rather than a service charge) and the ownership risk is negligible given that the bank only holds ownership over the assets for a moment in time before it is transferred to the customer.[97]

While *murabaha* and *tawarruq* were used in the early days of Islamic project financing, it is now widely accepted that they are not very well suited to the sector. The deferred payment period for a *murabaha*/*tawarruq* is typically less than three years, whereas project financings typically have much longer tenors. They are seldom used as the main financing instrument in project financings, but are often used to provide equity bridge financing and working capital facilities (as was the case for the Riyadh PP11 Power Project (Saudi Arabia 2010)).[98]

96 See section 2.4.1 (*The Question of* Riba*: Legalist & Moralist Approaches*).

97 Charles Tripp, *Islam and the Moral Economy: The Challenge of Capitalism* (CUP 2006) 143.

98 See eg Dewar and Hussain (n 29) paras 11.17, 11.72.

The subject matter of a *murabaha/tawarruq* transaction must be goods (not services). The goods can be tangible (such as commodities and metals), or intangible (such as airtime on a telecommunications network). According to *shariah* principles, the goods being sold in a *murabaha* transaction must have value and exist at the time of sale. As a general rule, goods that are forbidden under *shariah* principles—such as alcohol, pork products, and objects used in gambling—cannot be the subject of any Islamic finance transaction.

In *murabaha/tawarruq* transactions, it is also important to strictly abide by contractual formalities. Violation of these formalities can negate the transaction's *shariah*-compliance and void the *murabaha* sale. These formalities include: (i) clear offer and acceptance; (ii) certainty as to price at the time the offer is made; (iii) certainty as to how and at what time the deferred payment is to be made; (iv) immediate performance (ie the sale cannot be attributed to a future date or conditional upon a future event); and (v) independent agreements, with the beginning and end of each clearly evident. This is most important in a *tawarruq* where the final step (whereby the customer resells the commodities purchased) is usually documented separately to avoid any inference that the transaction is merely a disguised interest-bearing loan.

The *murabaha/tawarruq* structures continue to be used in the project finance sector to provide working capital facilities and equity bridge financing given their flexibility and low risk.

4.4.3.A Murabaha *Structure*

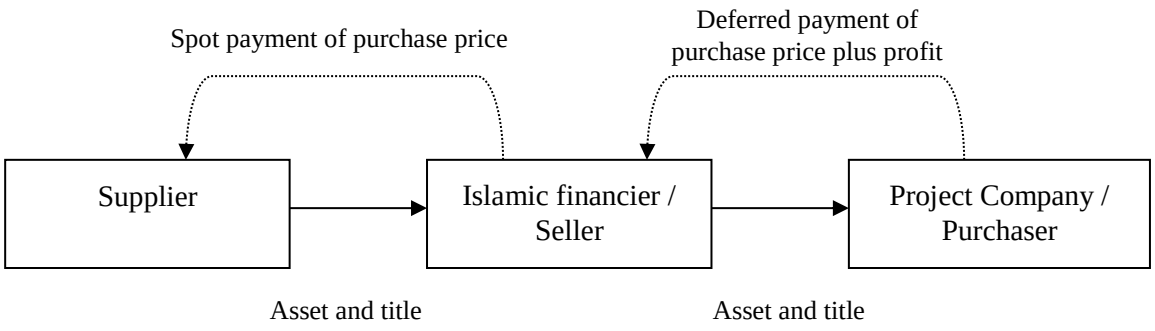

Figure 6: *Murabaha* Structure

In a *murabaha* (also known as 'true' or 'asset' *murabaha*) transaction, the Islamic financier buys an asset based on the project company's specifications or, more likely, appoints the project company as its agent to purchase the asset from the supplier on its behalf. The Islamic financier then sells the purchased asset to the project company at an agreed mark-up on the purchase costs. Both the purchase price and the mark-up must be disclosed. Payment by the project company is often deferred and can be made in instalments. A 'true' *murabaha* is used in situations where the project company requires the purchased goods for its own use—as it gives the project company immediate ownership and possession of the goods it requires, with the ability to pay for them in the future.

4.4.3.B Tawarruq *Structure*

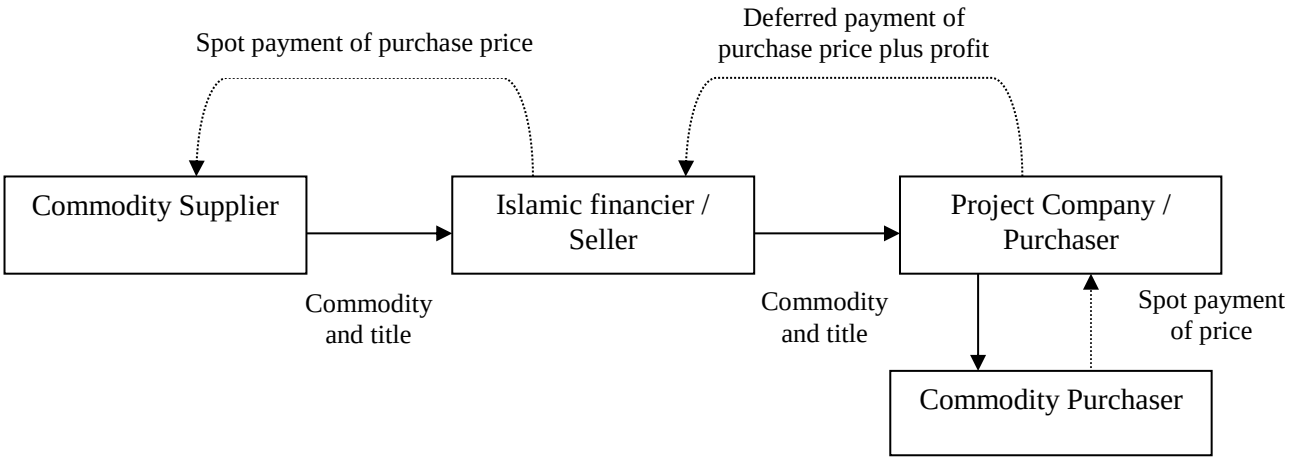

Figure 7: *Tawarruq* Structure

A *tawarruq* (also known as 'commodity' *murabaha*) begins with the same steps as a 'true' *murabaha* and adds a further step whereby the project company resells the asset purchased by way of the *murabaha* transaction. This is because—unlike in a 'true' *murabaha*—in a *tawarruq* the project company does not require the purchased asset for its own use and is only interested in the cash value it can receive by immediately reselling it.[99] These

99 The most important difference between a *murabaha/tawarruq* and a conventional interest-bearing loan is that in a *murabaha/tawarruq* the financier takes ownership of the goods that are

transactions are called 'commodity' *murabaha* because the goods commonly used for this purpose are commodities such as aluminium, copper, zinc, lead, and platinum, which can be traded with low transaction costs and have readily-accessible spot markets (eg the London Metal Exchange). Gold and silver cannot be used for *tawarruq* transactions, as they are governed by a specific set of *shariah* principles.

4.5 LEGAL ISSUES & RISKS

The bigger the project, the greater the legal and practical risks. Below are some examples of the issues that may arise in Islamic project financings.

4.5.1 Interface with Conventional Finance

Given the size of project financing transactions, it is rare for the funds to be raised from IFIs alone. This means the Islamic tranche (or more often tranches) appear(s) alongside conventional financing tranches from export credit agencies, commercial banks, development finance institutions, and capital market issuances.[100]

The most critical issue for a multi-sourced project financing is to ensure that the project is treated as an 'indivisible whole'.[101] The aim is for all financiers to be treated equally—achieving the same commercial outcome regardless of the tranche they are participating under. The various tranches can use different routes, but they must all reach the same destination.

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the subject of the transaction. This ownership may result in potential liabilities, even if the ownership merely lasts for a moment in time and is indirectly acquired through an agent. Of course, contractual and statutory liabilities will be excluded to the extent permitted by law. However, in instances where exclusion is not permitted, ultimately the Islamic financier may need to get comfortable with the idea that it bears the risk of loss or damage to the goods from the time of purchase from the supplier to the time of sale and delivery to the project company. Islamic financiers will ensure that this risk is remote by timing the purchase from the supplier and the subsequent sale to the project company so close together that they are virtually simultaneous.

100 McMillen, 'Islamic Project Finance' (n 65).

101 Dewar and Hussain (n 29) para 11.74.

Previously, there was a perception that conventional and Islamic finance were 'so fundamentally divergent' that the gap between them was 'unbridgeable' in the same project.[102] Now these concerns have been largely addressed and interface between Islamic and conventional financiers on issues such as *pro rata* utilisations and payments, *pari passu* security, sharing of sponsor support and post-enforcement cashflows is largely settled (but continues to be refined).[103]

Earlier in my career as a lawyer specialising in Islamic project finance, I would often have to educate the export credit agencies (and less often the conventional commercial banks) on the Islamic finance structures being incorporated into the overall project financing. But since the mid-2010s the conventional players in the project finance sector, especially in the Middle East, are fully familiar and comfortable with these structures. International corporates co-sponsoring projects in the Middle East may still need a measure of handholding and education, but IPF arrangements are now more or less settled for both the IFIs and conventional financiers.

Due to some of the unique features of the Islamic finance tranches, IFIs must abide by certain structuring parameters to ensure *shariah*-compliance—while not being placed in a position that is any worse or any better than the other financiers. This gives rise to a variety of *shariah* issues that need to be carefully coordinated from the outset among the IFIs and their *shariah* scholars, the conventional financiers, and the project company.[104]

The first step in achieving this equal treatment is getting all financiers signed up to the common terms agreement (CTA) and intercreditor agreement (ICA). The CTA regulates the relationship between the project company and the financiers under all tranches—ie the CTA

102 McMillen, 'Islamic Project Finance' (n 65).

103 Ahmed and Khoshroo (n 14).

104 Dewar and Hussain (n 29) para 11.74.

provides the terms that are common to all financiers. These ensure that the payment obligations of the conventional and Islamic financiers are *pro rata* at all times—with no party having to extend more funds than its proportionate share among all other financiers.

The ICA regulates the relationship of the financiers among themselves. It governs the decision-making procedure among the various tranches for all things including waivers and amendments to the finance documents as well as their termination or any acceleration/enforcement thereunder. Under the ICA, the IFIs benefit from any sponsor support and share in the security *pari passu* with the conventional financiers.

As the CTA and ICA are conventional finance documents, there have been issues with the IFIs signing these documents directly. This is because the signature of the IFIs of these documents would necessitate the approval of their *shariah* boards. Given the conventional nature of these documents, which are the cornerstone of the much bigger financing arrangement between the multiple financiers (only a small percentage of which are Islamic), there is limited scope to make meaningful modifications to accommodate the comments of the *shariah* scholars.

A decade ago, this concern was addressed by using a separate Islamic common terms agreement which largely duplicated the provisions of the conventional CTA but in a *shariah*-compliant manner.[105] Given the additional work required to produce a separate CTA and the comfort that *shariah* scholars have now gained with IPF structures, many IFIs (especially the Islamic windows of conventional banks) sign the CTA and ICA directly or through the Islamic facility agent. The *sukuk* issuer will also sign on behalf of the *sukuk*-holders.

Sometimes the local Islamic banks participating under the *wakala* facility cannot get *shariah* approval to sign these conventional documents. In these instances, the *wakala* facility

105 See eg PetroRabigh Phase I from 2007. When the project was expanded in 2015, it no longer used an Islamic common terms agreement.

participants (often through an agent) enter into a *Wakala* Undertaking Agreement whereby they take benefit of the security package provided under the main financing and undertake to only exercise their rights under the *wakala* facility (where they own certain assets) in accordance with the ICA. The *Wakala* Undertaking Agreement is usually governed by English law to provide adequate confidence to the conventional financiers that the undertaking will be enforceable.[106]

One of the ways in which IFIs have gotten comfortable with signing the CTA and ICA is that these documents now reflect terminology that is consistent with the Islamic finance tranches and does not dispel 'the fiction of *shariah*-compliance'.[107] For example, the term 'project company' is used instead of 'borrower', 'creditors' or 'financiers' is used instead of 'lenders', and 'commission' instead of 'interest'.

4.5.2 Governing Law & Dispute Resolution

In an IPF transaction, one of the most important considerations that needs to be settled at the outset is the law that will govern the project financing and the Islamic finance documents (and resolve any disputes thereunder).[108] The governing law determines whether 'the agreed-upon rights and obligations of, and remedies available to, each of the parties (in other words, the agreed-upon allocations of risks) will be sustained and enforced in a predictable, consistent, certain, and transparent manner'.[109]

Of course, whether a governing law attains this standard is a matter of perception—a perception that is most often shaped in a Western interest-based economic and legal system. This is because of the dominance of the Western system (and the prevalence of the

106 Ahmed and Khoshroo (n 14).

107 Interview with Lawyer06 (n 38).

108 Dewar and Hussain (n 29) para 11.39.

109 Michael JT McMillen, 'Contractual Enforceability Issues: Sukuk and Capital Markets Development' (2007) 7 Chicago Journal of International Law 427.

professionals who service it) on the one hand, and the relative infancy of modern Islamic law and finance and a general lack of knowledge of the *shariah* on the other.[110]

To benefit from efficiencies and best practices, parties to a multi-sourced financing will try to follow standardised practices and contracts (like those produced by the Loan Market Association (LMA)) where possible. This standardisation, of course, has emerged and evolved in a Western interest-based context with no regard for *shariah* concerns.[111] Naturally, these contracts are designed to be enforced in the Western legal system. Moreover, most participants in a multi-sourced project financing will need to operate in a secular legal and regulatory framework applicable in the many countries in which they do business in a globalised world. This often means that parties prefer that their contracts are governed by English law,[112] rather than the law of the host country where the project is situated, especially if the host country is Islamic in nature and incorporates *shariah* concepts with which many participants will not be familiar.[113]

Why English law? English law has achieved a high degree of certainty and is globally renowned for its 'creditor-friendly approach, established system of precedent, and the willingness of English courts to accept jurisdiction … even when there is little nexus to the jurisdiction other than the election of the parties'.[114] Thus, it has emerged as the favoured choice of law for most complex cross-border Islamic financing transactions. Other factors which have helped English law rise to such prominence are London's historical significance

110 ibid.

111 See eg Kilian Bälz, 'Shari'ah Risk? How Islamic Finance Has Transformed Islamic Contract Law' [2008] Occasional Publications, where it stated that even when Islamic finance documents were to be standardised by the LMA, this was done by international law firms with no input from *shariah* scholars or AAOIFI standards.

112 And to a lesser extent New York law.

113 McMillen, 'Contractual Enforceability Issues' (n 109).

114 Dewar and Hussain (n 29) para 11.39.

as a financial centre, its sound regulatory framework, abundance of skilled service providers, and attractive time zone, especially for the Middle East and North Africa.[115]

Today, in cross-border financing transactions, 'using English law is akin to using the English language. Nothing else would work'.[116] The standard form documentation produced by the International Islamic Financial Market (IIFM) stipulates as default that transactions will be governed by English law.[117] Even the Dubai International Financial Centre (DIFC) uses non-native judges to adjudicate and arbitrate cases in accordance with English law.[118] Indeed, article 8 of the Dubai Law on the Application of Civil and Commercial Laws[119] states that the DIFC is able to apply in civil and commercial matters, notwithstanding any UAE federal law, any law validly chosen by the parties. Paragraph (2) of the article makes the law of England and Wales the default law.[120] It must be noted that these developments, whereby *shariah* concerns take a backseat to secular Western laws, have not been welcomed in all Islamic circles.

So why is it that *shariah* is not used as the governing law of Islamic finance documents and transactions? For starters, which *shariah*? There are no universally accepted principles of *fiqh* and countless variations of interpretations are possible not only between the *madhaheb* (schools of thought), but also within the same *madhhab*. For example, the constitutions of Iran, Egypt, and Saudi Arabia all state that *shariah* will be the principal source of their laws,

115 See eg Askari, Iqbal and Mirakhor (n 43) 22.

116 Interview with Lawyer32, 'Senior Associate and Islamic Finance Specialist in London Office of International Law Firm' (19 August 2016).

117 David Eisenberg, 'Islamic Financial Law in the UK and the West' (2014).

118 See David Mednicoff, 'Hybridised Legal Growth in the GCC: Insights from Qatar and the UAE' (*LSE Middle East Centre Blog*, 12 January 2016).

119 DIFC Law No 3 2004.

120 Barry Rider, 'Corporate Governance for Institutions Offering Islamic Financial Services' in Craig Nethercott and David Eisenberg (eds), *Islamic Finance: Law and Practice* (OUP 2012) para 5.12.

but in reality these countries have markedly different legal systems.[121] Moreover, who would adjudicate any disputes arising under these *shariah* law governed documents? There are no internationally recognised *shariah* courts that could adjudicate disputes in accordance with *shariah* law.[122] Even in England, where the legal systems accommodates IBF and plays a major role in the industry, its courts have effectively refused to adjudicate issues of Islamic financial law.[123]

Thus, Islamic finance 'floats in a systemic vacuum'.[124] It is based on Islamic law, but Islamic law lacks an underlying legal system in the Western-style nation-state mould with which most project finance participants would be familiar. In a multi-sourced project financing, a system is needed that all parties understand. Financiers will need to know with a high level of certainty their rights and obligations under the various finance documents to be able to determine what risks they are accepting and what remedies they have available to decide if they will participate in a given project. Thus, financiers will insist on a governing law that is accessible and has a solid track record of dealing with issues that arise in complex cross-border financings.[125]

Where does that leave us? Inevitably this means, in a project financing, we will need to designate the law of a particular country as the governing law of the documents, including the Islamic finance documents. In the UK, this is supported by case law and statue. In

121 See eg Frank Vogel and Samuel Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Kluwer Law International 1998) 28.

122 Dewar and Hussain (n 29) para 11.39.

123 Nicholas HD Foster and Simon Archer, 'Islamic Financial Law: Law without a Legal System', *Business in between Cultures: The Development of Islamic Finance* (EABH 2012). See also Jonathan Ercanbrack, 'The Regulation of Islamic Finance in the United Kingdom' (2011) 13 Ecclesiastical Law Journal 69.

124 Foster and Archer (n 123).

125 Dewar and Hussain (n 29) para 11.39.

Musawi[126] it was held that under English common law as well as the Rome Convention,[127] 'the only law which the courts may apply is the law of a country', not a non-national legal system such as the *shariah*.[128]

Merely designating that contracts will be governed and disputes will be resolved in accordance with a secular Western law is unsatisfactory to those who would like their contracts to be governed by *shariah*. An additional concern would be that such a secular forum would not render judgments in accordance with the letter, or the nuanced spirit, of *shariah* law. Moreover, in addition to mere ignorance of Islamic law, there may also be legal (usually constitutional) limitations and even outright hostility towards giving scope to Islamic jurisprudence in the judicial forums of some countries.[129]

Shariah scholars find it unacceptable that, for example, English law would take precedence over *shariah* in the event of a conflict between the two.[130] But mere mention of *shariah*, or subjecting English law to the *shariah* in the contract's governing law provision, will not be enough to alter this situation—two laws cannot govern the same contract.[131] In 2002, in *Symphony Gems*,[132] the first Islamic finance case to be brought before the English

126 *Musawi v RE International (UK) Ltd* [2007] EWHC 2981 (Ch), [2008] 1 All ER (Comm) 607, [2008] 1 Lloyd's Rep 326, [2007] NPC 137.

127 The Convention on the Law Applicable to Contractual Obligations 1980 as applicable in England pursuant to Contracts (Applicable Law) Act 1990.

128 See also Julian White, 'Dispute Resolution and Specialized ADR for Islamic Finance' in Craig Nethercott and David Eisenberg (eds), *Islamic Finance: Law and Practice* (OUP 2012).

129 ibid para 12.05. For constitutional challenges against Islamic finance brought in India and the US see Zulkifli Hasan and Mehmet Asutay, 'An Analysis of the Courts' Decisions on Islamic Finance Disputes' (2011) 3 ISRA International Journal of Islamic Finance 41.

130 Dewar and Hussain (n 29) para 11.39.

131 See eg Hasan and Asutay (n 129).

132 *Islamic Investment Co Ltd v Symphony Gems NV* [2002] All ER (D) 171, QB, [2009] EWHC 2378 (Comm), [2009] All ER (D) 07, [2008] All ER (D) 141. For full details of the Symphony Gems case see Kilian Bälz, 'A Murābaḥa Transaction in an English Court: The London High Court of 13th February 2002 in Islamic Investment Company of the Gulf (Bahamas) Ltd. v. Symphony Gems N.V. & Ors' (2004) 11 Islamic Law and Society 117.

High Court, the argument of *shariah* non-compliance was dismissed and it was held that it was sufficient that a contract be valid as a matter of English law.

In the *Shamil Bank*[133] case the agreements contained a governing law clause which read, 'Subject to the principles of the Glorious *Sharī'ah*, this Agreement shall be governed by and construed in accordance with the laws of England.' In considering the purported choice of law, the Court of Appeal held that the clause was not successful in choosing the *shariah* as the governing law (either alone or coupled with English law)[134] and further held that reference to the *shariah* was not intended to replace English law but was merely meant to reflect the concerned party's nature of business.[135]

Legal practitioners welcomed the judgement as it exempted them from ensuring that the agreements they draft are indeed in compliance with Islamic law, and it was sufficient that these contracts were valid under English law—and were thus afforded the considerable legal certainty and predictability of the English legal system.[136]

This has also resulted in adding 'Waiver of *Shariah* Defence' clauses, which prevent the parties from asserting that the contract in question is void or unenforceable for lack of *shariah*-compliance. Using *shariah* non-compliance as a defence against fulfilling one's obligations under the contract is said to undermine the entire Islamic finance industry.[137] It is viewed to be a bad faith attempt at reneging on a contract that was viewed to be

133 *Beximco Pharmaceuticals Ltd & Ors v Shamil Bank of Bahrain EC* [2004] EWCA Civ 19, [2004] 1 WLR 1784, [2004] 2 All ER 1072, [2004] 2 All ER (Comm) 312, [2004] 2 Lloyd's Rep 1, [2004] 1 CLC 216, (2004) 101(8) LSG 29.

134 White (n 129) para 12.44.

135 For details of the case and analysis see Hasan and Asutay (n 130); McMillen, 'Contractual Enforceability Issues' (n 109).

136 See Foster and Archer (n 123).

137 See eg Interview with Islamic Banker55, 'Head of Islamic Finance for Large Asian Bank' (22 February 2018) where it was said, 'If we lost the case [in which a *shariah* defence was raised], we would have lost a lot of money and our senior management would shut the whole thing down'. The 'whole thing' being the bank's entire Islamic finance department.

compliant when it was entered into only to be subsequently protested against when for some other reason one of the parties no longer wanted to fulfil its obligations thereunder.[138]

This approach was attempted in the *Blom Bank*,[139] *Arcapita*,[140] and *Dana Sukuk*[141] cases, to much criticism from industry observers. The *shariah* defence threatens the stability of Islamic finance documents to such an extent that it is said that 'from a legal perspective Islamic law is no longer perceived as "law" but as "risk"… *Shariah* is a risk, which allows the transaction to be attacked on the basis that it did not conform to Islamic legal principles'.[142] Lawyers believe that, given the lack of a proper legal framework, the *shariah* becomes the weakest point in a transaction on which litigators will press to make it fall apart and become unenforceable.[143] In addition to waiver of *shariah* defence clauses, this *shariah* non-compliance risk can be mitigated by having proper *shariah* governance and monitoring processes in place.[144]

In this situation, there are three solutions for incorporating *shariah* into your contracts, as follows:

Shariah-*compliant contract governed by secular law*: The most common approach is to spell out in their entirety the *shariah* provisions you would like respected in your contract and have them blessed as *shariah*-compliant by the *shariah* scholars. In other words, write a *shariah*-compliant contract, rather than try to incorporate *shariah* into the contract by reference. Among

138 See Hasan and Asutay (n 129).

139 *The Investment Dar Company KSCC v Blom Developments Bank Sal* [2009] EWHC 3545 (Ch), [2009] All ER (D) 145.

140 *In re Arcapita Bank, BSC(c), et al* Bankr SDNY 12-11076 (SHL). For details see Michael JT McMillen, 'The Arcapita Group Bankruptcy: A Restructuring Case Study' (ISRA and Thomson Reuters Report 2015).

141 *Dana Gas PJSC v Dana Gas Sukuk* [2017] EWHC 2928 (Comm).

142 Bälz (n 111).

143 Interview with Scholar51, 'Islamic Commercial Law Academic Based in UK' (22 February 2018).

144 See eg Ahmed and Khoshroo (n 14).

sophisticated commercial parties, 'the contract itself is "the law of the land" with respect to that transaction'.[145] This approach allows you to adopt—and reflect in your contract—your preferred interpretation or school of *shariah*. Your contract would then be governed and enforced by its terms, not any *shariah* concern external to it that will need to be ascertained—or second-guessed—through expert witnesses. English law, which is the most common secular law chosen to govern these contracts, will apply a literal interpretation of commercial agreements and enforce them as drafted in the contract.[146] In our Project, this was the approach adopted in the procurement facility. The *istisna-ijara* documents, while governed by English law, were drafted to be *shariah*-compliant and were approved as such by the *shariah* scholars.

Islamic dispute resolution (IDR): Another approach that has not yet gained significant traction is to refer disputes to arbitration in accordance with pre-specified *shariah* standards. The hope is that IDR will one day replace litigation as the most popular means of dispute resolution in Islamic finance transactions. Litigation is 'woefully inadequate' in its interpretation and application of *shariah*.[147] Judges will often have no knowledge or experience with *shariah* or Islamic finance transactions. IDR is a viable alternative to litigation as the Arbitration Act 1996, as was reiterated in *Musawi*, allows parties to choose non-national legal systems or principles as the basis on which disputes are resolved by arbitrators. An added benefit of this approach is that:

> [I]t is being recognised that *shariah*-based IDR helps ameliorate the tensions that naturally occur at the intersection of the State and Islam. In addition, creating new frameworks for IDR will be quicker and simpler, with greater flexibility and fewer political obstacles, than trying to fit new *shariah* courts into exiting legal systems or reworking established *shariah* court/civil court dichotomies.[148]

145 McMillen, 'Contractual Enforceability Issues' (n 109).

146 Hasan and Asutay (n 129). See also McMillen, 'Contractual Enforceability Issues' (n 109).

147 Mohamad Illiayas Seyed Ibrahim, 'Islamic Finance Dispute Resolution: The Need to Complement Litigation with Expert Determination' [2008] *MIF Monthly* 20.

148 White (n 128) para 12.06.

To avoid the 'which *shariah*?' confusion discussed above, parties wishing to submit to IDR should identify in detail the specific *shariah* principles they wish to be governed by—complete with reference to the specific *madhhab* and *fiqh* procedures they wish to follow, and even *fatawa* or standards they have in mind.[149]

Local law of a jurisdiction that incorporates shariah: Another approach is to have the transaction governed by the law of a country that incorporates *shariah* principles (eg Saudi Arabia or Iran). This situation often occurs in the Middle East, especially when domestic banks are involved or where there is no real choice of law due to the application of conflict of laws principles such as *lex situs*.[150] In these instances:

> [P]rovisions of the *shariah* are either literally incorporated into the text of the substantive law of the nation or incorporated as an interpretive matter by the courts or other enforcement bodies. In either case, a contract that is governed by the law of the *shariah* incorporated jurisdiction will be enforced in accordance with the *shariah* to the extent that the *shariah* is so incorporated and applicable, whether or not the specific substantive legal provisions are referenced in the contract. Thus, in a *shariah*-incorporated jurisdiction, the parties cannot, by contract, alter the applicable *shariah* provisions, and it is not necessary for the parties to specifically incorporate applicable *shariah* provisions as they will be incorporated into the contract by operation of law.[151]

In our Project, the *wakala* facility documents and the *sukuk* documents were governed by Saudi law in accordance with the *shariah* principles embedded in the Saudi legal system.

4.5.3 Tax[152]

One of the key considerations that can make or break an Islamic project financing is tax. Thus, careful tax due diligence is required on a jurisdiction-by-jurisdiction basis. Given Islamic project financings asset-based nature, it is exposed to tax liabilities that do not come up in conventional financings. When the Islamic financiers transfer the title of the assets

149 See eg White (n 128), where wording for such designations are suggested for governing law and dispute resolution clauses.

150 Dewar and Hussain (n 29) para 11.43.

151 McMillen, 'Contractual Enforceability Issues' (n 109).

152 This section is based heavily on Ahmed and Khoshroo (n 14).

underlying the Islamic facility to the project company, adverse tax implications may arise. These may include liability for VAT, stamp duty, or direct sales tax which would have otherwise not been applicable. When the project company makes lease payments under the *ijara* structure, its payments may be subject to withholding tax.

Project participants try to manage these issues through the use of double taxation treaties or special purpose vehicles in tax neutral jurisdictions. However, this process needs to be managed through obtaining time-consuming and costly professional advice—driving up the project's transaction costs. To attract the IBF industry to its shores, certain jurisdictions (such as the United Kingdom and Luxembourg) have put in place tax frameworks to mitigate adverse tax treatment for some *shariah*-compliant structures.[153]

As a practical matter, the IFIs participating in the project will ensure they are not left footing the tax bill for the financing. This is achieved by incorporating tax indemnity and tax gross-up provisions in the finance documents where the IFIs pass potential tax liabilities onto the project company. However, if such liabilities cannot be passed on and tax experts say that there is more than a remote chance of incurring tax liability then the prospects of using Islamic financing would be greatly diminished.

Moreover, even if the project can manage to avoid incurring an adverse tax treatment, it may still suffer a loss of tax benefits that it would have enjoyed in a conventional financing. For example, interest payments on loans are sometimes tax-deductible, which is not the case for payments made to purchase goods. Such tax benefits are generally lost in an Islamic finance transaction.[154]

In our Project, Saudi tax became a significant and time-consuming issue for the *sukuk* issuance. Saudi Arabia's Department of Zakat and Income Tax (DZIT) had determined that

153 See section 7.3.2 (*Levelling the Playing Field*).

154 Discussed in detail in McMillen, 'Islamic Project Finance' (n 65).

as a domestic issuance, the *sukuk* issuer was liable to pay the 2.5% *zakah* tax. To avoid this *zakah* liability, the issuer was incorporated with five foreign shareholders (the minimum number of shareholders allowed under Saudi company law). While this added additional time and cost to the transaction, it was still more cost-effective than paying the *zakah* tax.

4.6 CONCLUDING REMARKS

In this chapter I have provided insight on how the Islamic banking and finance industry works as a practical matter. Given the many flavours of IBF and the limited scope of a doctoral dissertation, I have narrowed my focus to the Islamic project finance sector. I have looked at the convergence of Islamic finance and project finance and how they interact when they are used alongside each other despite the different paradigms in which they have developed and typically operate.

The scale and complexity of the projects in this space means that a whole host of participants—project sponsors, Islamic banks, conventional banks, export credit agencies, development finance institutions, and other government entities—need to cooperate and coordinate closely to achieve a clear and fair allocation of risks and rewards among each other.

The unique structuring concerns of the *shariah*-compliant participants gives rise to tensions as they are pushed into the mould of the overall conventional financing. The challenge is to come up with structures that allow the presence of both Islamic and conventional participants without (overtly) violating *shariah* principles or the deal's bankability. To achieve this, the competing commercial, political, legal, regulatory, and institutional constraints of each of the participants must be navigated until a satisfactory landing is reached.

I use a real project as an actual example of how these tensions are resolved in real-world situations, providing practical insights at the micro-level. I have sought to move beyond general structuring discussions and provide insight into the details, where, as is often the case, the crux of the matter lies. I have been able to glean this insight as a practitioner and through discussions with other practitioners. Through these micro-examples, I demonstrate how compromises are struck, who has the negotiating power, which corners are cut, and who is turning a blind eye. In other words, I have tried to show the difference between the theory and practice of IBF in the context of the Islamic project finance sector.

Of course, there are trends to try and bridge this gap between theory and practice, but progress has been incremental and there is still a lot of 'fudging' that goes on to make the structures hold together. This fudging is required to refine the myriad concerns of a wide range of participants who have different business needs and constraints, which may not align with the needs and constraints of the other participants.

Some of the factors driving the growth of IPF have also been explored to show the real—often political and commercial—driving forces behind the sector. As the industry develops, participants have more options but also more risks and concerns. I have provided some insight into these risks and the solutions that have been devised to address them.

There is an underlying incentive that is driving resolution of these issues. If conventional and Islamic finance institutions are able to harmonise their perspectives and work together, they will have a competitive advantage in project finance markets. Failing to do so will place them at a disadvantage and possibly drive them out of the markets in question all together.

The role of each of the stakeholders playing at the 'Game of Islamic Bank Bargains' table is further explored in the following chapters on faith, capital, and power.

CHAPTER 5: FAITH

5.1 THE SCHOLARS
5.1.1 THE MAKINGS OF A SCHOLAR
5.1.2 THE THEORY & PRACTICE OF *SHARIAH* SCHOLARSHIP

5.2 THE CHALLENGES
5.2.1 STANDARDISATION
5.2.2 LEGAL FICTIONS
5.2.3 LACK OF SCHOLAR REGULATION
5.2.4 CONFLICT OF INTEREST
5.2.5 SITTING ON MULTIPLE BOARDS
5.2.6 FEE INCOME
5.2.7 OPAQUENESS

5.3 THE INTERACTIONS: COOPERATION & COMPETITION
5.3.1 LAWYERS
5.3.2 BANKERS
5.3.3 SCHOLARS

5.4 THE CUSTOMERS
5.4.1 THE PIOUS
5.4.2 THE COST-CONSCIOUS
5.4.3 CLASS-DIVIDE

5.5 CONCLUDING REMARKS

'It is true that they both produce the same economic result, but the difference between conventional and Islamic finance is like the difference between legitimate and illegitimate children. They are both children, but one is born of sin.'

– Lawyer at the Islamic Development Bank

In this chapter I explore the role of 'Islam' in Islamic finance. How is Islamic faith and ideology incorporated into the industry? What is the role of *shariah* scholars—and customers—in this process? I will answer these questions by explaining who these scholars are and how they incorporate Islamic ideology into financial products—in theory and in practice—and what challenges arise along the way.

I will also look at how the scholars interact with other stakeholders in the industry and the concerns and incentives that drive them. I will seek to answer what is the role that *shariah* scholars play in the Game of Islamic Bank Bargains, what are the considerations they must balance in conducting their functions, and whether they are the cause or cure of the industry's ills. I will look at what drives customers—is it faith or financial considerations? Answering these questions will help us better understand the nuanced role of 'Islam' in Islamic finance.

Ibrahim Warde makes an apt observation in this regard:

> The battle to define the parameters of Islamic finance—and more generally the struggle over the authoritative interoperation of Islam—is not exclusively or even principally about religion. … [R]eligion cannot be separated from other factors—economic, political, cultural, ideological, historical, etc. Yet since political and economic struggles are fought on the religious terrain and expressed in religious terms, we need to be able to isolate, insofar as it is possible at all, religious issues.[1]

5.1 THE SCHOLARS

Shariah, in its early usage, referred to 'the path' to water—the all important source of life in arid Arabia. It has come to be known as the path to salvation—the way a Muslim must conduct her/his life in service to Allah. *Shariah* governs every aspect of life—the moral, behavioural, spiritual, and legal.

Islamic finance is the pursuit of commercial interests in accordance with the *shariah*.[2] This body of divinely-inspired law has developed over 1400 years and the principles governing Islamic finance are found in writings at least 500 years old. In most of the Islamic world, Islamic law has been separated from legal practice in all but personal affairs for 150 years—no one alive today has ever observed or used classical Islamic commercial law in its entirety in actual commerce.[3] Modern society looks almost nothing like the society that was ruled by classical Islamic law. The form and substance of almost every transaction is either altered or completely new.[4] So while *shariah* is 'timeless', our understanding of it is not.[5]

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1 Ibrahim Warde, *Islamic Finance in the Global Economy* (2nd edn, EUP 2010) 234.

2 Michael McMillen, 'Shari'a Compliant Project Finance: A Structural Overview' in Humayon Dar and Umar Moghul (eds), *The Chancellor Guide to the Legal and Shari'a Aspects of Islamic Finance* (Chancellor Publications Ltd 2009).

3 Frank Vogel and Samuel Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Kluwer Law International 1998) 28–29.

4 ibid 29–30 provides several good examples.

5 ibid 23–24. See also Nicholas HD Foster and Simon Archer, 'Islamic Financial Law: Law without a Legal System', *Business in between Cultures: The Development of Islamic Finance* (EABH 2012) where it is stated that, 'The *sharia* is what God has decreed as legislator, "a perfect and immutable Divine Law separate and apart from any human effort to understand that law" or, in another way of looking at it, the injunctions contained in the Holy Koran and the Sunna … The learned study, development and application of the *sharia* is *fiqh*, sometimes translated as "Islamic jurisprudence". "*Sharia*" is often used in a looser way to refer to the combination of

The *shariah* scholars are the ones who are meant to guide us along the correct path in our commercial pursuits. They are the gatekeepers, guarding us against straying from 'the path'—determining what is, or is not, *shariah*-compliant. It is the job of the *shariah* scholars to apply classical Islamic law, with all its richness and complexity, to the modern financial world. All of this interest and activity has made Islamic finance the most innovative area of contemporary Islamic law.[6]

5.1.1 The Makings of a Scholar

'The ulema [scholars] of my umma [people], are superior to the Prophets of the Israelites.'

– Prophet Mohammad[7]

Quite the ringing endorsement, when you consider that Jesus and Moses were prophets of the Israelites—and deemed in Islam as Prophets of *ol-ul-azm* (profound greatness).

Such an endorsement also carries with it great power. The prominent *shariah* scholars in Islamic finance today wield extraordinary powers that can make or break markets. For example, on the sidelines of the AAOIFI conference in 2007, Sheikh Taqi Usmani, a world renowned *shariah* scholar from Pakistan, spoke a few words to a journalist about his view that *sukuk* with capital guarantees (about 85% of the market) were not *shariah*-compliant. The resulting piece, entitled 'Most *Sukuk* Not Islamic', sent the entire multi-billion dollar *sukuk* industry into a nosedive—with *sukuk* issuances suffering a 40% decline during the

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sharia in its strict sense and *fiqh*. "Islamic law" is a Western terminological invention which refers to this combination' with citations from Haider Ala Hamoudi, 'Present at the Resurrection: Islamic Finance and Islamic Law' (2011) 26 American University International Law Review 1107.

6 Vogel and Hayes (n 3) 29.

7 Interview with Scholar30, 'Prominent Islamic jurist based in Iran' (19 April 2011) citing (in jest) this *hadith* when asked about the importance of *shariah* scholars.

first half of 2008 compared to the same period in 2007.[8] Quite the outcome from the words of a frail old scholar.

The *shariah* scholars are the first to admit their influence on the industry:

> Out of all the professionals involved in this industry, the gatekeepers are the scholars. Deals are not compliant unless a scholar says they are compliant. The scholars are a very small group. There is a large group of lawyers and bankers and other advisors and stakeholders, but the scholars are very few, so they have a monopoly over the whole industry.[9]

This power is often a source of concern for the lawyers and bankers trying to get deals done (and ensure their continuity once they are executed). This is of particular concern in the context of multi-sourced project financing, where a fully funded multi-billion-dollar finance plan can be scuppered by a *shariah* scholar saying that the Islamic tranche of the financing is no longer *shariah*-compliant. Indeed, with ongoing *shariah* monitoring, scholars can review and reassess the *shariah* compliance of existing transactions.[10]

With this great power comes great responsibility. Many Muslims involved in IBF believe that scholars are great men[11] of learning who have to interpret God's law, and if they

8 David Bassens, Ben Derudder and Frank Witlox, 'Setting Shari'a Standards: On the Role, Power and Spatialities of Interlocking Shari'a Boards in Islamic Financial Services' (2011) 42 Geoforum 94.

9 Interview with Shariah Scholar05, 'Shariah Scholar' (12 May 2015).

10 See Richard de Belder, 'Shari'a Supervisory Boards and Shari'a Compliance' in Roderick Millar and Habiba Anwar (eds), *Islamic Finance a Guide for International Business and Investment* (Blue Ibex 2008). See also discussion of 'Waiver of *Shariah* Defences' in section 4.5.2 (*Governing Law & Dispute Resolution*).

11 Malaysia has been the first country to allow female *shariah* scholars. There is an increasing trend of female participation in all aspects of Islamic finance, many of whom claim inspiration from Khadijah, Prophet Mohammad's first wife, who was a successful merchant who bankrolled the Islamic community at its outset.

are negligent in their pursuit they face an eternity in hellfire.[12] As one scholar put it, 'Scholars are not only responsible to their banks, but also their Lord'.[13]

Given their role as gatekeepers,[14] *shariah* scholars have also become the major source of ingenuity when coming up with structures. Islamic hedge funds, Islamic derivatives, use of intangible assets, and *sukuk* convertible to equity were all devised by scholars.[15] They, of course, were aided by bankers and lawyers, but the main grey matter was coming from the scholars and the lawyers and bankers were only executing their vision.[16]

Qualifications of the scholars: To be a *mujtahid* (qualified to engage in a process of *ijtihad*),[17] a classical training in Islamic law and jurisprudence is required. One would need a deep knowledge of the Quran, *hadith*, *ijma* (consensus), and the *usul-ol-fiqh* (principles of jurisprudence),[18] along with all the associated disciplines (such as Islamic history, Islamic legal theory, and classical Arabic). Of course, these are only the studies they must have completed. To become a renowned scholar, one must possess 'perhaps the most rare and subjective of all attributes, … sufficient wisdom of judgement to be trusted'.[19]

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12 Interview with Lawyer09, 'Partner and Head of Islamic Finance at London Office of International Law Firm' (9 February 2015). Also see eg Harris Irfan, *Heaven's Bankers: Inside the Hidden World of Islamic Finance* (Constable 2014) 55.

13 Interview with Shariah Scholar41, 'Shariah Scholar' (17 August 2016).

14 See eg David Bassens, Ben Derudder and Frank Witlox, '"Gatekeepers" of Islamic Financial Circuits: Analysing Urban Geographies of the Global Shari'a Elite' (2012) 24 Entrepreneurship & Regional Development 337.

15 Interview with Shariah Scholar28, 'Prominent Shariah Scholar' (8 April 2014).

16 Interview with Lawyer06, 'Partner at London Office of International Law Firm' (3 February 2015). Also see Irfan (n 12) 93 describing the working relationship between Sheikh Hassan Hussein, a world-renowned *shariah* scholar and the Chairman of Deutsche Bank's *shariah* board, and the 'Samadiites'—a group of expert Islamic bankers and lawyers who attended the same mosque in Dubai.

17 On the continued existence of *mujtahids* see Wael B Hallaq, 'On the Origins of the Controversy about the Existence of Mujtahids and the Gate of Ijtihad' [1986] Studia Islamica 129.

18 For further discussion on sources see section 2.1 (*Theoretical Framework*) and John Dewar (ed), *International Project Finance: Law and Practice* (2nd edn, OUP 2015) para 11.04–05.

19 Irfan (n 12) 57.

Add to this already very high bar, expert knowledge of finance and banking transactions and you have the makings of a *shariah* scholar in Islamic finance. Thus, it is no wonder their number is so few and they command such staggering fees for their services. Indeed, finding quality personnel is frequently cited as one of the Islamic finance industry's major challenges.[20]

Studying the backgrounds of the *shariah* scholars, I have identified a trend.[21] They have university degrees in Islamic law from an Islamic country (eg Saudi Arabia, Pakistan, Egypt). The older scholars tend to have completed their Islamic education at seminaries rather than universities. They also have degrees in finance, economics, and sometimes law from Western universities (predominantly in the United States and the United Kingdom). They have published extensively on Islamic finance in books and articles, in English and other languages, and are actively involved in Islamic finance regulatory and supervisory institutions (such as AAOIFI and the Fiqh Academy). It is common for scholars to sit on multiple *shariah* supervisory boards (SSBs)—for example, there are six Islamic windows in Saudi Arabia and they all have the same three scholars sitting on their *shariah* boards.[22]

Shariah scholars are usually selected to *shariah* boards of Islamic banks in one of two ways: first, through mentor/mentee relationships, whereby senior scholars will recommend junior scholars who are typically their favoured students; and second, banks will send their selection committees to the relevant universities and *madares* (seminaries) scouting for promising potential.[23] The students taken from universities are further trained in *fiqh al-*

20 Interview with Regulator42, 'Regulator at the Central Bank of Pakistan' (17 August 2016).

21 See also Ibrahim Warde, 'The Role of Shariah Boards: A Survey' (IBPC 1998); Bassens, Derudder and Witlox (n 14) which presents an analysis of the nationality and educational background of 253 *shariah* scholars.

22 Interview with Lawyer15, 'Partner with Islamic Finance Specialisation in London Office of International Law Firm' (30 April 2015).

23 Interview with Shariah Scholar31, 'Prominent Shariah Scholar' (12 December 2011).

mu'amalat (Islamic commercial jurisprudence)[24] and those taken from seminaries are taught accounting and finance.[25]

Functions of the scholars: Now that we have an idea of who the scholars are, we can turn to what the scholars do. According to AAOIFI, every IFI should have a *shariah* board that: (i) is 'an independent body of specialised jurists in *fiqh al-mua'malat*'; (ii) is 'entrusted with the duty of directing, reviewing and supervising the activities' of the IFI in order to ensure that they are *shariah*-compliant; (iii) can issue *fatawa* which shall be binding on the IFI; (iv) shall prepare a report on the *shariah*-compliance of all the IFI's contracts, transactions, and dealings; and (v) shall state that 'the allocation of profit and charging of losses related to investment accounts conform to the basis that has been approved' by the board.[26]

AAOIFI further provides that each board shall have at least three members. Most IFIs stick to this minimum, but some have as many as nine scholars sitting on their board. The members are each appointed by the shareholders upon the recommendation of the board of directors. Directors and significant shareholders cannot be members of the *shariah* board. In addition to suggesting the scholars, the board of directors (or in some cases the shareholders) sets the remuneration of the *shariah* scholars. In reality however, management has a strong influence on this decision (like on many other decisions of the board of shareholders). Therefore, top executives at the IFI will play a key role in determining the composition of the *shariah* board and the financial and non-financial rewards of its members.[27] As one scholar put it, 'The banks can make a scholar rich and famous'.[28]

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24 For an explanation of this term see Foster and Archer (n 5).

25 Interview with Regulator42 (n 20).

26 AAOIFI Governance Standard No. 1 on the 'shari'a supervisory board: appointment, composition and report' cited in Volker Nienhaus, 'Governance of Islamic Banks' in Kabir Hassan and Mervyn Lewis (eds), *Handbook of Islamic Banking* (Edward Elgar 2007).

27 ibid. See also Warde (n 21).

28 Interview with Shariah Scholar05 (n 9).

It is worth noting that even though an IFI has a *shariah* board, the management remains responsible for ensuring that the IFI's business is conducted in accordance with the *shariah*. The board's responsibility is 'to form an independent opinion' on the *shariah*-compliance of the IFI's activities. In this way, they are similar to a bank's auditors—even though they are remunerated by the bank, they must remain independent.[29]

But the AAOIFI standard is far from comprehensive. It leaves out guidance regarding how often the *shariah* board should meet, the duration of board membership, possibilities and procedures for dismissal or reappointment, and the criteria for scholar selection and compensation. Given the lack of a clear governance framework, the IFI's management tends to exercise its absolute discretion when making these decisions, with no reporting or accountability to the general public. This lack of transparency gives the management of IFIs more or less free rein to modify the composition of the board as they see fit to promote their commercial endeavours—and exert pressure when required.[30]

5.1.2 The Theory & Practice of *Shariah* Scholarship

Islamic rulings can be divided into two parts: those that govern the relationship between God and humans (*ibadat* or worship); and those that govern the relationship between humans themselves (*muamalat* or transactions).[31] For an act to be permitted as worship, it must be explicitly ordained as such. On the other hand, in transactions, everything is permitted unless it is explicitly prohibited. Iqbal and Molyneux call this the 'Doctrine of Universal Permissibility'[32] of transactions.

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29 Warde (n 1) 235. See also Faris Mahmoud Abumouamer, *An Analysis of the Role and Function of the Shariah Control in Islamic Banks* (University of Wales, College of Cardiff 1989).

30 Barry Rider, 'Corporate Governance for Institutions Offering Islamic Financial Services' in Craig Nethercott and David Eisenberg (eds), *Islamic Finance: Law and Practice* (OUP 2012).

31 Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects* (Palgrave Macmillan 2005) 6.

32 ibid.

Related to this doctrine is the principle of 'Freedom of Contract'. This principle is recognised by Islam and supported by a well-known *hadith* which states, 'All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful'.[33] Thus, there is a wide scope for crafting *shariah*-compliant structures—provided they do not violate any prohibitions (such as *riba* and *gharar*).

There are now calls—mostly from academic circles—to have *shariah* scholars not only approve the legal structures of the financial instruments, but also their social impact and utility—a consequentialist rather than intentionalist approach.[34] On this basis, it is suggested that Islamic credit cards (because of the role credit cards play in a high percentage of personal bankruptcies) and *tawarruq* (because of its debt-like function) should not be allowed, even if their legal form is *shariah*-compliant. These calls have mostly fallen on deaf ears, as the scholars say they do not have conclusive data to determine social utility of financial instruments and the Doctrine of Universal Permissibility would not allow them to prohibit something that is lawful.[35]

Scholars are consulted by financial institutions, lawyers, regulators, financial, and tax advisors. They are not only consulted on financial products but also for advice on regulation and legislation. Scholars have an advisory role, transactional role, and also sometimes serve as expert witnesses in contentious issues.[36]

There are various scenarios for the involvement of *shariah* scholars in a deal. The size and length of the deal can also determine the extent of a scholar's involvement. Sometimes the deal is so short you can get the scholar's opinion in one go, other deals, like project

33 *Sunan Abu Dawood*, vol 10 (Cagri Yaginlari 1981) 19 cited in Iqbal and Molyneux (n 31) 7.

34 See eg Interview with Scholar54, 'Prominent Islamic Finance Academic Based in UK' (21 February 2018).

35 See Interview with Regulator39, 'Prominent Malaysian Regulator and Shariah Scholar' (17 August 2016); Interview with Shariah Scholar41 (n 13).

36 Interview with Shariah Scholar05 (n 9). See also Belder (n 10).

financings, you will need the opinions of the scholars at the beginning, throughout the process, at financial close, and when the deal is in effect.[37] Even requests for amendments, waivers or consents under the Islamic documents must be done in a manner that does not negate the *shariah* approval received at the outset of the transaction.[38]

In a typical project finance deal, the lawyers and bankers will discuss the financing needs of the company and decide which Islamic finance instrument best meets that need. The banks will usually have their own *shariah* board or if there is a *sukuk* being issued, if the issuer is a *shariah*-compliant entity it may have its own board. When a deal has multiple Islamic banks involved, one *shariah* board will typically take the lead and coordinate the comments and sign-off of the other boards.

In smaller deals where the parties involved do not have a *shariah* board, the parties will appoint scholar(s) on a consultancy basis. In a phenomenon that is referred to as '*fatwa*-shopping'[39] (similar to forum-shopping), the deal's sponsors sometimes seek to find a scholar that is willing to provide the *fatwa* required to allow the deal to go ahead without scrutinising its structure too much. At least two of my interviewees[40] recalled personal experiences where they were approached by an institution and asked if they had any reservations for approving that institution's proposed structure. When my interviewees suggested that certain modifications would be required for their approval, the institution took their structure elsewhere and had it approved by other scholars in its original state. This creates an obvious internal conflict for these consultant-scholars between their role as

37 Interview with Lawyer16, 'Partner in London Office of International Law Firm' (4 November 2015).

38 Shibeer Ahmed and Sajjad Khoshroo, 'Islamic Project Finance' in Rahail Ali (ed), *Islamic Finance: A Practical Guide* (2nd edn, Globe Business 2014).

39 Interview with Shariah Scholar20, 'Senior Shariah Scholar' (12 February 2016).

40 Interview with Shariah Scholar05 (n 9); Interview with Islamic Banker11, 'Prominent Islamic Banker' (22 April 2015).

businesspeople trying to secure mandates and their role as *shariah* scholars trying to uphold the *shariah*-compliance of transactions.

Moreover, in these type of scholar-consultant situations, once the *fatwa* is issued, the *shariah* scholar's job is done. If the entity receiving the *fatwa* does not abide by it, or subsequently challenges the *fatwa*'s validity as a means of reneging on its underlying obligations (as was perceived to be the case in the *Dana Sukuk*[41] matter), the *shariah* scholars are no longer involved to prevent this. This can be contrasted with the *Blom Bank*[42] case, where there was a *shariah* board and they spoke out against management's attempt to raise a *shariah* defence to invalidate the deal.

The parameters of the main Islamic finance structures have been put in place by eminent scholars and are largely followed by the *shariah* boards. The lawyers and bankers make the required tweaks to the structure to tailor it to the specific deal at hand,[43] sometimes this is as simple as plugging in party names. They then share the tailored structure paper—with a diagram and details of the deal—with the relevant boards. The scholars then bless the structure (or request certain modifications) and lawyers begin drafting the deal documents on that basis.[44] The drafts will be circulated back and forth between the lawyers for the company and the lawyers for the banks. When the documents are close to final form, the lawyers send them to the lead *shariah* board who will coordinate the gathering of final comments or sign-off from the other boards and scholars. Sometimes, when you have multiple scholars involved in a transaction, you will reach the lowest

41 *Dana Gas PJSC v Dana Gas Sukuk* [2017] EWHC 2928 (Comm).

42 *The Investment Dar Company KSCC v Blom Developments Bank Sal* [2009] EWHC 3545 (Ch), [2009] All ER (D) 145.

43 Interview with Lawyer06 (n 16).

44 Interview with Lawyer14, 'Partner and Global Co-Head of Islamic Finance Practice in Dubai Office of International Law Firm' (11 February 2015).

common denominator, which enhances *shariah*-compliance.[45] This is why sometimes deals are advertised as having received approval from a multitude of scholars. The lawyers typically draft the *fatwa* for the scholars that set out the structure and the fact of the approval (but not the reasoning underpinning it). The *fatwa* itself is usually a condition precedent to the closing of the deal—so for the purposes of transaction management, it is treated much like another legal opinion issued at closing.[46]

5.2 THE CHALLENGES

During my research and interviews, several themes emerged that showed how the incentives of the various stakeholders have resulted in alliances in the Game of Islamic Bank Bargains which have created certain challenges for the industry, as explored below.

5.2.1 Standardisation

'Standardisation of [Islamic] products? We haven't managed to standardise the spelling of "shariah".'

– Islamic finance lawyer referring to spellings such as *sharia*, *shari'a*, *syariah*, *shari'a*

Lack of standardisation is identified by corporates and their lawyers as the most pressing issue with IBF.[47] One senior lawyer said:

> [*Shariah* scholars] are a pain in the backside. They are inconsistent and often change their mind. These changes cost a lot of money and time. Often with these deals there is a tight timeframe that needs to be met. There is no precedent value to the work that they have done, as they can change their mind the year after … Given that each bank has its own *shariah* board and each jurisdiction has its own *shariah* preferences the uncertainty and inefficiency that is created is significant … Evolution in a body of law is something that happens over a hundred years not something that can happen every couple of years. The lack of certainty and efficiency significantly impairs the industry.[48]

45 Interview with Lawyer17, 'Senior Associate and Islamic Finance Specialist in Abu Dhabi Office of International Law Firm' (31 March 2015); Interview with Lawyer06 (n 16); Interview with Lawyer14 (n 44).

46 Interview with Lawyer09 (n 12).

47 See eg Interview with Government Official22, 'Practice Head at Leading National Oil Company' (4 November 2013).

48 Interview with Lawyer01, 'Senior Partner at London Office of International Law Firm' (3 February 2015).

This lack of standardisation stems from the potentially different *shariah* interpretations amongst *shariah* boards, even within a single board from one year to the next, and differences in *madhahib* (schools of thought) and geographies.[49]

Scholars can refer to the various sources of Islamic law and interpret *shariah* in 'different yet equally permissible' ways based on the methodology they may apply.[50] This means that there can often be different opinions and interpretations on the same point or even the same word.[51] This difference of methodology for interpreting *shariah* and the body of *fatawa* (Islamic legal opinions) derived thereby is one reason why several *madhahib* have developed over the centuries.[52]

Some believe that these schools have done the interpretations and have standardised them over centuries. The job of the modern scholar should be taking those existing interpretations and applying them to Islamic finance structures. It is only rarely that scholars are presented with a genuinely novel case that would require them to preform *ijtihad* and come up with new *fiqh* (Islamic law).[53] Scholars tend to rely on allowances in the existing body of jurisprudence. Alternatively, they can also rely on the concepts of *maslaha* (expediency, public good) or *dharurah* (necessity) to allow something for a specific time and place.[54] This was often used in the nascent days of IBF, where substandard *shariah* solutions were the best alternative to conventional finance. This means that a *shariah* approval of a certain structure does not make it 'Islamic' for all parties at all times. The approval may well be based on nothing more than a temporary necessity or public good.

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49 Vogel and Hayes (n 3) 9–10.

50 Dewar (n 18) para 11.06.

51 See Warde (n 1) 238–41 showing a variety of different interpretations on some important points of Islamic law.

52 Dewar (n 18) para 11.06, which also contains a brief explanation of the Hanafi, Maliki, Shafei, and Hanbali schools.

53 Interview with Shariah Scholar05 (n 9).

54 Vogel and Hayes (n 3) 40–41.

This lack of standardisation, and the ensuing fragmentation of the market, leads to various problems for the industry. It causes the loss of time and money—the wheel needs to be reinvented for each deal and there is no standard precedent that can be used as a starting point.[55] It prevents joint investments and syndications, as each bank may have its own unique requirements.[56] This in turn also hampers the development of a secondary market.[57] In times of tight competition, Islamic finance institutions may start competing on the basis of the leniency of their *shariah* boards and 'race to the *shariah* bottom'.[58] This is probably due less to specific disagreements in legal reasoning than to differing degrees of strictness in general, which tends to be more geographical (eg Saudi Arabia and the UAE are considered stricter than Malaysia and Pakistan).[59]

In the context of big project finance transactions, involving several Islamic finance institutions, each will have their own *shariah* board, with their own interpretations. This can create significant uncertainty and delay as sign-off will be required from each board, who may have different—hopefully not contradicting—comments on the transaction. In a multi-sourced project financing, where the Islamic facilities are only part—and usually a small part—of the equation, this delay can hold up the broader effort.[60] This significantly limits cross-border transactions, making them only possible when the Islamic banks in each jurisdiction enter into a separate Islamic tranche with separate documentation—even though they achieve nearly the same outcome.[61]

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55 Interview with Lawyer16 (n 37); Interview with Lawyer15 (n 22).

56 Vogel and Hayes (n 3) 41.

57 Warde (n 1) 236.

58 ibid 235–36.

59 Interview with Scholar23, 'Prominent Islamic Finance Academic Based in US/Saudi Arabia' (12 February 2016).

60 Interview with Government Official04, 'Legal Counsel at a Leading National Oil Company' (13 May 2015).

61 Dewar (n 18) para 11.28; Interview with Lawyer01 (n 48).

In response to these problems, various solutions have been proposed and pursued. As the market has developed, a measure of standardisation has been achieved for the more typical Islamic finance structures within a given geographical jurisdiction. For example, the *istisna*, *wakala*, *ijara*, and *murabaha* documentation is now fairly standardised within the Saudi market—which was not at all the case a decade ago.[62] This means that the banks, the company taking on the financing and other participants, like the export credit agencies (ECAs), have gained familiarity with the typical structure of these products and know how to deal with them.[63]

As part of this trend, regulatory bodies such as the Islamic Fiqh Academy of the OIC, AAOIFI, IFSB, and IIFM have taken steps towards establishing global standards that are followed by many Islamic finance institutions.[64]

On a transaction level, deal teams opt for using a joint *shariah* committee when multiple Islamic banks are participating in a large project financing, especially if they are from different jurisdictions. On a national level, certain jurisdictions have established National Shariah Boards (NSBs) that regulate *shariah*-compliance nationwide—in contrast to the *shariah* supervisory boards that regulate it at an institutional level. Malaysia is the most prominent example of this where the Shariah Advisory Council of Bank Negara Malaysia was established in 1997.[65] Other countries are also following suit, such as Afghanistan,[66] Uganda,[67] and the UAE.[68]

62 Interview with Lawyer15 (n 22).

63 Interview with Lawyer17 (n 45).

64 Interview with Regulator02, 'Senior Legal Counsel at the Islamic Development Bank' (14 February 2015); Dewar (n 18) para 11.09.

65 Warde (n 1) 237.

66 'New Afghanistan Banking Law May Jump-Start Islamic Finance' *Reuters* (27 March 2015).

67 Yasiin Mugerwa, 'Parliament Okays Islamic Banking' (*Saturday Monitor*, 8 January 2016).

NSBs are also said to have the additional benefit of avoiding the 'capture' of the *shariah* board members by the Islamic bank's management—which can lead to the *shariah* boards becoming too permissive.[69] On the downside, using NSBs could have an impact on timing—especially if the NSB has a backlog or the deal is working to a tight timeline. Also, if the deal is bespoke and the first of its kind (which can often be the case in a project financing) it is important to have close coordination and dialogue with the *shariah* scholars in the structuring phase. This coordination is easier to achieve with an individual *shariah* board than the National Shariah Board.[70]

Of course, the drive towards standardisation is not without its obstacles and various industry participants resist it. This is in part because, thinking in terms of the Game of Islamic Bank Bargains, standardisation would significantly erode the influence and power of *shariah* scholars. Only a limited role would remain for them in the overall Islamic finance industry. Some observers interpret the actions of some scholars through this lens—'they are merely preserving their monopoly rents'.[71] An example they cite in this regard is, when the *sukuk al-ijara* structure was achieving a high degree of standardisation, the prominent Sheikh Taqi Usmani commented to a journalist that the structure, comprising 85% of the sector, was not *shariah*-compliant in his view.[72] This upended the sector and forced the participants back to the drawing board with their *shariah* scholars, who would have otherwise been superfluous.

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68 Daria Solovieva, 'UAE Standards Board Set to Boost Dubai in Global Islamic Race' (*Bloomberg.com*, 22 March 2015).

69 See section 5.2.4 (*Conflict of Interest*).

70 Interview with Lawyer17 (n 45).

71 Interview with Lawyer32, 'Senior Associate and Islamic Finance Specialist in London Office of International Law Firm' (19 August 2016). See also Interview with Lawyer01 (n 48).

72 Warde (n 1) 237.

Thus, some scholars have been seen to resist this drive towards standardisation by insisting that Islamic law is inherently diverse and this is a desired aspect of it. To do this, they draw upon Islamic teachings, such as this saying from the Prophet Mohammad, 'My community's *ikhtilaf* [(differences of opinion)] are a blessing'.[73] They highlight the fact that there is no authoritative body that can speak for all of Islam, which results in this desirable diversity of opinion. A senior Saudi regulator says in this regard:

> *Shariah* law in itself is not standardised. In Islam you have two main sects, Sunni and Shia. In the Sunni sect you have four main schools: Hanbali, Maliki, Shafei, Hanafi. Even within the same school you have different scholars that have different opinions on the same matter. Nobody has the right to monopolise the truth and to appoint himself as a speaker in the name of God. I can't say my opinion is the best and most Islamic. Who am I? Islam is not like Catholicism where they have a Pope and a Vatican.[74]

Another criticism of standardisation is that it stifles innovation. The IBF industry has not yet reached a happy landing and needs further innovation to develop structures that are generally acceptable by the Islamic community and the leading *shariah* scholars globally. Global bodies and industry leaders should come up with structures that more closely reflect the *shariah* principles. Leading Islamic finance practitioners believe that reaching that point would naturally trigger standardisation—because as those structures gain widespread following they will become standardised by themselves.[75]

Moreover it is said that standardisation codifies conventional finance and risks—formalising the replication of the conventional debt industry. Practitioners believe that standardisation will strengthen the industry's 'form over substance' approach and lead participants to disregard the underlying fundamentals of a project that is hoping to use the Islamic funds. Rather than assessing projects on a case-by-case basis for the nature of their business, their assets, their customers, their policies and practices, the industry will move towards a box-ticking-exercise to ensure the form of the transaction is followed. The

73 Cited in Dewar (n 18) para 11.07.

74 Interview with Regulator03, 'Senior Regulator in Saudi Arabia' (14 May 2015).

75 Interview with Lawyer14 (n 44).

practitioners argue that this will not promote the Islamic economic model—the *maqhasid al-shariah*, as they understand it.[76]

So standardisation remains one of the most problematic and contested issues in the industry[77] and one in which the *shariah* scholars have a significant stake.

5.2.2 Legal Fictions

Amongst *shariah* boards, a legalistic view has become the dominant approach—whereby complex financial products are deconstructed and dissected into their basic components in a way that they resemble nominate contracts existing in traditional Islamic commercial transactions. The boards assess the *shariah*-compliance of each of these components separately. Once each individual component is sanctioned, the complete product is blessed as *shariah*-compliant.

The proponents of this view believe that it supports product innovation and is within the permitted methodology of Islamic law.[78] The opponents believe that components which are perfectly legitimate separately may interact in such a way that the result comes into contradiction of fundamental principles of Islamic law.[79]

As mentioned in section 5.1.2 (*The Theory & Practice of* Shariah *Scholarship*), most Islamic project financings use a structure approved by eminent scholars as the starting point for the Islamic finance instrument. Mahmoud El-Gamal explains how these initial structures have formed as follows:

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76 Interview with Islamic Banker11 (n 40).

77 See Foster and Archer (n 5) for a discussion and comparison of standardisation in Islamic finance against Western legal systems.

78 See eg Interview with Lawyer01 (n 48); Interview with Lawyer06 (n 16); Interview with Islamic Banker08, 'Board Director & CEO of Leading Islamic Bank' (12 February 2015); Interview with Shariah Scholar19, 'Senior Shariah Scholar' (12 February 2016).

79 See eg Nienhaus (n 26); Interview with Lawyer14 (n 44); Interview with Shariah Scholar20 (n 39).

> Interactive discussions between bankers, lawyers, and jurists commonly start with an existing conventional product for which no Islamic alternative is available. The three groups then engage in a process of financial reengineering of the product, replacing its various conventional components that are deemed un-Islamic with others that can be presented to the public and defended as Islamic. In the later stages of product development and marketing, the vehicle of choice has been modification and adoption of premodern nominate financial contract names. Coverage of the premodern contracts in classical jurisprudence texts thus makes the new products identifiable as Islamic. To maintain credibility, industry practitioners insist on using Arabic names of contracts, for instance, '*ijara*' instead of the equivalent 'lease,' or '*murabaha*' instead of the equivalent 'cost-plus sale.' In many cases, the contemporary practice marketed under some premodern Arabic name bears only very superficial similarity to the premodern financial practice discussed in classical jurisprudence.[80]

Charles Tripp adds in this regard:

> The drive behind these transactions is the drive to profit and to compete within an established financial market for clients. In some respects, this inverts the role originally foreseen for the Islamic banks. Instead of seeking to depart from existing practices by introducing those which are distinctive of an Islamic tradition, the trend has been to scour the Islamic tradition … in order to find ways of legitimating financial transactions developed in the larger context of global finance capital.[81]

These legal fictions, that cast novel practises as old law, have wholly transformed Islamic commercial law in practice and will eventually also do so in theory.[82] Of course, these legal fictions have also contributed to bringing about the state in which many involved in the industry have come to deride it as excessively 'form over substance'.[83] This criticism has discredited IBF for many Muslims, which now see it as a money-making endeavour devoid of any religious and moral merit. This in turn has led to calls for reorienting Islamic finance towards an Islamic economics understanding.[84] In the words of El-Gamal, 'the "Islamic" in

80 Mahmoud El-Gamal, *Islamic Finance: Law, Economics, and Practice* (CUP 2006) 11–12.

81 Charles Tripp, *Islam and the Moral Economy: The Challenge of Capitalism* (CUP 2006) 142–43.

82 See Lon Fuller, *Legal Fictions* (SUP 1967) cited in Vogel and Hayes (n 3) 32–46.

83 This topic came up in over half of my interviews conducted amongst Islamic bankers, lawyers, regulators, customers, and even scholars. See also section 6.3 (*Commercial Justifications for the Industry's State*).

84 See eg Mehmet Asutay, 'A Political Economy Approach to Islamic Economics: Systemic Understanding for an Alternative Economic System' (2007) 1 Kyoto Bulletin of Islamic Area Studies 3.

"Islamic finance" should relate to the social and economic ends of financial transactions, rather than the contract mechanics through which financial ends are achieved'.[85]

5.2.3 Lack of Scholar Regulation

There remains no adequate body for the regulation of *shariah* scholars. This was raised as an issue by a number of interviewees, who called for the establishment of a professional body for *shariah* scholars, similar to the bodies that regulate solicitors, accountants, and barristers.[86] The scholars too need a code governing ethics, confidentiality, insider information, and conflicts of interest. Such standards are lacking for scholars.[87] There are even calls for a body that can 'strike off' scholars that violate conduct standards and bring the Islamic finance industry into disrepute, as is the case for other professionals.[88]

This led some prominent scholars—who together shared close to 270 seats on *shariah* boards around the world—to launch an association to develop professional conduct standards for the gatekeepers of Islamic finance.[89] The Association of Sharia Scholars in Islamic Finance (ASSIF), a British registered charity, was established in 2013 to address this longstanding problem in the industry.

ASSIF intended to organise advisory providers by a verifiable unified standard of *shariah* guidance, promoting greater uniformity and consistency amongst the rulings of the *shariah* boards. The activities of ASSIF were meant to complement efforts of AAOIFI and the Malaysian-based Association of Sharia Advisors in Islamic Finance (ASAS).

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85 El-Gamal (n 80) xiii.

86 See eg Interview with Shariah Scholar05 (n 9); Interview with Shariah Scholar20 (n 39).

87 Liau Y-Sing, 'Scholar Ethics Rule Pushed Globally by Malaysia: Islamic Finance' (*Bloomberg.com*, 2 March 2015).

88 See eg Interview with Shariah Scholar05 (n 9).

89 Bernardo Vizcaino, 'Islamic Scholars Launch Global Professional Association' (*Reuters*, 30 October 2013).

However, despite the initial fanfare, ASSIF was quietly dissolved in August 2015, without making much impact on this issue.[90] With no adequate oversight and regulation, scholars are seen to enjoy free rein over the industry and there are no safeguards in place to ensure they do not succumb to the commercial pressures inherent in their roles.[91]

This has eroded trust in the industry to such an extent that, in response to louder calls for transparency and accountability, the Islamic Finance Council UK (UKIFC) and International Shariah Research Academy for Islamic Finance (ISRA) are urging governments and Islamic finance institutions to implement mandatory independent external *shariah* audits.[92]

5.2.4 Conflict of Interest

The Game of Islamic Bank Bargains creates both an alignment and a conflict of interest between the Islamic banks and their *shariah* boards.[93] *Shariah* board members get paid by an institution and are expected to approve its products. In theory, *shariah* scholars are independent and free to approve and reject products, practices, and transactions at their discretion. In this way, they are similar to external auditors and accountants. Proponents of this arrangement dismiss any claims of conflict as a common feature of service providers hired by institutions and not unique to *shariah* boards.[94]

> There's a criticism levelled at the scholars, saying you're compromised, you get paid [by the banks for your *fatawa*], therefore you will always be compromised. Do auditors get

90 'Association of Shariah Scholars in Islamic Finance' (*Companies House*) <https://beta.companieshouse.gov.uk/company/08482606> accessed 20 January 2016.

91 Discussed in section 5.1.2 (*The Theory & Practice of* Shariah *Scholarship*).

92 'Strong Calls for Mandatory Independent Shariah Audit for Islamic Financial Institutions' (2016) 13 *Islamic Finance News*.

93 This has been raised in the Interview with Islamic Banker11 (n 40); Interview with Regulator02 (n 64); Interview with Regulator27, 'Regulator' (15 May 2015).

94 See eg Interview with Islamic Banker08 (n 78); Interview with Shariah Scholar19 (n 78).

> compromised? Oftentimes auditors get paid and are very tough on their clients, because that's what they get paid to do.[95]

Critics say, and I think they have a point, while *shariah* boards are not subject to the instructions of management, directors, or shareholders, they do not operate in a vacuum. Volker Nienhaus aptly identifies the myriad of incentives of the scholars and the tension between them as follows:

> [*Shariah* supervisory board (SSB)] members had an initial motivation to accept their appointment (whatever that motivation was, whether scholarly reputation, the sake of Islam, financial reward or public visibility). If the membership of a SSB does promote the achievement of individual goals, it is a plausible assumption that the SSB members are interested in a continuing membership respondent in a reappointment. This creates a factual dependence on the board of directors which nominates SSB members and on the shareholders who appoint them. In addition, if the interests of the management are well represented in the board of directors, the SSB members have to take these into consideration. As long as the management is supported by the board of directors and the shareholders, this boils down to the hypothesis that SSB members will not ignore the interests of the management when they apply their interpretation of *shariah* principles to the activities, contracts and transactions of their Islamic bank. This does not mean that they will always find ways to accept whatever new financial product or transaction is submitted by the management. It must be a prime concern of the SSB that the Islamic character of the institution is recognised by the general public. But the SSB must also bear in mind the survival and commercial success of the institution.[96]

Observers believe that these behavioural assumptions for *shariah* scholars can help explain the obvious change of attitudes of *shariah* boards towards financial innovation—from being rather restrictive to becoming quite permissive.[97]

This conflict of interest can lead to what some have called the 'capture' of the *shariah* scholars—whereby they become instruments manipulated by bankers for achieving their desired commercial outcomes while paying lip service to *shariah* compliance, 'scholars for dollars' so to speak.

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95 Interview with Lawyer47, 'Partner and Global Head of Islamic Finance Practice in Dubai Office of International Law Firm' (8 March 2017).

96 Nienhaus (n 26).

97 See eg Interview with Scholar29, 'Prominent Islamic Finance Academic Based in US/Egypt' (21 November 2012); Interview with Scholar21, 'Member of International Advisory Panel, World Islamic Economic Forum Foundation' (12 February 2016).

Of course, there are also instances where scholars withstand this conflict and act in an independent way. A prominent example of this is the *Blom Bank* case.[98] Very briefly,[99] the facts of the case are that The Investment Dar Company (TID) owed Blom Bank US$10 million but was trying to avoid payment by raising a '*shariah* defence' and saying that the underlying *wakala* contract they had entered into was not Islamic in the first place and their articles of association only allow them to enter into *shariah*-compliant transactions, thus the agreement was null and void.

This could have significantly eroded confidence in the Islamic finance market where parties would constantly worry that their Islamic contracts could be nullified by their counterparties disputing its *shariah* compliance. The *shariah* board of TID stepped in and acted in an independent way—without consulting TID's management—and issued a press statement that basically said, 'The transaction in dispute was indeed *shariah*-compliant; TID must return Blom's money; and never use *shariah* as a defence in a court of law without our consultation or say so'.[100] This is an interesting example of a *shariah* board acting independently and very publicly disagreeing with the management of the bank that employed them.

Another example is the mass resignation of the *shariah* board of South Africa's First National Bank (FNB) after a dispute with the bank's management.[101] The dispute, however, was not over a point of *shariah*, but rather over the fact that the bank's management had

98 *Investment Dar v Blom* (n 42).

99 For further background on the case see Michael Godden, 'The Implications for the Islamic Finance Market of The Investment Dar Company KSCC v Blom Developments Bank Sal [2009] EWHC 3545 (Ch)' (*Norton Rose Fulbright*, March 2010); Atif Hanif and others, 'Wakala Contracts: What Are the Implications of the Judgment in TID v Blom?' (*Allen & Overy*, 5 March 2010).

100 Interview with Islamic Banker11 (n 40).

101 Xola Potelwa, 'S.Africa's FNB to Appoint New Sharia Board by Year-End' *Reuters* (28 August 2012).

'failed to consult with the board on several occasions, and hired a new head of its Islamic finance business without input from the board'.[102]

5.2.5 Sitting on Multiple Boards

Everyone agrees that distinguished and well-known *shariah* scholars are in short supply.[103] This is not surprising when one considers the qualifications they must possess.[104] This shortage means that key scholars often sit on a multitude of *shariah* boards,[105] in addition to advisory boards, committees of regulatory authorities, and standard-setting organisations (eg IFSB and AAOIFI). By way of demonstration, there are fewer than ten Islamic banks in Saudi Arabia and the *shariah* boards of six of these banks are made up of the same three scholars.[106] In other words, the *shariah* boards of over 60% of Saudi banks are comprised of the same individuals.

Some say the fact that the same scholars sit on a number of boards is a good thing because it helps with bringing a measure of standardisation to the industry. Scholars sitting on multiple boards see more of the market than anyone (even the lawyers) and are thus best placed to determine what market practice is.[107] This helps move the entire industry towards greater harmony, uniformity, and consensus.[108]

Others—often regulators—say it is not a good thing because it means that the scholars are stretched so thin that they are not properly reviewing the deals and are merely

102 Bernardo Vizcaino, 'Islamic Scholars Propose New Sharia Board Model' *Reuters* (13 September 2012). See also Interview with Islamic Banker45, 'Senior Islamic Banker Based in Oman' (17 August 2016).

103 See Nienhaus (n 26).

104 See section 5.1.1 (*The Makings of a Scholar*).

105 See McMillen (n 2).

106 Interview with Lawyer15 (n 22) confirmed by Interview with Regulator03 (n 74).

107 See eg Interview with Islamic Banker26, 'Senior Islamic Banker' (14 October 2014); Interview with Lawyer09 (n 12); Interview with Regulator27 (n 93);

108 Interview with Lawyer33, 'Partner and Islamic Finance Specialist in the New York Office of International Law Firm' (12 February 2016); Interview with Shariah Scholar20 (n 39).

'rubber-stamping' them.[109] This can be the case in a project financing where the deal documents easily stretch over thousands of pages, especially if the scholars also request to see the finance documents like the Common Terms Agreement and the Intercreditor Agreement.[110]

Moreover, scholars sitting on a number of boards will influence the other (typically more junior) scholars sitting alongside them, as the junior scholars will be hesitant to challenge a view that is widely disseminated in the market by more eminent scholars.[111] To counter this worrying trend, jurisdictions like Malaysia do not allow *shariah* scholars to sit on more than one board. So where there are around 50 scholars in the entire GCC, there are over 200 in Malaysia alone. Moreover, the remuneration of the scholars in Malaysia must be published publicly[112] and stands around an average of US$75,000 per annum—far below that of their GCC colleagues.[113]

The multiple roles played by scholars also raise several governance issues. For example, *shariah* scholars determine the framework of Islamic structures, monitor their implementation, audit their own structures and procedures, and give advice to regulatory agencies.[114] There are now calls for enhancing governance and transparency by way of external *shariah* audits and independence of regulatory bodies.[115]

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109 Warde (n 1) 236; Interview with Regulator02 (n 64).

110 See eg Irfan (n 12) 89 where it states how Sheikh Hussain Hassan, Chairman of Dubai Islamic Bank's *shariah* board, would read everything, saying 'how can I find a cure when I don't know all the symptoms and the patient's history?'

111 Interview with Lawyer06 (n 16).

112 In accordance with Bank Negara's Shariah Governance Framework of 2005. See also Interview with Regulator39 (n 35).

113 Interview with Shariah Scholar37, 'Malaysian Shariah Scholar' (17 August 2016).

114 Nienhaus (n 26).

115 See eg 'Strong Calls for Mandatory Independent Shariah Audit' (n 92).

5.2.6 Fee Income

'Lawyers and bankers get huge fees; should we just sit in front of the mosque door and beg?'

– Sheikh Hassan Hussein, Chairman of Dubai Islamic Bank's *shariah* board[116]

It pays to play the Game of Islamic Bank Bargains. One of the most controversial issues that comes up with regard to *shariah* scholars is the staggering fees they receive for their work.

It is first worth determining how much the scholars make. A senior regulator was complaining that scholars are making 'hundreds of millions!'[117] On closer examination, I have learned that a typical arrangement is a retainer of around US$50,000 per deal that the scholar examines—however a top scholar typically earns around US$250,000 on a single capital markets deal.[118] This adds up to around US$2 million a year with an international bank that has offerings around the world.[119] Given that scholars often sit on more than one board, their income in some cases can approach US$10 million per year.

Of course, the controversy arises depending on how you see the scholars. Practitioners often see the scholars as peers in the industry. In this regard, an Islamic finance lawyer says, 'If you see them as religious figures that need to rise above the economic fray then maybe you worry about these issues. I see them very much as experts—like lawyers in *fiqh*—and they are contributing to the structuring in the same way that we [lawyers] are contributing to the structuring'.[120]

116 Cited in Irfan (n 12) 74.

117 Interview with Regulator03 (n 74).

118 Interview with Shariah Scholar37 (n 113).

119 Interview with Shariah Scholar05 (n 9).

120 Interview with Lawyer09 (n 12).

For the Islamic bankers, the fee paid to the scholars is 'negligible; it costs nothing'.[121] The real transaction cost of Islamic products comes from legal and tax structuring concerns.

The remuneration of the scholars is not impacted by their approval or rejection of any particular transaction. However, if management believes that a particular scholar is not promoting the commercial vision of the institution, it could have an impact on their longevity.[122] Practitioners believe that *shariah* scholars should not be singled out on this count:

> The issue of whether fee income is related to the advice given is not unique to Islamic finance. It is a big issue in conventional finance as well. If you look at the boards of large Western corporations, it is a pretty closed universe of participants. I don't think there is a material difference between Islamic finance and conventional finance in this respect.[123]

The significant fee income of *shariah* scholars is seen to impact their desire, as well-compensated incumbents, to make fundamental changes to the industry. They use their clout in the industry to discredit their critics, but are otherwise quite private about their day-to-day activities and earnings.

Indeed, less than 5% of the 54 Islamic finance institutions in the GCC disclose the remuneration of their *shariah* boards.[124] This lack of transparency can cast serious doubts over the desire and ability of *shariah* scholars to be true representatives of religious interests—rather than commercial ones—within the IBF industry.

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121 Interview with Islamic Banker08 (n 78).

122 Interview with Islamic Banker11 (n 40). See also section 5.2.4 (*Conflicts of Interest*).

123 Interview with Lawyer06 (n 16).

124 Interview with Regulator39 (n 35).

5.2.7 Opaqueness

'It is hard enough to remember my opinions, without also remembering my reasons for them!'

– Friedrich Nietzsche

The lack of transparency with the scholars does not stop at their remuneration. Another issue that arises with *shariah* scholars is that the reasoning behind their pronouncements is also opaque. This hampers the ability of industry observers to oversee their work and spares them from any measure of public audit or accountability.

Practices vary widely on this. An Islamic finance lawyer explains:

> Sometimes you get the one line and sometimes you get the pages and pages of explanation. It really depends on what the parties are looking for. We have certainly drafted *fatwas* for *shariah* boards which explain all the unusual elements of the deal and explain why the scholars believe it is acceptable. Of course what happens to that *fatwa* varies too: sometimes the fact that a *fatwa* has been issued is contained in the [*sukuk*] prospectus, sometimes the whole *fatwa* is contained in the prospectus (but generally not). So it could be that there is a detailed *fatwa* somewhere; it's just that the investors don't get to see it and only the issuer and bank get to see it. That would be the same position for legal opinions too.[125]

Indeed in many Islamic project financings, it is typical that the *fatwa* is not produced, let alone the reasoning underpinning it. The prospectus of *sukuk* issuances often contain a confirmation of the existence of a *fatwa*, but will tell prospective investors not to rely on it and consult their own *shariah* advisors. The *fatwa* can often only be examined in physical form upon prior request and arrangement.

As coming up with new and innovative products is a main way that IFIs compete amongst themselves, the institutions defend the practice of having their *shariah* boards issue 'opaque *fatwas*' as a means of protecting their intellectual property. This allows them to maximise their 'monopoly profits' (or 'innovation rents') before imitators catch up. A transparent *fatwa* would allow other IFIs to replicate the innovative product.[126] Protecting

125 Interview with Lawyer09 (n 12).

126 Nienhaus (n 26).

this intellectual property is a serious business. A senior Islamic banker tells me, 'We follow closely where our *fatwa* is, who has requested it, who takes it out, and who brings it back'.[127] A notable exception in this regard is Bank Negara Malaysia's Shariah Advisory Council, which publishes its rulings and reasoning (in English) on its website within a week of issuance.[128]

Moreover, eminent *shariah* scholars often provide insight into their thinking in public forums and the media. Again a London-based lawyer believes Islamic finance should not be singled out on this basis, 'At least these eminent *shariah* scholars will often publicly express their views, so they provide more reasoning for their actions than a member of Google's board, for example'.[129] A prominent example of this was Sheikh Taqi Usmani speaking amongst the world's business and political leaders at the World Economic Forum in Davos to champion Islamic finance as an alternative financial system in the aftermath of the financial crisis.[130]

Overall, this opaqueness strengthens the suspicion surrounding the actions and incentives of *shariah* scholars. There often seems to be a disconnect between the public pronouncements of the scholars and their private actions. Some of the actions the scholars publicly denounce are occurring within the institutions they preside over. When challenged about this, they are often dismissive of those levelling the challenge, accusing them of misunderstanding or incompetence, or justifying it as a temporary measure on the grounds

127 Interview with Islamic Banker55, 'Head of Islamic Finance for Large Asian Bank' (22 February 2018).

128 See 'SAC Latest Updates' (*Bank Negara Malaysia*) <http://www.bnm.gov.my/index.php?ch=en_about&pg=en_sac_updates> accessed 24 February 2018.

129 Interview with Lawyer06 (n 16).

130 'Mufti Taqi Usmani Presents Paper at World Economic Forum Annual Meeting 2010' *Islamic Finance Resource* (30 January 2010).

of *dharurah* (necessity) or *maslaha* (public good). They also often use the confidentiality of the *fatawa* as a shield against having to engage with the substance of the criticisms.

5.2.8 *Shariah* Monitoring

'A neighbour came to Mulla Nasreddin's yard and asked to borrow his donkey. The Mulla said, "I'm sorry, but I've lent it to someone else". The donkey then started braying loudly from behind the wall. "But Mulla, I can hear it behind the wall!" the neighbour exclaimed. The Mulla replied, "Well, whom do you believe, the donkey or the Mulla?"'

– Folktale recounted by Islamic scholar at Islamic finance event on *shariah* auditing

An important governance issue for Islamic banks is ongoing *shariah* monitoring—whereby the bank must check that deals are being done in accordance with the *shariah*-compliant mechanisms set out by the scholars. This ongoing monitoring is often done by the scholars themselves as a form of *shariah* audit.[131] Although there are now calls to have this function performed by an independent and external *shariah* auditor,[132] as the current system is too much akin to marking one's own exam.

It is often the case that once structures are approved on paper, they are not implemented appropriately in practice and, without ongoing *shariah* monitoring, no one will know.[133] This could damage an Islamic bank's reputation with its investors and shareholders who believe the bank is operating on a *shariah*-compliant basis but then turns out, in reality, it is not. One of the ways in which this can come up is when Islamic windows of conventional banks commingle their *shariah*-compliant funds in the same accounts as their interest-bearing conventional funds. An observer remarks that, 'This is like spending time

131 Dewar (n 18).

132 'Strong Calls for Mandatory Independent Shariah Audit' (n 92).

133 Interview with Shariah Scholar05 (n 9).

separating the recycling and garbage into different bins at home, only for it to be thrown into the same pile on the garbage truck'.[134]

On the flip side, this poses a major concern for conventional participants in a project finance transaction that includes one or more Islamic finance tranches. The worry is that, even though *shariah* approval was obtained at the outset of the transaction, it can be revoked at any time and put the project in default.[135] This has come to be known as '*shariah* risk'[136] and many contracts now include a 'waiver of *shariah* defences' clause. Other ways in which lawyers will stretch to try to get conventional participants comfortable with this risk is by saying things like:

> *Shariah*-compliance doesn't go to validity as a matter of law; it goes to the acceptance of that instrument by investors. So, yes, it could potentially impact the resale value of that instrument in the secondary market—but there is not much of a secondary market for these instruments anyway. So ultimately there is not much that comes from it.[137]

This is yet another example of how Islamic finance may have trouble competing with conventional finance from a purely commercial perspective and may need certain governmental initiatives to support it for it to be a viable financing option.

5.3 THE INTERACTIONS: COOPERATION & COMPETITION

You are not playing on your own in the Game of Islamic Bank Bargains. Each stakeholder at the table is in competition and cooperation with other players, and the scholars are no exception. In this section I will examine how the scholars interact with the lawyers and bankers as well as the other scholars in pursuit of their interests.

134 Interview with Lawyer32 (n 71).

135 Interview with Lawyer15 (n 22).

136 See eg Kilian Bälz, 'Shari'ah Risk? How Islamic Finance Has Transformed Islamic Contract Law' [2008] Occasional Publications.

137 Interview with Lawyer17 (n 45).

5.3.1 Lawyers

'The serenity prayer comes to mind when thinking of our role: God grant me the serenity to accept the things I cannot change, the courage to change the things I can, and the wisdom to know the difference'.

– Islamic finance lawyer

By and large, lawyers tend to view *shariah* scholars with a measure of respect. Scholars are viewed as peers, fellow lawyers in *fiqh*,[138] who are trying to navigate a difficult space as best they can. Of course there is a spectrum of views, with some viewing the scholars as 'a pain in the backside',[139] while others have the utmost admiration for them as learned men doing Allah's work in which negligence would earn them an eternity in hellfire.[140]

Most lawyers will admit that, even though they document the Islamic transactions, the *shariah* scholars are the real source of innovation and ingenuity. Lawyers operating outside the Islamic legal tradition have only a rudimentary understanding of Islamic law and will follow the directives of the scholars, the basis of which often remain incomprehensible to them.[141]

As the scholars often sit on numerous boards, they will have a broad view of the market and can guide and educate the lawyers as to what is acceptable market practice and suggest solutions that the lawyers may not be aware of. Increasingly the interaction between the lawyers and scholars is becoming more collaborative.[142] It is described as 'a mutually productive relationship' by a London-based lawyer.[143]

138 Interview with Lawyer09 (n 12).

139 Interview with Lawyer01 (n 48).

140 Interview with Islamic Banker11 (n 40).

141 Interview with Lawyer06 (n 16).

142 Interview with Lawyer14 (n 44).

143 Interview with Lawyer09 (n 12).

Thus, the main role of lawyers is to ensure the deal is 'bankable',[144] while also accommodating the comments and concerns of the *shariah* scholars as much as possible without impacting bankability. Finance lawyers with an Islamic finance specialisation play a crucial role in getting Islamic project finance deals done. They combine their knowledge of conventional finance and the commercial considerations of a range of project finance participants (such as ECAs), with *shariah*-compliant structuring concerns.

As mentioned, the Islamic tranche in a typical project finance transaction is just a small piece of the puzzle. Thus, the conventional finance documents are the starting point for the Islamic documents, which must replicate the economic outcome of the conventional facilities (in terms of tenor, return, security, etc). Otherwise, the deal will not be bankable for the conventional banks, who will insist on *pari passu* treatment amongst all financing participants. 'You could have a perfect structure from a *shariah* perspective, however it will be dead in the water if it doesn't work from a commercial perspective. You need to marry both.'[145]

Lawyers need to determine which *shariah* points can be accommodated without impacting the commercial considerations of the deal. There are certain points lawyers can fight for, but others will be pushed back to the *shariah* scholars for them to compromise on. As part of a lawyer's job, they must take the *shariah* comments back to their clients and 'sell them' on their rationale.

The lawyers representing the banks and/or ECAs will often be the first line of resistance against the comments of the *shariah* scholars.[146] They will insist that the *shariah* comments are a non-starter as they are against ECA policy. Given the clout and significance

144 Interview with Lawyer24, 'Partner and Head of Department in London Office of International Law Firm' (6 March 2016).

145 Interview with Lawyer17 (n 45).

146 Interview with Lawyer15 (n 22).

of the ECAs compared to the Islamic banks, the ECAs will typically be able to force the Islamic banks and their *shariah* boards to make compromises. 'As a lawyer you often feel like you are mediating between two parties.'[147]

In short, lawyers will get the wider lender group to accept the *shariah* comments that will not have a significant impact on the commercial underpinning of the deal and will get the scholars to compromise on the rest. In this regard, an Islamic finance specialist lawyer says:

> The *shariah* scholars are pragmatic and they are aware of the fact that they have a small piece of the transaction and they can't go around punching above their weight, because ultimately how much say you have over how [the deal] is structured is governed by your level of participation. In these scenarios I have found [the scholars] to be pragmatic and they say you should ask for it and if you don't get it, it is what it is.[148]

Another way lawyers manage to reach a middle ground between the conventional participants and the *shariah* scholars is by 'hiding the ball' or closely controlling what the scholars get to see. A common technique is pushing any offending provisions out of the Islamic documents that will be examined by the scholars into side letters that they will not see. This sometimes happens with the tacit consent of the scholars, who say, 'if this provision is in a document that I don't see, then I won't complain about it'.[149] The scholars do not want to taint their reputation by approving offending provisions in the documents themselves, but understand because of commercial realities those provisions must be included as part of the deal.

In this way, lawyers and scholars serve the commercial interests of the Islamic banks, who themselves are trying to get deals done for their governmental and corporate customers in a time- and cost-effective manner. The way the players are cooperating in the Game of

147 Interview with Lawyer17 (n 45).

148 ibid.

149 Interview with Regulator03 (n 74).

Islamic Bank Bargains, no party believes they should shoulder the blame for the state of the IBF industry, but of course no party is completely absolved from the responsibility either.

5.3.2 Bankers

'The fatwa prohibiting [bank interest as] riba was an obstacle, but it has now turned from an obstacle into an opportunity.'

– Senior Saudi regulator

One of the most significant and interesting relationships shaping the IBF industry is that of the bankers and the scholars. A common theme that emerges when examining this relationship is that bankers use the reputation and credibility of the scholars as a means of marketing their services.

This trend first began with the conventional banks. Initially the big international conventional banks merely oiled the wheels of the IBF industry by providing money-market lines to the Islamic banks desperate for liquidity. Then the international banks realised there was money to be made for themselves and approached the scholars directly—who were more than happy to be paid extraordinary fees for their views on Islamic commercial law.[150]

For conventional banks, Islamic finance is an additional service provided to unsophisticated anachronistic clients. It is a product to be offered in an alternative legal jurisdiction. There is little added in terms of ethics or participation in the real economy.[151] The bankers are just churning out products to meet their targets at the bank. An Islamic finance practitioners says that, 'There is a vested interest in making the products *shariah*-compliant and making sure it succeeds, but it is almost just the ability to say it is compliant that is important, and only so that investors will buy it, not from a principled point of

150 Irfan (n 12) 14.

151 ibid 40–41.

view'.[152] The reality is that banks are also driven by maximising profits for their shareholders, who often just do not seem to care about genuine *shariah*-compliance.[153]

Both the local Islamic banks and Islamic windows of the international banks realised they can corner a portion of the market in this way. Not only will they have a captive audience, but they can also charge a higher rate and make more money with IBF compared to conventional finance.[154] This marketing strategy—or marketing ploy as it is sometimes called[155]—is criticised as deceptive by many industry practitioners.

> In Islamic banking, you are trading in the name of God for which people will pay more. You are marketing your product as the product of God but in reality it is manmade. None of these products have been created by the text of the Quran; you are the one that has created them. You are fooling people with the name of God. You are taking their money and charging way more than conventional banking.[156]

The bankers are sometimes seen as manipulating their *shariah* boards and doing whatever is required to get deals done and bring in new business. The *shariah* board is independent of the bank's commercial teams, but the commercial teams will manage their boards in a way to get the desired result.

These actions can be designed to deceive the boards—pushing things into side letters, slicing the deal into its composite parts to avoid revealing its true intent and economic impact,[157] selectively sending information to the board, or providing Arabic translations that do not reflect the true meaning of the English documents (as some *shariah* boards only review documents in Arabic).[158]

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152 Interview with Lawyer47 (n 95).

153 Interview with Islamic Banker11 (n 40).

154 Interview with Regulator03 (n 74).

155 See eg El-Gamal (n 80) 11–12, 20–21.

156 Interview with Regulator03 (n 74).

157 Interview with Shariah Scholar05 (n 9).

158 Interview with Lawyer15 (n 22). See Irfan (n 12) 234 for further examples of 'bankers defrauding their scholars'.

This practice of deception has become so prevalent that you have certain Islamic scholars, such as Hamza Al-Salem, denouncing the entire IBF industry as a fraud and *haram* (forbidden) on that basis.[159] The scholars have become more aware of the 'deception problem',[160] as it was impacting their reputation and relevance.

But if the bankers cannot deceive the scholars into getting their way, they will resort to other pressuring tactics to get deals done. As discussed in section 5.2.4 (*Conflict of Interest*), there is an inherent conflict of interest in the arrangement between the scholars and the banks. The way this conflict plays out is that, during the deal's documentation, issues are raised by the *shariah* scholars that have a potential to delay the entire transaction or hamper a client's timely access to capital markets. As a first step the lawyers and bankers will 'play ball' with the scholars and try to negotiate a compromise.[161] Failing that, the more aggressive 'hard balling' approach will be implemented, whereby the client[162] will call their key contant and relationship manager on the commercial team of the bank or even a member of the bank's management and tell them that we need this deal done.[163]

If these calls need to be repeated they will carry with them a threat of implicit and sometimes explicit consequences. These can range from incentives such as a promise of preferred roles in upcoming deals, to threats of not receiving any further business in the near future, or ever again.[164] Depending on who the client is, this could mean the bank is

159 Hamza Al-Salem, 'Examination of Subjecting Today's Paper Currency to the Prohibition against Interest' (2010) 3 Journal for Global Business Advancement 193. See also Muhammad Saleem, *Islamic Banking – A $300 Billion Deception* (Xlibris Corp 2006).

160 Interview with Shariah Scholar05 (n 9).

161 See section 5.3.1 (*Lawyers*) on how lawyers do this.

162 The person raising money on a *shariah*-compliant basis.

163 Interview with Government Official04 (n 60).

164 Interview with Government Official22 (n 47).

effectively barred from doing Islamic finance work—or in extreme circumstances, any other work—in that country ever again.[165]

This pressure is of course transferred from the bank's management and commercial teams to the *shariah* scholars.[166] While the scholars are independent and can in theory withstand this pressure, they understand that standing in the face of the management's demands can impact their continued employment at that bank (and potentially other banks).

So while their refusal to give in to pressure may not impact their remuneration on the deal in question, it will impact their long-term remuneration if they are labelled a troublemaking scholar who will be shunned by the banks for future appointments.[167]

The way scholars address this pressure varies. The scholars have two main concerns, protecting their reputation and their income. The junior scholars who do not yet have much of a name or reputation will likely fold under pressure and give in to the bank's demands to ensure their continued employment and relevance in the cut-throat world of *shariah* scholarship.[168]

The world renowned scholars have a reputation to uphold; so they can stand up to the bank and insist on their interpretation. The bank may be able to spin this by saying to their client that the approval of this eminent scholar will increase the marketability of your product and is in your long-term interest.[169] Another way scholars will try to meet both of

165 See eg Irfan (n 12) 118–21 where it is explained how HSBC was almost barred from the Malaysian retail market for failing to approve a *sukuk* for the Malaysian Ministry of Finance.

166 Interview with Shariah Scholar19 (n 78).

167 Interview with Shariah Scholar20 (n 39).

168 Interview with Lawyer17 (n 45).

169 Interview with Regulator03 (n 74).

their main concerns is by very vocally taking a tough line on *shariah*-compliance in their public appearances and publications but approving compromised deals in private.[170]

Of course there are instances where scholars do act in an independent manner contrary to the desires of the bank's management.[171] It appears that scholars will stand their ground and act independently to protect their reputation. If independence is harmful to a scholar's longevity, a tarnished reputation is even more so.

In summary, this relationship between Islamic bankers and their scholars is having a profound impact on the shape of the IBF industry. Despite some ebb and flow, the trend that I have been able to identify in my research is that the relationship tends to be driven by incentives that are primarily commercial, rather than religious.

5.3.3 Scholars

'Knowing Arabic doesn't make you a scholar any more than knowing English makes you a doctor.'
– *Shariah* scholar, disparaging the credentials of other *shariah* scholars

Another interesting dynamic is the relationship of the *shariah* scholars amongst themselves. Scholars maintain a thin veil of civility amongst each other, but will ferociously criticise each other's opinions and accuse each other of turning a blind eye on *shariah*-compliance. This could be part of any intellectual debate and exchange, but the aggression amongst scholars towards each other was somewhat surprising for me. Indeed, the harshest criticism—or outright vitriol—I have seen aimed at *shariah* scholars comes from other *shariah* scholars (and academic scholars to a lesser extent).

170 Interview with Lawyer17 (n 45).

171 See eg the *Blom Bank* case and the issues surrounding First National Bank of South Africa, discussed in section 5.2.4 (*Conflict of Interest*).

Some scholars will accuse others of 'rubber-stamping deals that are conventional in all but name'.[172] Those scholars respond by saying, 'you know nothing of Islamic jurisprudence' and 'you've just marketed yourself as a scholar' and 'you are not a player in the industry'.[173] The attacked scholars will retort that, 'you are worried we will ruin your moneymaking endeavour, which is why you try to discredit and silence us through aggressive personal attacks'.[174]

Scholars jealously guard their reputation and are dismissive or aggressive in responding to any critics.[175] Picking a fight with a prominent scholar or the international banks that employ them can also damage your prospects of ever working in the industry.[176] An interesting trend emerges in this space. The 'rock star' scholars tend to cooperate closely and reinforce each others' views and credibility. In this regard, an industry insider observes:

> [The rock star scholars] are pretty similar in terms of outlook, user friendliness, and involvement in the international deals. You don't see a diversity of view amongst them. They kind of stick pretty close to each other because they're acutely aware that united they stand and divided they fall. They make no attempt, from what I can tell, to broaden the pool of scholars like themselves by training people, leveraging juniors, and building organisations. Their incentive, unsurprisingly, is to keep their monopoly rents.[177]

5.4 THE CUSTOMERS

Islamic banking would not have existed if classical Islamic law did not still command overwhelming authority and prestige amongst most Muslim populations.[178] The growth of IBF is driven by the desire not to replace classical Islamic law, but to apply it. If religious

172 Interview with Shariah Scholar20 (n 39).

173 Interview with Shariah Scholar05 (n 9).

174 Interview with Regulator03 (n 74).

175 See eg Irfan (n 12) 158–62 describing a dispute between two of the most prominent *shariah* scholars, Sheikh Hussain Hassan and Sheikh Yusuf Tala DeLorenzo, as an 'acrimonious mudslinging'. See also Tripp (n 81) 143.

176 See eg Irfan (n 12) 247–50 regarding the experience of Mohammad Khnifer after criticising the Goldman Sachs *sukuk* issuance.

177 Interview with Regulator46, 'General Counsel at Multilateral Institution' (28 January 2017).

178 Vogel and Hayes (n 3) 26.

Muslims accepted a reinterpretation of the Quran's ban on *riba* to permit modern banking interest,[179] the IBF industry in its current form would have little purpose.

There is a feeling amongst many Muslims that classical Islamic law has never been given a fair chance in modern times. The surge in IBF is part of the much larger phenomenon of Islamic reassertion.[180] Of course, there is a sizeable minority that believe that the *shariah* must be reinterpreted and not applied literally to modern day bank interest. For them, literal application of classical law would be a denial of modern day realities—a pointless return to the past and a diversion of energy from genuine Islamic causes.[181]

Many Muslims also remain undecided as to what Islamic commercial morality demands. This confusion is exacerbated by some scholars who have said that modern bank interest is not a form of forbidden *riba*.[182] Given Islam's emphatic and far-reaching strictures in matters of commerce,[183] these Muslims would prefer Islamic finance when it is available to them at a comparable cost to conventional finance. The question becomes how much of a 'piety premium' (in terms of additional risk, lower returns, or added costs) are they willing to endure when it is not. The efficiency of IBF and its associated transaction costs become important in IBF's drive to become competitive with conventional banking, as this is the industry's biggest barrier to growth. In other words, many more Muslims would opt for IBF if it were not financially detrimental to do so.

As mentioned in section 1.4 (*Research Methodology*), this dissertation will focus on Islamic finance as utilised in the project finance industry, but examination of the role customers play in the wider Islamic finance industry is crucial as they form part of the

179 As suggested by scholars such as Al-Salem (n 159).

180 Vogel and Hayes (n 3) 21–24.

181 ibid 24.

182 See eg Interview with Shariah Scholar31 (n 23); Interview with Scholar30 (n 7).

183 See eg Quran 2:275–80 where taking *riba* is equated with being at war with God and His messenger.

Muslim's world business culture that drives project participants to incorporate Islamic financing in deals, even when it makes perfect financial sense not to do so. In other words, retail customers impact the political context in which Islamic finance (and Islamic project finance as a subset of the broader industry) operates.

Of course, the customers of IBF are not a homogenous group. There are significant social and professional divisions between them. In this section I will look at the pious poor, the cost-conscious wealthy, the headline-grabbing super wealthy, and the professionals (lawyers, bankers, scholars) who work in the industry.

5.4.1 The Pious

'Tomorrow you will have a bank established rather than named HSBC, or Al-Rajhi, it will be named "the bank of those who will go to heaven".'

– Saudi regulator

Estimates suggest a-third of IBF customers are driven by religious conviction.[184] They believe that Allah's law is correct and through IBF they will experience 'worldly success yielding moral, financial and social rewards … leading to a more just society, enjoying fairer distribution of wealth, greater support for the poor and needy, and less corruption and dishonesty'.[185]

This group respects and defers to the judgement of *shariah* scholars and accepts their assessment on the Islamic nature of the products offered by Islamic banks; often preferring the more strict ones, even if they are more expensive.[186] To them it is akin to *zakah* (alms

184 Interview with Islamic Banker08 (n 78). See also Clement Henry, 'Financial Performances of Islamic versus Conventional Banks' in Clement Henry and Rodney Wilson (eds), *The Politics of Islamic Finance* (EUP 2004) where this group is described as 'non-commission sensitive'. See further MEED, 'Banking: A Fistful of Dollars' (14 June 2002) 2.

185 Vogel and Hayes (n 3) 26.

186 Interview with Customer07, 'Islamic Finance Customer' (21 April 2015).

giving) and they do not view the extra money they pay as a loss, but rather an investment in the afterlife.[187]

In a way, it is this committed hardcore of IBF customers that drive the industry forward—so long as there are customers who want it, there will be banks that will provide it and governments that will need to regulate it.[188] These religiously motivated customers are also the tough audience who will determine if they find something sufficiently *shariah*-compliant or not. It is the judgement of this group that will form the reputation of a *shariah* scholar.[189] These customers will reward institutions who they find of a sufficient *shariah* standard with more business.[190] So the strictest Islamic bank in Saudi Arabia, Al-Rajhi, also has the most business.[191]

These religious sensibilities have formed the basis of a pervading business culture in places like Saudi Arabia,[192] where even conventional banks will operate through Islamic windows and issue *sukuk* instead of bonds as a way of marketing products to a religious population. Another example is that *shariah*-compliant stocks in Saudi Arabia will fetch higher prices even if their underlying performance is not as good as the conventional.[193] For this reason, many project finance transactions in the Middle East that are envisaging an initial public offering will ensure they have Islamic tranches so they are more palatable to the local populations.[194]

187 Interview with Shariah Scholar20 (n 39).

188 Interview with Regulator03 (n 74).

189 Warde (n 1) 234.

190 Interview with Regulator02 (n 64).

191 Clement Henry and Rodney Wilson, *The Politics of Islamic Finance* (EUP 2004) 6–7; Henry (n 184).

192 Interview with Government Official04 (n 60).

193 Interview with Regulator03 (n 74).

194 Interview with Lawyer01 (n 48).

Sometimes customers will approach an Islamic bank asking for a certain *shariah*-compliant product, but the Islamic bank will not be able to provide it because of the regulatory and legislative frameworks they must operate in. The bank will often implore the customers to go push their request with the regulators on behalf of the banks.[195] The committed pious customers are viewed as a real force behind the industry and cannot be ignored by the government or its regulators, for risk of alienating this potentially powerful political group.[196]

The pious customers will support the IBF industry as a matter of Islamic identity and as their 'least worst option'.[197] Other expressions I heard on this topic include, 'The Islamic finance industry is in need of support in its infancy/adolescence';[198] 'Islamic finance is nothing but a charade, but it is still better than conventional banking';[199] 'We cannot live without banks and this is the best we have at moment';[200] 'You want to invest in a *shariah*-compliant way but there is no asset to use, so you are stuck and end up using a *tawarruq*';[201] 'To operate in the global conventional system, there are certain concessions that you have to make';[202] and finally, 'You have to start somewhere!'[203]

This group of customers have become somewhat disenchanted with Islamic finance through the mediocre attempts at *shariah*-compliance by conventional banks through their Islamic windows.[204] These customers care about *shariah*-compliance. For example, when

195 Interview with Islamic Banker08 (n 78).

196 Interview with Islamic Banker25, 'Senior Islamic Banker' (24 October 2014).

197 Interview with Regulator03 (n 74).

198 Interview with Islamic Banker11 (n 40).

199 Interview with Customer07 (n 186).

200 Interview with Customer10, 'Islamic Banking Customer Living in UAE' (24 August 2014).

201 Interview with Lawyer14 (n 44).

202 Interview with Islamic Banker44, 'CEO of Islamic Bank Based in London' (17 August 2016).

203 Interview with Customer36, 'Islamic Finance Customer' (10 August 2016).

204 Interview with Customer10 (n 200).

Islamic banks in the UK used 'interest' on forms to benefit from tax efficiencies, many of these customers decided to shun them, eventually driving them out of business.[205] The customers argued that, 'If we wanted something so close to conventional, we would just go with conventional'.[206]

It is this group of bankable pious customers that are leading the calls for a fundamental change in the industry as they are the most disappointed with the hand they are dealt in the Game of Islamic Bank Bargains—they suffer the 'piety premium' without achieving their desired level of *shariah*-compliance.

5.4.2 The Cost-Conscious

'It's cheaper to get married at the registry office, but a lot people still prefer a religious wedding.'

– Islamic finance lawyer

Those who deal with IFIs act from a variety of motives, but it seems clear that, like the customers of other financial products, most are looking for secure returns on their capital in the first instance. At the same time, like those who invest in ethical funds, they do not want their money used in ways that contravene their principles. While religious/ethical concerns clearly count for something, it would be difficult to argue that these considerations are always most important. A CEO of an Islamic bank in London says, 'People come to us for *shariah*-compliance, but people also come to us for the rates we offer.'[207]

A prominent Islamic banking executive based in Kuwait believes two-thirds of his bank's customers are motivated by commercial considerations when engaging in IBF.[208] So they will only deal in IBF when it is financially neutral or it is in fact cheaper than

205 Irfan (n 12) 227.

206 Interview with Customer35, 'Islamic Finance Customer' (10 May 2015).

207 Interview with Islamic Banker52, 'CEO of Islamic Bank in London' (21 February 2018).

208 Interview with Islamic Banker08 (n 78).

conventional finance. Given the various government incentives that can be provided to support the sector, IBF can sometimes work out to be cheaper than conventional finance in certain jurisdictions.[209] The people who use Islamic finance in these conditions cannot really be considered a win for the industry.

Sophisticated customers will not pay a piety premium for something that is mimicking the conventional.[210] On the other hand, banks complain that there are genuine profit-and-loss sharing products available, but customers do not want them as they would like a measure of protection for their principal and return.[211] There are also other *shariah*-compliant investment options (such as equity investments and partnerships), but customers still prefer financing options that often look debt-like.[212] The majority of GCC-based investors would buy Islamic products if they matched the economics of their conventional alternatives.[213]

Ultimately the customers and banks want the same things: leverage and capital guarantee. Customers have greed and the banks engage in contractual manipulation and *shariah* arbitrage to satisfy that greed. In this regard a Saudi-based banker says:

> When you're *shariah* compliant, the customer takes more risk and they will typically price in for that which can mean that the *sukuk* issuer is leaving money on the table and paying out a higher than needed premium on its coupon. If it could scale back the *shariah*-compliance and hence the risk, it could issue a lower coupon *sukuk*—both the issuer and the customer (who takes less risk) are happier.[214]

209 See section 6.2.2 (*Cost-Effectiveness*); Neville Spykerman, 'More Non-Muslims Using Islamic Finance in Malaysia' *AsiaOne Business* (4 November 2015).

210 Interview with Customer10 (n 200).

211 Murat Çokgezen and Timur Kuran, 'Between Consumer Demand and Islamic Law: The Evolution of Islamic Credit Cards in Turkey' (SSRN 2015) SSRN Scholarly Paper ID 2553445.

212 Interview with Lawyer09 (n 12).

213 Interview with Islamic Banker25 (n 196); Interview with Customer36 (n 203).

214 Interview with Islamic Banker26 (n 107).

An industry observer summarises the situation as follows, 'Most [customers] are straight-up economically rational actors. Others have fervour to defer that up to a point, but not a very painful point. Very few institutional customers are wiling to pay the piety premium'.[215]

5.4.3 Class-Divide

There appears to be a correlation between socio-economic background and the uptake of Islamic finance. The intellectual and economic elite tend not to bother with IBF, but the lay Muslim seems to engage with it as a matter of religious devotion.

My research shows that even the professionals/practitioners who deal with IBF products—the bankers, lawyers, regulators and, yes, even the *shariah* scholars—tend not to consume the products themselves. Given their superior knowledge and insight into how these products work, they recognise that they are engineered to achieve a certain economic output and are not willing to pay more for it. Indeed, a Muslim CEO of an Islamic bank in London complained that he had to take a financial hit to open a *shariah*-compliant account with his own bank when he became CEO, as not doing so would send the wrong message to the bank's customers.[216]

This is while unsophisticated customers are often primarily driven by religious considerations and are willing to pay a piety premium to 'put a scholar between themselves and the hellfire'.[217] A Saudi regulator explained the situation as follows:

> The public doesn't want to take a [religious] risk. They see a guy held out as an Islamic expert and they will follow him and if there is a mistake, [the scholar] will be responsible in the eyes of God. Because people here [in Saudi Arabia] still have huge huge respect for anyone who represents themselves as an Islamic scholar and has the beard and doesn't wear the *egal* and has a short *thobe* and uses the appropriate terminology. They will trust

215 Interview with Regulator46 (n 177).

216 Interview with Islamic Banker44 (n 202).

217 Interview with Lawyer32 (n 71).

> him blindly and whatever he says they will follow him. So this is why most people still prefer Islamic finance.[218]

So those gaining often significant financial benefit from IBF are accused of being 'rarely motivated by religion and in fact milking the religious sensibilities of their believing customers'[219] who are paying a premium for so-called '*shariah*-compliant' products, which the practitioners themselves do not bother with.

Of course, many IBF practitioners are not Muslim. Even the Muslim practitioners, in true Islamic finance style, will find clever solutions from amongst the rich offerings of *fiqh* to justify their avoidance of Islamic finance. One London-based Muslim Islamic finance lawyer said:

> I am relying on the *shariah* ruling that says that *shariah*-compliance is not required in foreign lands, which I know there is disputes around, but I am relying on it. I'm sure there are people who are willing to pay the piety premium for Islamic mortgages, I'm just not one of them. Even if there was a competitively priced *shariah*-compliant mortgage available to me, would I go for it? I don't know. Do I want my home owned by the bank, till I pay it off? I don't think so. I would much rather that I own it and someone have a charge over it than the other way around.[220]

At the elite level, it becomes a calculation of the financial elements in the equation, devoid of any religious concerns. 'The lawyers and the bankers and the educated class look at it like they were buying a car. They look at price—pure and simple. If the price is right they will go for it, of course they have the nice comfort of saying it is also *shariah*-compliant which is why I chose it.'[221]

The debates about IBF being 'form over substance' or mimicking conventional finance is not something that is happening at the layperson level, especially in Muslim-majority countries like Saudi Arabia. In religiously conservative societies, the average

218 Interview with Regulator03 (n 74).

219 Interview with Regulator27 (n 93).

220 Interview with Lawyer13, 'Senior Associate and Islamic Finance Specialist in London Office of International Law Firm' (31 March 2015).

221 Interview with Shariah Scholar05 (n 9).

customer will have great trust and respect for the scholars. Customers tend to be more sceptical of the Islamic windows of the international banks compared to Islamic banks even if the Islamic banks are doing the exact same thing. This is because the customers feel that the international banks have no cultural affinity or religious buy-in into the principles of Islamic finance.[222]

There is also a further level of Muslim customer that is uneducated and unbanked. In this regard a scholar mentioned a project he was conducting in rural Egypt whereby the village women would be given a participation fee for sitting through a presentation on banking and finance. Many of the women would forego their fee and leave the session immediately on hearing the word 'bank'. To their minds, a bank was a *riba*-based institution that would bring nothing but hellfire into their lives.[223] This group of unbankable Muslims, which comprise around 75% of the Muslim population,[224] has no access to banking whether Islamic or conventional. To them, any banking product is an elite product.[225]

The IBF industry has failed this group the most. The industry has done almost nothing to promote social welfare and give the masses of poor Muslims better access to banking and finance.[226] An Islamic thinker and activist states in this regard that:

> Islamic banks continue to play in the sandbox of 'money now for more money later'. This shapes the way they function. When making a lending decision, like conventional banks, [Islamic banks] look at the wealth of the borrower—to ensure they have enough collateral to secure repayment. If the Islamic banks did profit-and-loss sharing, they would look at the strength of the ideas—and poor people can have good ideas too—because that is how

222 See 'Global Islamic Finance Report (GIFR) 2017' (Edbiz Consulting 2017) 37.

223 Interview with Scholar29 (n 97).

224 TheCityUK, 'The UK: Leading Western Centre for Islamic Finance' (2015) 18. See also Usman Hayat and Adeel Malik, *Islamic Finance: Ethics, Concepts, Practice* (CFA Institute Research Foundation 2014) 56–57 where it is stated that in 2012 only 18% of adults in the Middle East and North Africa had an account with a formal financial institution—the lowest average of all other developing regions.

225 Interview with Lawyer47 (n 95).

226 Islamic microfinance being a notable exception, but even instances of that have been few and far between.

> they would generate a return. Poor people cannot play in the sandbox of money now for more money later and this has a profound impact on wealth inequality in society.[227]

On the flip side, you have high net-worth individuals in the GCC who use the sophisticated services of Islamic windows of international banks. For them, it is often a matter of prestige and recognition. They are willing to pay more to be seen as supporting the IBF industry and thus gaining popularity and political clout within their communities. They often strive to win industry awards as a means of achieving recognition for their activities in this field.

Another group whose involvement is conspicuously absent are those sometimes called the 'real scholars'—the imams of mosques around the world. Islamic finance has not resonated with these community leaders that conduct Friday prayers each week, and through them to the Muslim masses. If these imams get involved, it will get Islamic finance on the radar of around 3 million Muslims in the UK, 20 million in Europe, and 1.6 billion around the world.[228] In this regard a *shariah* scholar says, 'The prolific *shariah* scholars are around 20, but the imams are hundreds of thousands around the world. Islamic finance should have been like bushfire, it should have gone everywhere.'[229]

This disconnect exacerbates the distrust between Islamic finance practitioners and Muslim masses, who continue to see Islamic finance as largely irrelevant to their lives. Thus, it is the elite professionals (scholars, lawyers, and bankers) that have the best hand in the Game of Islamic Bank Bargains. They enjoy all of the upside (the staggering fees and captive audience), without paying any of the costs (the 'piety premiums'). In effect, the pious are bankrolling the elite in the Game of Islamic Bank Bargains.

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227 Interview with Scholar56, 'Islamic Thinker/Activist' (21 February 2018).

228 Conrad Hackett, '5 Facts about the Muslim Population in Europe' *Pew Research Center* (19 July 2017).

229 Interview with Shariah Scholar05 (n 9).

5.5 CONCLUDING REMARKS

Amongst all the actors in the IBF industry, the *shariah* scholars play the most-nuanced role. They have a variety of considerations to balance against each other: their desire to earn (an often substantial) financial reward, to earn and maintain a robust reputation, to strive to serve the will of Allah, to promote their practice, and to shape the industry.

The scholars know they do not operate in a vacuum. 'We cannot create a perfect alternative world, we have to operate within the world as it is and try to make the changes as we can.'[230] To maintain their positions on the *shariah* boards of Islamic banks they must interact constructively with the bank's commercial teams and management—despite being formally independent from them. They must be mindful of the commercial realities that pervade the financial industry. This approach can be very lucrative, earning them 'hundreds of millions of dollars'[231] over a career as a *shariah* scholar.

On the other hand, they must also try to push for as much improvement in *shariah*-compliance as is achievable. On a metaphysical level, as pious practicing Muslims (which many of the scholars appear to be), they would not want to be facilitating a *haram* (forbidden) act.[232] On a practical level, they do not want their reputation tarnished as scholars 'captured' by the money-making international banks that have no ideological or moral buy-in to the principles of Islamic finance. This would discredit them in the eyes of pious customers who have genuine demand for their financial affairs to be conducted in accordance with their faith.

230 Interview with Shariah Scholar19 (n 78).

231 Interview with Regulator03 (n 74).

232 Of course, certain industry participants do not ascribe any moral or spiritual dimension to the scholars and merely view them as contributing to the structuring of deals, the same way as secular lawyers structure deals. See eg Interview with Lawyer09 (n 12).

So it is often two steps forward and one step back for the scholars. In each deal they will try new provisions. Some of them will stick, others will get pushed back and the scholars will try again next time—incrementally and gradually enhancing *shariah*-compliance through the iterative process of 'civil compromise'. Junior scholars may start out as lenient in the interests of getting deals over the line and avoiding anything that may endanger their reappointment. These junior scholars can become more and more conservative as they establish clout and develop a reputation to uphold. Of course, junior scholars will come under immense pressure to approve deals if similar structures have been previously signed-off by eminent scholars—as not doing so would get them labelled as troublemakers and would not bode well for their longevity.

For eminent scholars, reputation is as important as income (if not more so, as the latter is often derived from the former). Islamic banking is often more complicated and less transparent than conventional banking. More complicated because it has to abide by the requirements of both the secular and the Islamic legal systems. Less transparent because it has to protect 'Islamic business secrets' and 'innovation rents'. In such an opaque environment, credibility of an Islamic bank is not achieved by the quality of its products, but by the reputation of its scholars.[233]

Scholars can say something very vocally in public, but do something else very quietly in private—in confidential *fatawa* that are not produced or disseminated outside the deal team. Scholars also tend to speak about technical or abstract aspects in public settings and avoid discussion of the elephant in the room—Islamic finance's failure to fulfil commonly perceived Islamic economic principles. Scholars will of course present themselves as part of the solution rather than the problem. They will readily blame another group of industry participants that everybody loves to hate, such as the lawyers or bankers.

233 Nienhaus (n 26).

This is a state of 'cognitive dissonance' experienced by many well-intentioned industry insiders.[234] Indeed this state is so prevalent in the industry, particularly amongst the scholars, that very few would agree to interview me and those who did only did so on an anonymous basis after a strong personal recommendation from a mutual contact. You could see that they were not very eager to subject themselves to questioning by a student that could potentially make them look bad by seeking to expose inconsistencies between their words and their actions that have contributed to the mistrust many Muslims feel towards the IBF industry.

Despite the common accusations, my experience shows that it is not accurate to say *shariah* scholars generally disregard *shariah* for personal financial gain. Most genuinely strive to create a compromise between the restrictions of Islamic law and the modern requirements of finance in today's world, in a way that allows Muslims to benefit from banking and finance without violating their religious beliefs. 'We don't wake up in the morning and think how will we circumvent the *shariah* today.'[235] A non-Muslim Islamic finance lawyer defends the scholars in this way, 'People only look at the exceptions that [the scholars] make, they don't look at the 99 times they said no for all the other things that we tried'.[236]

Acquiescence and compromise are said to be key attributes of *shariah* scholars. They will allow themselves to be deceived and selectively informed, to spare their conscience and reputation for approving deals that are not sufficiently compliant. Of course, it must be noted that *shariah*-compliance is a spectrum. The *shariah* is open to a variety of interpretations, and this gives scholars space to manoeuvre in coming to a common ground between *shariah* considerations and commercial realities. This manoeuvrability within

234 See eg Irfan (n 12) 277–80.

235 Interview with Shariah Scholar41 (n 13).

236 Interview with Lawyer47 (n 95).

formalised legal systems is a key feature of Islamic law. There is little objection when the same techniques are used to neutralise the impact of *hudud* punishments or matters of Islamic personal and family law.[237] Why does the use of the methodology come under fire when applied to commercial dealings? The scholars feel they have tools in their *shariah* arsenal to justify their acts and approach. 'The spirit of the law is missing. What is there is the letter, and it is open to multiple interpretations. You have given your view, but it is just that, a view.'[238]

Of course, there are examples where scholars—backed by committed customers—take a stand and withstand commercial pressures. The Goldman Sachs *sukuk*,[239] the Malaysian Ministry of Finance's *sukuk*,[240] the Petronas *sukuk*,[241] the *Arcapita* bankruptcy,[242] the *Blom Bank* case,[243] and the en masse resignation of the *shariah* board of South Africa's First National Bank[244] can all be cited as examples in this regard.

The IBF industry is not believed to be in a good place; and many industry participants see the scholars as the cause of the industry's ills, or at least best placed to cure them.[245] Scholars are seen as having the clout and influence to change the direction of the industry to one that better reflects common conceptions of the *maghasid al-shariah* (the objectives of

237 Interview with Lawyer06 (n 16).

238 Interview with Shariah Scholar57, 'Shariah Scholar' (21 February 2018).

239 Discussed in Irfan (n 12) 247–50.

240 Discussed in ibid 118–21.

241 Interview with Lawyer17 (n 45).

242 *In re Arcapita Bank, BSC(c), et al* Bankr SDNY 12-11076 (SHL). For details see Michael JT McMillen, 'The Arcapita Group Bankruptcy: A Restructuring Case Study' (International Shari'ah Research Academy for Islamic Finance and Thomson Reuters Report 2015).

243 *The Investment Dar v Blom* (n 42).

244 Potelwa (n 101).

245 See eg Interview with Lawyer01 (n 48); Interview with Government Official04 (n 60); Interview with Regulator03 (n 74).

Islamic law).[246] In other words, making IBF less form and more substance—a means of enhancing human wellbeing and achieving economic justice and poverty alleviation.[247]

Many participants are disappointed that the scholars, as supposedly pious men of God, do not rise above the economic fray and make sacrifices to their personal income to promote a more moral and ethical form of finance, that is a real alternative to the conventional. They believe that the scholars should prioritise *shariah*-compliance over money[248] and they have failed to do so and the industry has not been able to inspire confidence amongst the Muslim masses as a result.[249] 'It is not despite, but because of, the activities of SSBs that the economic (and ideological) distinctiveness of Islamic banking becomes blurred.'[250]

Scholars, for their part, are aware of the role they play in this Game of Islamic Bank Bargains. They recognise the bigger forces at play and will not try to overplay their hand. They understand that they need to play along, or will be asked to leave the table for someone who will.

Finally, the impact of IBF on the development of Islamic law is also noteworthy. IBF is the area in which Islamic law is undergoing the most rapid and fertile development.[251] This includes training a cadre of highly-skilled and multilingual scholars and establishing a whole host of well-funded institutions and research centres dedicated to the commercial

246 For a statement of the *maqhasid* see Asutay (n 84).

247 Ahmed E Souaiaia, 'Theories and Practices of Islamic Finance and Exchange Laws: Poverty of Interest' (2014) 5 International Journal of Business and Social Science.

248 Interview with Regulator02 (n 64).

249 Interview with Shariah Scholar05 (n 9).

250 Nienhaus (n 26).

251 Vogel and Hayes (n 3) 20–22.

aspects of Islamic law.[252] Islamic finance is one of the few exposures that non-Muslim countries have to Islamic law. In this regard, Vogel says, 'The potential for long-range success in Islamic finance has great significance for assessing the potential of Islamic law to continue to shape the worldly affairs of Muslims'.[253]

252 See Henry and Wilson (n 191) 5–9 setting out the most important Islamic finance institutions and their functions.

253 Vogel and Hayes (n 3) 22.

CHAPTER 6: CAPITAL

6.1	**CONVENTIONAL CO-OPTING ISLAMIC**	**6.3**	**COMMERCIAL JUSTIFICATIONS FOR THE INDUSTRY'S STATE**
6.2	**INCENTIVES DRAWING CUSTOMERS**	6.3.1	DRIVEN BY CLIENTS
6.2.1	SOURCE OF LIQUIDITY	6.3.2	DRIVEN BY REGULATORS
6.2.2	COST-EFFECTIVENESS	6.3.3	THERE IS SUBSTANCE TO THE FORM
6.2.3	DIVERSIFICATION	6.3.4	ALL FINANCE IS FORM
6.2.4	DEMOGRAPHICS	6.3.5	DEVELOPMENTS ARE ON-GOING
6.2.5	RELIGIOUS & ETHICAL INTEREST	**6.4**	**CONCLUDING REMARKS**

'Islamic finance is a business; and the business of business is business.'

– Islamic banker

In this chapter I will examine the role that capital and business interests play in shaping the Islamic finance industry. I will start by setting out how commercial interests are seen to be co-opting the industry and moving it away from its initially-stated objectives. Is the industry helped or hindered by the participation of conventional banks? I will look at why, despite its many detractors, the Game of Islamic Bank Bargains continues to draw in customers and IBF remains a relevant part of the global financial order. I will look at the gap between the promise and reality of Islamic finance and look at the commercial justifications offered by the practitioners for the current 'form over substance' state of the industry.

6.1 CONVENTIONAL CO-OPTING ISLAMIC

IBF started as a grassroots faith-based initiative in the 1960s[1] and grew into a niche business with the support of wealthy Muslims and governments.[2] *Shariah*-compliance became a competitive advantage for Islamic banks, allowing them to compete with conventional

1 As discussed in section 2.4.2 (*Practical Experiments with Islamic Banking*).

2 See eg Ahmed Abdel-Fattah El-Ashker and Rodney Wilson, *Islamic Economics: A Short History* (Brill 2006) 337–38.

banks in Muslim countries and make money from a captive audience, where their smaller scale and lack of expertise would have prevented them from doing so in the past.[3]

Given their teething troubles,[4] Islamic banks needed the support of conventional banks to function effectively and to grow. In the initial years of their establishment, Islamic banks needed investment opportunities to utilise the liquidity they had gathered from their depositors. For this, they turned to conventional banks to use their funds in commodity trade and trade finance transactions.[5] As the Islamic banks required their funds to be dealt with in a *shariah*-compliant manner, the conventional banks found themselves negotiating *murabaha* deals with third parties.[6] As time went by, conventional banks realised they were leaving money on the table—rather than merely assisting fledgling Islamic banks, they could muscle-in on their space through Islamic windows and claim a share of their market. In this regard, a senior Saudi regulator says, 'When the UK established its first Islamic bank, they didn't do it because they believed in Islamic banking, they did it because they realised it was a profitable business'.[7]

Islamic banking customers also started shopping around and comparing the products offered by Islamic banks against those offered by their conventional counterparts—if not for anything else than to ensure the system which they believed in religiously was working.[8] Some of these customers began to push Islamic banks towards seeking greater profit and

3 Interview with Regulator27, 'Regulator' (15 May 2015).

4 As discussed in section 3.1.1 (*Triumph of Capitalist Logic*).

5 Harris Irfan, *Heaven's Bankers: Inside the Hidden World of Islamic Finance* (Constable 2014) 14–16.

6 Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects* (Palgrave Macmillan 2005) 58.

7 Interview with Regulator03, 'Senior Regulator in Saudi Arabia' (14 May 2015).

8 El-Ashker and Wilson (n 2) 337–38.

reduced risk—the stable returns of debt-like products and no risk of an equity stake—in effect, demanding that 'a square peg be fitted into a round hole'.[9]

This has become a common gripe among practitioners who say that 'there are plenty of products for those who want proper profit and risk sharing—they exist'.[10] Indeed, purchasing equities, investing in ventures, and entering into partnerships are all viable options. The problem arises when customers do not want to take an equity risk or shareholders do not want to dilute their ownership in their companies—and neither wants to pay more than they would in a conventional transaction. There are not many options to achieve this that do not look debt-like.

As a result, IFIs have come to market the same products as their conventional counterparts—'whatever they are providing, we should be providing as well'.[11] Regulators and industry observers are not pleased with this trend, 'We need to know what comes before what. Does *shariah*-compliance come before money or does money come before *shariah*-compliance?'[12] A key difference between conventional and Islamic products is that the former can guarantee investment principals and returns, but the latter cannot—indeed in a *shariah*-compliant transaction you need to share in profit *and loss*. Of course, *shariah* scholars are brought in to bless innovative arrangements that structure around these concerns.

So, in this way, the drive towards reduced risks and costs came at the expense of *shariah*-compliance as more and more 'Islamic' products attempted to replicate the economic

9 Interview with Lawyer32, 'Senior Associate and Islamic Finance Specialist in London Office of International Law Firm' (19 August 2016).

10 See eg Interview with Lawyer09, 'Partner and Head of Islamic Finance at London Office of International Law Firm' (9 February 2015).

11 Interview with Islamic Banker32, 'Junior Islamic Banker Based in Dubai' (11 February 2016).

12 Interview with Regulator34, 'Regulator at Multinational Regulatory Body in the Middle East' (15 May 2016).

outcome of debt instruments, albeit using *shariah*-compliant forms. Moreover, this product innovation and design was often done at the hands of conventional bankers and their lawyers (under the guidance of the *shariah* scholars they had employed), as such level of financial engineering expertise was not present at the Islamic banks.[13] A banking and Islamic finance law firm partner in London put it this way:

> The quality of the people at some of these [Islamic] banks is not the highest. These banks are relatively new to international banking standards. If you are a Saudi bank, you are not applying the same international banking standards as the likes of BNPP, HSBC, SocGen. So their sophistication and internal know-how is not on the same level, it is fair to say.[14]

During this financial engineering process, some *shariah* scholars are 'captured'[15] and future scholars are selected for their compliance with, not the *shariah*, but the wishes of the bankers. This means conventional bankers—who, whilst competent, had no commitment to the Islamic principles underlying Islamic finance[16]—became the biggest players in the industry and the primary force shaping it. In this regard a prominent Islamic banker from Kuwait says even their customers prefer the conventional banks, as they view them as wielding more financial power.[17]

The conventional bankers not only introduced IBF to capitalist techniques, but also imbued Islamic finance with capitalist logic and ideology.[18] Several practitioners have shared their observations with me that it is not the norm to find practising Muslims in the IBF industry. 'Those people tend not to last very long because they can't believe the rest of us

13 See eg Irfan (n 5) 141–43 where it is explained how a Belgian Catholic at Deutsche Bank went about 'commoditising the industry' to 'make the Islamic Big Mac'.

14 Interview with Lawyer15, 'Partner with Islamic Finance Specialisation in London Office of International Law Firm' (30 April 2015).

15 As discussed in section 5.3.2 (*Bankers*).

16 Interview with Islamic Banker11, 'Prominent Islamic Banker' (22 April 2015) says 'the loyalties of conventional bankers are first to their bonus and then to their shareholders'.

17 Interview with Islamic Banker08, 'Board Director & CEO of Leading Islamic Bank' (12 February 2015).

18 Irfan (n 5) 176.

are not stopping to pray or whatever it is.'[19] Indeed, many of the practitioners are not Muslim at all, and merely view this sector as another financial product in which to gain a specialisation. On the other hand, some practising Muslims actively shun involvement in the Islamic finance industry. Speaking about her Muslim colleagues who do not get involved in Islamic finance transactions, a lawyer in London says, 'They don't want to be seen as doing God's work when they feel that they are not. They are happy to do the conventional because it makes no claim as to religious goodness'.[20]

So, in this way, the industry still suffers from what I call a 'competence commitment disconnect'. Those committed to Islamic principles lack the expertise to devise truly alternative financial products; and those with the competence and expertise for financial innovation lack commitment to the underlying Islamic principles. For conventional bankers, Islamic finance is just another service they provide anachronistic clients, with little belief in its value.[21] 'Conventional banks have no love for Islamic finance.'[22] They have created debt-like instruments that are accused of 'killing Islamic finance and disenchanting the customer base'.[23]

Most Islamic banks realised they had to follow the capitalist logic to survive (and in some cases, use Islam as a marketing tool to thrive). In this regard, an Islamic banker says, 'We are not competing amongst ourselves, we are competing with the conventional

19 Interview with Lawyer47, 'Partner and Global Head of Islamic Finance Practice in Dubai Office of International Law Firm' (8 March 2017).

20 Interview with Lawyer09 (n 10).

21 Irfan (n 5) 40.

22 Interview with Islamic Banker11 (n 16).

23 Interview with Regulator27 (n 3). See also Irfan (n 5) 40 for an example of how conventional bankers used real estate derivatives in Islamic structures without taking any real risk, and then mocked the clients for engaging in sham transactions.

institutions'.[24] And that competition is lopsided. The conventional banks have better infrastructure, processes, competence, and experience, not to mention greater financial firepower and stronger balance sheets. In trying to keep up with the competition, IFIs have had to do things that 'compromise what they really stand for'.[25]

Many faithful customers stay for a variety of reasons, but feel cheated.[26] They view engagement with Islamic finance as a form of piety tax or almsgiving to support their faith or Islamic identity. They are now pushing the pendulum towards further compliance with the *shariah*.

Serious doubts have been expressed regarding the religious permissibility of Islamic windows of conventional banks—with the Qatari Central Bank taking the unexpected step of banning all Islamic windows altogether.[27] *Shariah* scholars who once recognised the benefit of having big conventional banks involved in the Islamic finance industry are now scaling back the allowances they had given in the past.

A sweet spot between cost and compliance is yet to be achieved for the industry. Each bank caters for the risk, cost, and *shariah*-compliance appetite of a segment of the IBF customer base. This is a wide range, from Muslims who do not believe modern day bank interest is un-Islamic (indeed some view IBF as un-Islamic given the amount of, what they perceive as, deceit involved in the industry).[28] On the other end of the spectrum you have Muslims who believe all banking, including Islamic banking, is forbidden.

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24 Interview with Islamic Banker53, 'Head of Marketing at Middle Eastern Islamic Bank' (21 February 2018).

25 Interview with Regulator27 (n 3).

26 As discussed in section 6.2 (*Incentives Drawing Customers*).

27 Robin Wigglesworth, 'Islamic Directive Shocks Qatari Banks' *Financial Times* (14 February 2011).

28 See eg Muhammad Saleem, *Islamic Banking – A $300 Billion Deception* (Xlibris Corp 2006).

Despite some successes and growth, IBF has failed to establish itself as an uncontroversial go-to product for Muslims.[29] Indeed, it has had insignificant uptake amongst the world's Muslim masses, many of whom remain unbanked and unbankable in the formal sector. In places where the uptake is higher, it is driven by cultural norms (eg Saudi Arabia) or political/legal requirement (eg Iran).

In summary, the conventional institutions initially entered the IBF industry to help Islamic banks manage their liquidity, but ended up being the industry's dominant force to the extent that the Islamic banks must replicate their actions in order to survive. IBF has become a niche in global finance, not an alternative to it, as some proponents had originally promised.[30] Thus, it has had insignificant impact on Muslim masses. However, conventional bankers believe that this blame is misplaced and hold other factors and actors in the Game of Islamic Bank Bargains responsible for this situation.

6.2 INCENTIVES DRAWING CUSTOMERS

Despite all the perceived shortcomings, why is it that customers still play the Game of Islamic Bank Bargains and Islamic finance is still relevant and growing? There are a variety of incentives—financial and otherwise—that keep the industry afloat. As I will demonstrate below, not all customers care about *shariah*-compliance. Indeed, similar to the non-practising IBF professionals, many IBF customers are also non-practising and often non-Muslim. These customers only engage in IBF when it makes financial sense to do so as a means of accessing liquidity, enhancing cost-effectiveness, diversifying holdings, or enhancing community image.

29 See eg Mehmet Asutay, 'Islamic Banking and Finance and Its Role in the GCC and the EU Relationship: Principles, Developments and the Bridge Role of Islamic Finance', *The EU and the GCC: Challenges and Prospects under the Swedish EU Presidency* (Gulf Research Center 2010) where it is stated that 'IBF institutions do not serve communities, but rather (similar to conventional banks) they serve markets'.

30 See eg Ercument Aksak and Mehmet Asutay, 'The Maqasid and the Empirics: Has Islamic Finance Fulfilled Its Promise?', *Islamic Finance: Political Economy, Values and Innovation*, vol 1 (Gerlach 2015).

6.2.1 Source of Liquidity

The most commonly cited reason for using Islamic finance is that it gives access to a new source of funds and liquidity.[31] After 9/11 and the ensuing financial witch-hunt, much of the Middle East's petrodollars left US banks and found their way to the coffers of Islamic banks in the Middle East.[32] Add to this the deposits of the domestic population that had either shunned conventional banking on religious grounds, or were willing to switch to Islamic banking. The oil boom also strengthened the balance sheets of Islamic banks. With the 2008 financial crisis and the ensuing credit crunch, Islamic banks, with their ample liquidity, became a real viable source of funds as many Western conventional banks scaled back their funding of Middle Eastern transactions. Against this background, many practitioners came to see Islamic finance as key to any significant financings in the Middle East.[33]

As Islamic banks are required to invest their funds in *shariah*-compliant ways, the entities seeking to access this source of liquidity had to do so through Islamic finance instruments. This opened the door for companies and countries who had never been involved with IBF in the past to engage with the sector for the first time.[34] Examples of this would be The Dow Chemical Company (an American company) sponsoring a *sukuk* issuance on the Saudi stock exchange for the Sadara project[35] in 2013 and the UK becoming

31 See eg Interview with Lawyer01, 'Senior Partner at London Office of International Law Firm' (3 February 2015) who insists Islamic finance 'only' has merit as a source of liquidity, otherwise it is 'quite bogus'. Interview with Lawyer06, 'Partner at London Office of International Law Firm' (3 February 2015) also believes granting access to funds that would otherwise not be available is 'the main benefit' of Islamic finance.

32 See section 3.2 (*Post-9/11 Period (2001-2008)*).

33 See eg Interview with Lawyer15 (n 14); Interview with Regulator34 (n 12).

34 Interview with Islamic Banker26, 'Senior Islamic Banker' (14 October 2014).

35 'Sadara Announces Successful Closing of Its Sukuk' (*Sadara.com*, 13 April 2013).

the first country outside the Muslim world to issue sovereign *sukuk* in 2014,[36] later followed by Luxembourg, Singapore and South Africa.

6.2.2 Cost-Effectiveness

One of the most hotly disputed topics in Islamic finance is whether or not it costs more than conventional finance. The answer is, of course, that it depends. I will set out some of the factors on which it depends below.

The *prima facie* position is that of course Islamic finance costs more than conventional finance because it has higher transaction costs—documents that are not standardised, *shariah* scholars' fees, more inefficient processes, and smaller scale.

As discussed in section 5.4.2 (*The Cost-Conscious*), an estimated two-thirds of customers will only use Islamic finance if it is financially-neutral to do so. To attract these customers, the Islamic banks will need to 'bring down the cost of being Muslim',[37] thus expanding beyond a relatively small client base that focuses on *shariah*-compliance to a much larger one whose decisions are based on factors such as pricing and service quality.[38] If Islamic banks manage to do this, they may also attract a non-Muslim clientele who are interested in Islamic finance as an ethical form of finance or as an option for diversification—or just as a cheaper alternative to the conventional financing options available.[39]

Many practitioners in the West believe that Islamic finance is still more expensive because it is a much more complex process. For example, if an established corporate entity would like to raise funds, it could consider going to the bond market or *sukuk* market.

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36 HM Treasury, 'Government Issues First Islamic Bond' (*GOV.UK*, 25 June 2014).

37 Interview with Lawyer32 (n 9).

38 Bernardo Vizcaino, 'Researchers Take Scientific Approach to Islamic Finance' *Reuters* (19 February 2015).

39 See eg Interview with Islamic Banker26 (n 34) who explains how many of the Islamic finance customers in Malaysia are non-Muslims attracted to the industry because of its cost-effectiveness in that jurisdiction.

Going to the bond market using a Medium Term Note (MTN) programme it can issue a large bond in three to five days at a cost of around £15,000 whilst being strategic about the time they go to market. On the other hand, if they were to issue a *sukuk*, they would first need to allocate an asset, then they would need to get a *fatwa* from a *shariah* scholar (or board of scholars), and the process would be uncertain and time-consuming, raking up legal fees, scholar fees, and other associated expenses. These factors mean they cannot be strategic about the exact timing that their *sukuk* would hit the market. Finally, on-selling the *sukuk* will be more difficult, especially given that the *sukuk* secondary market is not nearly as developed as the secondary market for bonds.[40]

Given all these considerations, why would anyone bother? It may come down to non-financial considerations. 'It is cheaper to get married at the registry office, but a lot of people still prefer a religious wedding'.[41] Some practitioners view the cost disparity to be to such an extent—five to ten times more expensive in some cases[42]—that they are convinced the incentive to do Islamic finance cannot be financial. In this regard, a London-based lawyer told me, 'Why would a corporate who has to answer to its shareholders issue an instrument that, at least upfront, is going to be more expensive? So it has to be political'.[43]

This trend can be acutely witnessed in the public sector companies, such as national oil companies (NOCs). For example, an entity like the Malaysian oil company, Petronas, has a very healthy balance sheet. It does not even need to raise money from the conventional bond market, let alone the *sukuk* market. A lawyer familiar with their recent transaction tells me, 'Why have they issued *sukuk*? They don't need to, but there is pressure. Petronas

40 Interview with Lawyer09 (n 10).

41 Interview with Lawyer06 (n 31).

42 Interview with Customer35, 'Islamic Finance Customer' (10 May 2015).

43 Interview with Lawyer13, 'Senior Associate and Islamic Finance Specialist in London Office of International Law Firm' (31 March 2015).

answers to the Prime Minister of Malaysia directly and if the PM wants to kick-start the Malaysian *sukuk* market he can easily tell Petronas to issue a *sukuk*. And that's what they did'.[44]

However, this is not the full story. Several industry insiders I spoke with have insisted that the belief that Islamic finance is more expensive than conventional is a common misconception that needs to be dispelled. They claim that there may be an upfront investment of time and resources required to understand the industry as a new entrant, but the actual fees and pricing of the financing itself is not more expensive.[45]

The belief that Islamic finance is more expensive may be a historical hangover from around ten years ago when you 'didn't have pre-cooked structures and had to reinvent the wheel every time'.[46] Now that the documentation is relatively settled, you significantly reduce the amount of time (and expense, as lawyers preparing these documents often charge by the hour) required to do these deals. An Islamic banker made this comparison:

> Corporates also have R&D units that have a huge budget allocated to them. Even if you build a new house, how much would it cost to mandate an architect to design a unique building? It will be a cost. There is always a cost for doing something for the first time. Even introducing a new fragrance in the market will require a little bit of development. Introducing a new medicine, how much will it cost? Everything new has a cost. So previously yes, to structure a *shariah*-compliant transaction it would be a little bit more costly. Not any more.[47]

There also seems to be disagreement amongst the various stakeholders as to who is responsible for any additional costs. The bankers blame the lawyers and tax advisers.[48] The lawyers blame the *shariah* scholars.[49] The customers blame the bankers.[50]

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44 ibid.

45 Interview with Islamic Banker11 (n 16).

46 Interview with Lawyer15 (n 14).

47 Interview with Islamic Banker08 (n 17).

48 ibid.

49 Interview with Lawyer01 (n 31).

The bankers say the scholars' fees are negligible in the overall cost of a transaction.[51] The legal fees being charged to structure products in a tax efficient and *shariah*-compliant way in various jurisdictions is what creates the greatest cost-inefficiency. The lawyers respond to this saying that scholars add to the transaction cost, not because of their fees (which they agree are negligible overall), but because their decisions have no precedent value and can be changed in the future.[52] A lawyer complains that, 'you may do a deal in Saudi Arabia but will not be able to replicate it in Qatar, not because of the different tax regime, but because of the difference of opinion among the *shariah* scholars'.[53]

Another example of this is when *shariah* scholars change their opinions (often to enhance *shariah* compliance). This adds uncertainty and costs to the transaction. For example, when allocating assets to an Islamic finance transaction, it was initially the case that you could agree with an engineering, procurement, and construction (EPC) contractor that when certain, for example, turbines were built you could transfer them to the Islamic banks to form the underlying asset of the *shariah*-compliant structure. This was an acceptable process because it did not interfere with the EPC contracting that would be happening in advance of the financing. Then there was a change to the *shariah* requirement, as it was viewed that such after-the-fact transfer to the Islamic banks was merely an artifice and the asset must be constructed in the name of the Islamic banks from the outset. This created all sorts of issues and delays and required costly modifications to EPC contracts. The lawyers were not impressed and complained, 'why bother trying to avoid artifice in a certain portion

50 Interview with Customer36, 'Islamic Finance Customer' (10 August 2016).

51 Interview with Islamic Banker08 (n 17).

52 Interview with Lawyer32 (n 9).

53 Interview with Lawyer14, 'Partner and Global Co-Head of Islamic Finance Practice in Dubai Office of International Law Firm' (11 February 2015).

of the structure when the whole structure is artificial?"[54] Customers also see that they will often need to pay more when they want a product from an Islamic bank than when they want it from a conventional bank.

A nuanced insight into the cost question is that even though the transaction cost of Islamic finance may be higher, given the various government initiatives and incentives, the cost of funds is often so low that it more than makes up for the higher transaction cost in a way that, at a large enough scale, Islamic finance becomes a cheaper source of funds than conventional finance in that jurisdiction. Therefore, it sometimes becomes a question of scale: if your Islamic deal is big enough, the transaction costs of setting up a *shariah*-compliant structure and getting it blessed by a *shariah* committee will pale in comparison to the pricing benefit.[55]

But where does this pricing benefit come from? An interviewee tells me this favourable pricing may be less because it is *shariah*-compliant and, more simply, because it is money coming from inside the GCC—particularly Saudi Arabia. The reason it is cheaper is that the Saudi Arabian Monetary Authority (SAMA) restricts Saudi banks from investing outside of the Kingdom without express SAMA approval. This means there will be a lot of trapped liquidity that needs to be put into the market at a lower price. This is not just the case for massive projects worth billions of dollars. Even at the retail level, customers can get *shariah*-compliant personal financings at rates below 2%—well below the rate of inflation. So Islamic banks are willing to literally lose money to get their money into the market.[56] In short, there may be a pricing benefit through government support, but not otherwise.

54 Interview with Lawyer24, 'Partner and Head of Department in London Office of International Law Firm' (6 March 2016).

55 Interview with Government Official04, 'Legal Counsel at a Leading National Oil Company' (13 May 2015).

56 ibid.

In addition to government policy, there are commercial factors that keep the cost of Islamic finance down. The Islamic banks in the Middle East can operate at a lower cost and do not have to abide by the same capital adequacy restrictions that have been imposed on the Western banks post-financial crisis.[57] This allows them to charge cheaper margins, which makes them commercially attractive to project sponsors. 'Sometimes the cheapest debt comes from the local [Islamic] banks. I don't think it has anything to do with a desire to do Islamic banking.'[58]

6.2.3 Diversification

Another common usage of Islamic finance is by investors seeking to diversify their asset classes and exposures to different geographies. This is why a high quality *sukuk* issuance by the UK government, which has no real credit risk, was quickly over-subscribed.[59] Indeed, around half of the *sukuk* sold has been to conventional investors.[60]

Compared to Islamic bank financing, *sukuk* attracts a wider range of investors (including conventional bond investors). There is nothing inherent in a *sukuk* that limits its application to Muslim countries or investors. *Sukuk* can be issued by issuers anywhere in the world and be held by certificate holders in any jurisdiction.[61] Large insurance companies (such as AIG) and pension funds are now actively looking at *sukuk*, and this bodes well for the development of the still fledgling secondary market.[62]

This drive to diversify can also be seen at the state level. For example, the Nigerian Central Bank has been working with a variety of institutions, including the Islamic

57 Interview with Lawyer15 (n 14).

58 Interview with Lawyer24 (n 54).

59 Interview with Lawyer06 (n 31).

60 Irfan (n 5) 15.

61 John Dewar (ed), *International Project Finance: Law and Practice* (2nd edn, OUP 2015) para 11.23.

62 Interview with Lawyer13 (n 43).

Development Bank, to diversify its financial sector to offer a range of financial products—including Islamic finance instruments.[63]

Of course, some critics are sceptical of this diversification argument. With IBF making up only around 1% of the world's financial system, some ask, 'What diversification does 1% give you?'[64] Of course, those who use IBF as part of their diversification strategy believe that exposure to these products will provide a hedge from sometimes more speculative ventures as well as exposure to a different geography.[65]

6.2.4 Demographics

A portion of Islamic finance custom comes from geographic and demographic factors. Companies and banks situated in Muslim countries will often engage in Islamic finance given the prevailing commercial cultural norms. This allows them to create a brand and image as a *shariah*-friendly business, which may be looked upon favourably by the local population. An American working at an Islamic bank in Riyadh explains:

> [Islamic finance] is an opportunity to express a commitment to Islam by companies in Muslim majority countries who are servicing Muslim clients who are very much a part of that society…The clients aren't coming to us because they are interested in *shariah*-compliance [as a genuine economic need], rather they have some other consideration and would like us to structure their product for them accordingly.[66]

The most stark example of this is Saudi Arabia, where over the past decade almost all the retail banks have become Islamic[67]—with big conventional banks operating through Islamic windows—to cater to the preferences of the local population.

63 Interview with Regulator02, 'Senior Legal Counsel at the Islamic Development Bank' (14 February 2015).

64 Interview with Shariah Scholar05, 'Shariah Scholar' (12 May 2015).

65 Interview with Customer36 (n 50).

66 Interview with Islamic Banker26 (n 34).

67 Interview with Regulator03 (n 7).

Another factor is that many Muslim countries have significant population growth rates and economic growth rates, which means more and more Muslims are banking for the first time or becoming bankable for the first time and are choosing to go to Islamic banks that more closely accord with their faith preferences.[68] Prior to this, many of the faithful would keep their money in lockers or otherwise detached from the formal banking sector. In this regard, Iqbal says 'one of the biggest achievements of Islamic banking has been to bring this huge amount of funds into the formal sector'.[69]

6.2.5 Religious & Ethical Interest

'Alhamdulillah I was paid a big bribe, and I thought I would use it do the hajj.'

– A judge responding to 'what brings you to the *hajj*?' recounted by an Islamic scholar

Of course, there are those—both Muslims and non-Muslims—that are attracted to Islamic finance for its religious and ethical underpinnings.[70] There is ample evidence to suggest that in Muslim countries there is a significant preference for products that have been stamped as *shariah*-compliant—especially if they are cost-neutral for the consumer.[71] Critics of the industry believe that the IBF industry so closely mimics conventional finance that its claim to some sort of ethical superiority or religious relevance is completely disingenuous[72] or even fraudulent, given that the conventional finance it is so closely based on makes no claim as to religious or ethical goodness.

68 See eg TheCityUK, 'The UK: Leading Western Centre for Islamic Finance' (2015) 17–18 where it stated that Muslim populations are expected to grow twice as fast as non-Muslim populations over the next two decades.

69 Iqbal and Molyneux (n 6) 46.

70 See eg Asutay (n 29) where it is stated that, 'Integrating the moral proposition of IME (Islamic moral economy) in conventional financing could be the new face of capitalism, indeed, in a secular sense. Considering the growing ethical finance movement, particularly in the UK, IME should not be considered as an outsider'.

71 See eg Interview with Regulator03 (n 7) where it is explained how companies stamped as *shariah*-compliant fetch a much higher stock price on the Saudi stock exchange compared to companies with similar (or even stronger) underlying fundamentals that are financed on a conventional basis.

72 Interview with Lawyer06 (n 31).

As discussed in section 5.3.2 (*Bankers*), critics believe Islamic banks use popular preference amongst Muslim populations as a business opportunity or marketing ploy. In response, some Islamic bankers claim that, of course, they market their products and services to customers, but the decision to take up these products rests with the customer, who will make a determination considering all the merits.[73] Most customers will be driven by secular considerations of costs and even the religious customers will need to be treated fairly or they will take their business elsewhere.[74]

Another target for the marketing efforts of Islamic banks are the 'ethical investors'—those who, as Mehmet Asutay puts it, seek to 'shift from a neo-classical notion of efficiency to a morally informed equity'.[75] This trend gained traction after the financial crisis, which the Islamic banks weathered better than conventional banks at first.[76] Given the discrediting of conventional banks following the near collapse of the conventional financial system, Islamic finance institutions saw an opportunity to market themselves as a form of 'compassionate capitalism' and an alternative to the 'greed is good' ethos that had ruled the banking and finance industry.[77]

To benefit from the business and support of a reinvigorated trend of ethical investors, Islamic banks began touting their ethical credentials in their marketing by highlighting the criteria they use when selecting investment opportunities. For example, Islamic banks will avoid investments in companies whose major purpose is the production or distribution of alcohol, pork, or adult entertainment products, or the management of gambling facilities, or investment in interest-bearing financial products and institutions.[78] Islamic finance—given

73 Interview with Islamic Banker08 (n 17).

74 See eg Irfan (n 5) 227.

75 Asutay (n 29).

76 See section 3.3 (*Financial Crisis Years (2008-2013)*).

77 Interview with Islamic Banker11 (n 16).

78 Iqbal and Molyneux (n 6) 52.

its claimed ethical underpinning—also advertises itself as a natural ally for environmentally friendly initiatives, such as renewable energy. The launch of 'green *sukuk*' can be seen as a step in this direction.[79]

An interesting trend emerges where you have IFIs—mostly in the West given rampant Islamophobia—subtly shifting their marketing strategies 'toward the "ethical" and "socially responsible" labels and away from the "faith-based" and "Islamic" labels'.[80] On the other hand, you have *shariah*-compliant banks in places like Saudi Arabia and Turkey who would quite like to use the 'Islamic' label, but are prevented from doing so for political reasons.[81]

There is an undeniable opportunity for further cooperation between ethical investors and Islamic finance, but at present there seems to be only overlap rather than sustained collaboration. There are also some key differences between the two. Islamic finance looks at permissibility, while ethical finance looks at sustainability. The latter does not much care about the form of the financial instrument used, but the former is very much focused on form.[82]

6.3 COMMERCIAL JUSTIFICATIONS FOR THE INDUSTRY'S STATE

As seen in the previous section, Islamic finance seems to have its benefits. So what is the problem? A scholar explains it like this:

> Anything can be useful or harmful. Allah says in the Quran we have forbidden alcohol; there is benefit in it, but the evil is greater. So in this world, even the *haram* things have a benefit; the reason it has been prohibited is that the harm outdoes the benefit. Nothing is absolutely beneficial and nothing is absolutely useless. So we shouldn't start counting and listing the few benefits of Islamic finance. There may be, of course, some benefits to

79 Daniel Atzori, 'Are Islamic Finance and Renewable Energy Natural Allies?' *Inspiratia* (17 September 2015).

80 Bill Maurer, 'Articulating Islamic Knowledge to an American Dream: Islamic Home Financing Alternatives after September 11, 2001' (2003) 26 PoLAR 196.

81 See section 7.1.2 (*Appeasing Islamists*).

82 Interview with Scholar50, 'Islamic Scholar' (26 October 2016).

> Islamic finance, but I don't think there is any great benefit for a greater number of people and Islam is for the greater people.[83]

Herein lies the crux. Islamic finance, while having some tangential benefits, is seen as having not fulfilled its promise and has remained largely irrelevant to the Muslim masses. Proponents had argued that Islamic banking would achieve superior allocative efficiency, equity, stability, and growth compared to its conventional counterpart.[84] Falling far short of these lofty goals, it has retained 'merely a shallow formalistic adherence to the *shariah*'[85] through optics and terminology and has marketed itself as a niche in global finance—which itself has been discredited post-financial crisis. A banker told me,

> Even the West is crying out that their financial system has failed them and we are copying the same thing. A Western banker was telling me, 'I feel like Andy in *The Shawshank Redemption*, digging and digging to get out of banking, and then I see Muslims eager to jump in the hole I have gotten out of'.[86]

Islamic finance's role in bringing about social benefits has been disappointing—not much more is actually done than is required to maintain a good community image. The mundane commercial nature of IBF falls far short of the industry's professed aspirations to being Islamically-guided and socially-responsible. Indeed, for many the penny drops when they realise that Islamic banks are mere profit-making businesses, not 'religious' or 'charitable' institutions.[87] In reality, Islamic finance has had almost no benefit for the general public, or for poverty alleviation, or the redistribution of wealth.[88]

The biggest criticism that comes up time and time again is that commercial interests pursued by bankers and their lawyers have made Islamic finance 'form over substance'. Of

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83 Interview with Shariah Scholar05 (n 64).

84 See eg Iqbal and Molyneux (n 6) 31–34.

85 Interview with Scholar29, 'Prominent Islamic Finance Academic Based in US/Egypt' (21 November 2012).

86 Interview with Islamic Banker32 (n 11).

87 Interview with Scholar23, 'Prominent Islamic Finance Academic Based in US/Saudi Arabia' (12 February 2016).

88 Interview with Scholar30, 'Prominent Islamic jurist based in Iran' (19 April 2011).

course, the lawyers and bankers resent this assertion. The blame for the state of IBF cannot be neatly and conveniently placed on one group of so-called 'evil' lawyers and bankers. They too acknowledge that there is a problem, but do not find it fair that they are signalled out for blame—alas the 'compromised' scholars, 'lazy' regulators, and 'greedy' customers all contribute their fair share to the way the Game of Islamic Bank Bargains is played. Below I will explore the commercial justifications offered by the lawyers and bankers.

6.3.1 Driven by Clients

'Criticising lawyers and bankers for behaving just as you would expect is like criticising politicians for being political, well what would you expect?'

– Islamic finance lawyer

The most common response offered by lawyers and bankers to the 'form over substance' criticism is that they are merely doing their job and responding to client demand. When a corporate client comes to an Islamic bank—or seeks to incorporate an Islamic finance tranche in a project financing—they are looking to 'get the deal done' in a cost- and time-efficient manner.[89] As we saw in section 5.3.2 (*Bankers*), this pressure is translated from the bankers to their *shariah* scholars, who are pushed to come up with structures that closely mimic conventional products and achieve the same economic outcome. Nienhaus observes that:

> It seems that a sufficiently large number of clients of Islamic banks and public opinion leaders do not require a very strict adherence to instruments and techniques of the traditional Islamic business law. They are satisfied with the observance of legal minimum requirements. The ideological impetus of the early years has become a minority position.[90]

Lawyers were quite vocal in disavowing any responsibility for the way the Game of Islamic Bank Bargains is played. 'The decision is made by the client and other stakeholders before

89 Interview with Government Official22, 'Practice Head at Leading National Oil Company' (4 November 2013).

90 Volker Nienhaus, 'Governance of Islamic Banks' in Kabir Hassan and Mervyn Lewis (eds), *Handbook of Islamic Banking* (Edward Elgar 2007).

coming to a law firm. What I see are RfPs [(requests for proposals)] that already identify the type of Islamic finance product that they want.'[91] It will be the client and the bankers that have decided on the funding mix and have cooked up the structures before coming to the law firms. 'They come to us just to execute.'[92]

Lawyers will generally do whatever their clients want. 'Lawyers will do what lawyers always do, which is that we look at rules and within the parameters of those rules we pursue the interests of our client.'[93] If clients want a genuine profit-and-loss sharing instrument, the lawyers will be more than happy to structure it for them. 'You will come across lawyers who will try to innovate and that is more again as a way of trying to satisfy the needs of their clients and to show they are willing to apply themselves to innovation.'[94]

Lawyers do not see themselves as the custodians of the religious virtue of Islamic finance. They make statements such as, 'At the end of the day, we are lawyers, not theologians. We are not here to opine on the [religious] merits of the structure'.[95] We are 'a knife in the hand of a murderer or a surgeon'.[96] 'I'm not the person giving the *fatwa*, I'm just the person drafting the documents.'[97] 'We are there to tell our clients about the options that are available and the risks they take when they engage in one instead of the other.'[98] 'I will never say to somebody, what I have produced is religiously compliant or that it is a good

91 Interview with Lawyer06 (n 31).

92 Interview with Lawyer09 (n 10).

93 Interview with Lawyer47 (n 19).

94 Interview with Lawyer14 (n 53).

95 Interview with Lawyer13 (n 43).

96 Irfan (n 5) 76–77.

97 Interview with Lawyer09 (n 10).

98 Interview with Lawyer32 (n 9).

thing from a religious perspective because I think that is a matter for each person's own conscience and beliefs, not mine.'[99]

A common response offered by Islamic bankers is our customers are not interested in genuine profit-and-loss sharing instruments, so there is no commercial need for us to offer these products.[100] Customers tend to shy away from products that do not provide protection of principal. In risk-sharing products, the banks will take on more risk compared to a synthetic Islamic product—and will price for it accordingly. The *sukuk* issuer or Islamic banking customer will ask themselves, 'Is it worth doing this? I will have to pay a higher return to the bank. Why can't I take more risk (which I am willing to do) but pay a smaller premium/return?' So there is a balance that needs to be struck. So far, customers have preferred to take on more risk to pay a lower return.[101] Changing this balance will have pricing implications which have not been of interest to corporate customers of Islamic finance.

6.3.2 Driven by Regulators

Another common response provided by the Islamic bankers is that, 'We are required to package our products as conventional products so they are familiar to the regulators and they will pass muster with them'.[102] Central bank regulations and other monetary regulations are written with a conventional banking mindset. Islamic banks need to function within these same parameters to be approved.[103] Indeed, one banker commented that the UK has done more to accommodate Islamic finance and allow it to compete on a level playing field

99 Interview with Lawyer09 (n 10).

100 Interview with Islamic Banker25, 'Senior Islamic Banker' (24 October 2014).

101 Interview with Islamic Banker26 (n 34).

102 Interview with Islamic Banker08 (n 17).

103 Interview with Islamic Banker25 (n 100).

than many of the GCC countries.[104] 'The regulatory treatment of Islamic finance in the UK is the envy of the world, even the Muslim world.'[105]

Indeed, some Islamic bankers complain that the regulators in the Muslim world often discourage their customers from pursuing Islamic products.[106] The regulators would be more comfortable approving a standard 'off the shelf' bond document than having to parse through a multitude of bespoke *sukuk* documents. An Islamic banker tells me, 'This is why we end up mimicking. It's not in our hands. Our regulators want to see something that they know and understand'.[107]

Indeed, the treatment that genuine profit-and-loss sharing instruments receive from a regulatory perspective (in terms of capital adequacy and tax consequences) sometimes make them prohibitively expensive and time-consuming.

6.3.3 There is Substance to the Form

Another common response to the 'form over substance' criticism is that it is unfounded—Islamic banks do take additional risks compared to their conventional counterparts and are thus entitled to their profit element. In other words, there is substance to the form.

Oftentimes in Islamic project finance transactions, there is a very real asset involved, which is procured by the project company on behalf of the investors. There are real risks assumed by the investors, as they are owners of the asset. There is a real physical asset that needs to generate proceeds, and if it does not, there is a possibility that the investors do not get paid.[108] In *East Cameron Partners* bankruptcy proceedings in the US it was held that the

104 Interview with Islamic Banker08 (n 17).

105 Interview with Islamic Banker11 (n 16).

106 Interview with Islamic Banker08 (n 17).

107 Interview with Islamic Banker26 (n 34).

108 Interview with Lawyer15 (n 14).

sukuk-holders owned the assets that backed the *sukuk* issuance and were not merely secured creditors without an ownership interest.[109]

This issue of asset ownership is key. The Islamic financier will own the asset underlying the Islamic finance transaction and with that comes a whole host of risks. For example, will the Islamic financier be liable as the owner if the asset explodes or creates environmental damage? Of course, the Islamic financier will do everything legally possible to divest this risk either to the customer or the wider financing group (eg holding the asset as agent, taking out all possible insurances and passing the cost onto the customer). However, no matter how hard they try, certain residual risks cannot be divested, such as the risk of fraud or lender liability.[110] For example, even if the customer was contractually bound to adequately insure the underlying asset, in an event of damage or destruction, if it transpires that the insurance was not adequate or effective, the Islamic financier will be held liable as the owner of the asset—even if it may be able to potentially recover from the customer for breach of contract. So Islamic banks 'have skin in the game, and are justifiably entitled to the profit element'.[111] Indeed, the customers need to recognise the risks that Islamic financiers take and price for it accordingly.

The main issue remains—how is this profit element determined? Should the profit be a reflection of the actual risk accepted by the financier, which will often be remote and minuscule? The way the market has developed is that the profit is determined not on the basis of the risk itself, but on the basis of what equivalent conventional products would charge for a similar product. So whilst the risk in Islamic finance instruments is real, albeit remote, it has not been the basis on which the Islamic financiers have been remunerated.

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109 For a summary of the fact and issues in question see Zulkifli Hasan and Mehmet Asutay, 'An Analysis of the Courts' Decisions on Islamic Finance Disputes' (2011) 3 ISRA International Journal of Islamic Finance 41.

110 Interview with Lawyer32 (n 9).

111 Interview with Lawyer13 (n 43).

6.3.4 All Finance is Form

Another common response to the 'form over substance' criticism is that formalistic navigation is common in all of finance. David Eisenberg says the following in this regard:

> Cynicism about the use of legal stratagems (*hiyal*) to navigate around the various prohibitions imposed by Islamic law is arguably misplaced, though considerable scepticism is naturally aroused when the primary purpose of a transaction is completely reversed. Much of conventional finance is, after all, motivated by the objective of avoiding taxation. Indeed, anything modified by the term 'constructive'—such as a constructive trust—is by definition a legal stratagem.[112]

For the lawyer and bankers, the prohibitions imposed by Islamic law (eg on *riba* and *gharar*) are just another set of obstacles they have to navigate, like tax codes or other regulatory hurdles. In a way, structuring for Islamic finance, is not too dissimilar from their day-to-day jobs. Islamic finance 'is not necessarily uniquely complex'.[113] In this regard, if there is a criticism to be levelled against their actions, it would apply equally to what they do in the realm of conventional finance as well. It is true that Islamic finance has not been immune from the financialisation and the speculative trends within global finance in general, but it has not been uniquely exposed to these forces.[114]

Navigating the *shariah* restrictions in this manner has some support within the Islamic finance industry. These forms and navigation techniques are part of Islamic law as allowances available to be used. 'So long as the form is designed in a way that is *shariah*-compliant it should not be an issue. For us the route is important. If it is *halal* then that transaction is okay and it is based on trade which is allowed by the Quran.'[115] Indeed, this

112 David Eisenberg, 'Islamic Financial Law in the UK and the West' (Theorising the Reconciliation between the State and the Shari'a in a Western Context, with Special Reference to the United Kingdom, SOAS, London 2014).

113 Interview with Lawyer06 (n 31).

114 ibid.

115 Interview with Regulator02 (n 63).

form of navigation is often used in other aspects of Islamic law with little or no complaint.[116]

6.3.5 Developments are Ongoing

Islamic finance is not static and there is constant push and pull between cost-efficiency and *shariah*-compliance. This is how one lawyer describes the state of the industry:

> In a way this form over substance nature is a necessary evil if Islamic finance wants to remain competitive with conventional and keep abreast of the developments there (which are changing all the time). Unless we want to make a complete break from conventional and make our own benchmarks and price in accordance with those, but I think we are a long way away from that.[117]

Critics say that this argument that Islamic finance, in its infancy, needs certain stop-gap measures and products to be competitive and will move away from these as the industry develops, has been used for the past 20 years and the industry is still using the same instruments.[118] However, there have been certain steps taken in this regard. For example, the *tawarruq* structure,[119] which was once the overwhelming majority of Islamic financing, is now shunned by a number of leading Islamic banks for long-term and corporate financings, as it is seen to be artificial.[120]

The Islamic finance industry, of course, covers a wide spectrum of sectors and products—many of which are undergoing ongoing development. In the project finance space, the *istisna*, *wakala*, and *ijara* structures have seen important developments as we have discussed in chapter 4 (*Islamic Project Finance*). There are ongoing developments with regard

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116 For example, under traditional interpretations of Islamic family law, divorce is the exclusive right of the husband. However, using freedom of contract (which is generally sanctioned by Islamic law), the wife can include in her marriage contract a power of attorney that gives her the right to divorce herself on her husband's behalf at her discretion—a legal stratagem that functionally provides women with the ability to initiate divorce. This mechanism is reflected as Qanun Madani Iran [Iran's Civil Code] 1928 art 1119.

117 Interview with Islamic Banker11 (n 16).

118 Interview with Islamic Banker25 (n 100).

119 For further details see section 4.4.3 (Murabaha & Tawarruq).

120 Interview with Lawyer14 (n 53).

to *takaful* (mutual insurance), *tahawutt* (hedging), and *istithmar* (securitisation)—but these have yet to catch on.[121] In the retail sector, there are constant attempts to design products for retail consumption—such as Islamic mortgages, personal finance, and even credit cards. Other important sectors are the capital markets and their regulatory frameworks for issuing *sukuk*. Related to this are the Islamic finance indices on various stock exchanges, such as the Dow Jones Islamic Market World Index, whereby equities are screened for *shariah*-compliance. Another important development is the interest shown by pension funds and insurance companies that are seeking to diversify their holdings to include Islamic instruments. The presence of these actors will be significant for developing the secondary market for Islamic securities.[122]

6.4 CONCLUDING REMARKS

To answer the question set out in the chapter's introduction—has the participation of conventional banks helped or hindered the success of Islamic finance industry—I have no choice but to say that it depends on how you measure success.

On one hand, Islamic finance is involved in record-breaking multi-billion dollar deals raising *shariah*-compliant funds for luxury real estate development projects in iconic locations in capital cities of the Western world. On the other hand, those who bought into Islamic finance as a religious or ethical matter cannot help but feel disappointed that Islamic finance has failed to have any value for common people and play a constructive role as an alternative to conventional banking.

This group feels that some of the structures designed and put in place as a stop-gap measure to support a fledgling industry have been taken over by powerful conventional bankers, who have no regard for the principles underlying Islamic finance, and turbo-

121 See eg Iqbal and Molyneux (n 6) 56–58.

122 Interview with Lawyer13 (n 43).

charged and taken to an extreme, with the result being that the Islamic finance has lost its *raison d'être*. In contrast, the practitioners defend their practice by saying that they are creating a compromise between the restrictions of Islamic law and the modern requirements of finance in today's world, in a way that allows Muslims to benefit from world-class banking and financial services without violating their religious beliefs.

CHAPTER 7: POWER

7.1	**POLICY APPROACHES**	7.2.5	SOURCE OF INCOME
7.1.1	FULL ISLAMISATION	7.2.6	ISLAMIC IDENTITY
7.1.2	APPEASING ISLAMISTS	7.2.7	ABSENCE OF RELIGIOUS CONCERN
7.1.3	CONSOLIDATING POWER	**7.3**	**POLICY IMPLEMENTATION**
7.1.4	ACCOMMODATION	7.3.1	KICK-STARTING THE INDUSTRY
7.1.5	IGNORING THE DISENFRANCHISED	7.3.2	LEVELLING THE PLAYING FIELD
7.1.6	DISCOURAGING ISLAMIC FINANCE	7.3.3	USING STATE-CONNECTED ENTITIES
7.2	**POLICY DRIVERS**	**7.4**	**THE GEOPOLITICS OF ISLAMIC FINANCE**
7.2.1	RIVALRIES	7.4.1	MULTILATERALS DEDICATED TO IBF
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7.2.3	FINANCIAL REWARDS	**7.5**	**CONCLUDING REMARKS**
7.2.4	MARKET SIGNALLING		

'It may be the political connections as much or more than any technical differences between Islamic and conventional banks that condition their respective financial performances.'

– Clement Henry[1]

Nearly all participants I spoke with agreed that government support of the Islamic finance industry is critical to its sustained functioning. The state creates the legal and regulatory frameworks that will allow Islamic finance to flourish or wither, sink or swim. State support is often required, even at the micro level, as it may not be enough for the state to only provide the macro-level policies for the industry.

In this chapter I will examine the role that governments play in the Game of Islamic Bank Bargains. I will look at the stance adopted by governments in various jurisdictions vis-à-vis Islamic finance, why they have chosen this position amongst the various policy options available to them, and what mechanisms they use to advance their policy objectives. I will look at the role multilateral organisations play in the industry and the geopolitics of Islamic

1 Clement Henry, 'Financial Performances of Islamic versus Conventional Banks' in Clement Henry and Rodney Wilson (eds), *The Politics of Islamic Finance* (EUP 2004).

finance more broadly. Finally, I will draw conclusions on the industry based on how it has developed in response to a wide variety of state practices.

7.1 POLICY APPROACHES

It is a common misconception that the governments of most Muslim-majority countries actively support Islamic finance.[2] Indeed, except for Iran and Saudi Arabia, the market share of Islamic finance is less than a quarter of the entire banking sector—even in countries holding themselves out as the hub of the industry. The market share of Islamic finance is estimated to be 23% in Malaysia, 17% in the UAE, 10% in Pakistan, and 5% or less in each of Egypt, Indonesia, and Turkey.[3]

From the industry's formative days, different governments have adopted different stances vis-à-vis Islamic finance.[4] Countries like Iran, Pakistan, and Sudan have sought to make their entire financial system Islamic, to the exclusion of conventional finance. Countries such as Malaysia, Indonesia, and the UAE have embraced Islamic finance as their national policy, while supporting a dual banking system. Other countries—typically outside the Muslim world, such as the UK, Singapore, and Luxembourg—neither oppose nor significantly support (beyond seeking to provide a 'level playing field') the Islamic finance sector within their jurisdiction. Finally, certain countries, like Saudi Arabia and Turkey, have actively discouraged a separate and distinct Islamic finance presence.[5]

2 Usman Hayat and Adeel Malik, *Islamic Finance: Ethics, Concepts, Practice* (CFA Institute Research Foundation 2014) 6.

3 TheCityUK, 'The UK: Leading Western Centre for Islamic Finance' (2015) 20–21.

4 For further details see Frank Vogel and Samuel Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Kluwer Law International 1998) 10–12.

5 For a general discussion of the evolution of economic Islam in different countries, see Vali Nasr, *Forces of Fortune: The Rise of the New Muslim Middle Class and What It Will Mean for Our World* (The Free Press 2009).

Now too different states have different policies depending on factors such as their demographics, the religiosity of their population, and their autocratic or democratic nature.[6] Moreover, the policies pursued are not mutually exclusive—eg a state may develop its Islamic finance industry to appease its Islamists, but may then try to claim hub status as well. It is common to see the focus of states shift over time and this can lead to sometimes contradictory policies—eg pursuing a policy of *shariah* blindness and not allowing any domestic banks to market themselves as Islamic, while also seeking to raise *shariah*-compliant funds for public sector entities. Ibrahim Warde's comment is quite telling in this regard:

> Relationships between religion and politics are fluid, dynamic, and dependent on contingent factors as well as external events. While it is easy to think of a government's relations with Islamic groups in terms of simple dichotomies—opposition/loyalism, co-optation/repression, etc.—the reality is more complex. Governments often apply successively, and sometimes simultaneously, contradictory policies.[7]

Below I will explore some of the more politically significant policy approaches adopted by states vis-à-vis Islamic finance.

7.1.1 Full Islamisation

Countries such as Iran, Pakistan, and Sudan have sought to Islamise their entire banking systems—but have done so under different religious, political, economic, and cultural circumstances. Islamisation has not occurred through the careful application of Islamic jurisprudence, but in an ad hoc manner and under the pressure of events.[8]

Zia ul-Haq's pioneering vision in 1979 to fully 'Islamise' Pakistan's economy, whilst remaining deeply intertwined with the global economy, proved to be much easier to imagine than to implement. Despite strong political commitment by successive Pakistani

6 See eg Ibrahim Warde, 'Status of the Global Islamic Finance Industry' in Craig Nethercott and David Eisenberg (eds), *Islamic Finance: Law and Practice* (OUP 2012) para 1.39ff.

7 Ibrahim Warde, *Islamic Finance in the Global Economy* (2nd edn, EUP 2010) 214.

8 Warde (n 6) para 1.40.

governments, the British banking system's roots proved stronger still. The British legacy had created a financial culture that could not be undone by overnight reforms. The government's heavy foreign (interest-bearing) debt also meant that it had to operate within the International Monetary Fund's policy constraints when managing the economy. Pakistan did manage to introduce profit-and-loss sharing accounts and a nationwide *zakah* distribution network as well as outlaw interest. However, the interest ban's many exceptions effectively swallowed the rule. Despite early ambitions, Pakistan's Islamic sector accounted for only 9% of the market in 2013.[9] In Sudan too, despite President Gaafar Nimeiri's desire to Islamise the economy in 1983, IMF-dictated reforms have proven to be the real shapers of the poor, indebted country's economic policies, and real Islamisation has remained elusive.[10]

The experience of Iran, despite its shortcomings, has been the most successful and politically significant experience of full Islamisation.[11] In Iran, the Islamisation of the

9 For a detailed coverage of the Pakistani experience see Fuad Al-Omar and Muhammad Abdel-Haq, *Islamic Banking: Theory, Practice and Challenges* (Zed Books 1996) 99ff; Vali Nasr, *Islamic Leviathan: Islam and the Making of State Power* (OUP 2001) 130–46, 165–69; Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects* (Palgrave Macmillan 2005) 39-41; Ahmed Abdel-Fattah El-Ashker and Rodney Wilson, *Islamic Economics: A Short History* (Brill 2006) 334-35; Charles Tripp, *Islam and the Moral Economy: The Challenge of Capitalism* (CUP 2006) 140–41; Warde (n 7) 114–18; Hans Visser, *Islamic Finance: Principles and Practice* (2nd edn, Edward Elgar 2013) para 1.3; Hayat and Malik (n 2) 65–66.

10 For a detailed coverage of the Sudanese experience see International Monetary Fund, *Sudan: Recent Economic Developments* (IMF 1999); J Millard Burr and RO Collins, *Revolutionary Sudan: Hasan Al-Turabi and the Islamist State, 1989-2000* (Brill 2003) 21–24, 234–35, 254, 274–80; Endre Sĭansen, 'Interest Politics: Islamic Finance in the Sudan, 1977–2001' in Clement Henry and Rodney Wilson (eds), *The Politics of Islamic Finance* (EUP 2004); Tripp (n 9) 140–41; Frederic Pryor, 'The Economic Impact of Islam on Developing Countries' (2007) 35 World Development 1815; Warde (n 7) 122–25, 221–22, 226–27.

11 For a detailed coverage of the Iranian experience see Sohrab Behdad, 'A Disputed Utopia: Islamic Economics in Revolutionary Iran' (1994) 36 Comparative Studies in Society and History 775; Karim Eslamloueyan, 'Stock Market Operation and Equity Price Determination in an Economy with an Interest-Free Banking System: The Case of Iran' in Munawar Iqbal and Rodney Wilson (eds), *Islamic Perspectives on Wealth Creation* (EUP 2005); Nezamaddin Makiyan, 'The Lending Policies of Islamic Banks in Iran' in Munawar Iqbal and Rodney Wilson (eds), *Islamic Perspectives on Wealth Creation* (EUP 2005); Iqbal and Molyneux (n 9) 41–43; Tripp (n 9) 141ff; Volker Nienhaus, 'Governance of Islamic Banks' in Kabir Hassan and Mervyn Lewis (eds), *Handbook of Islamic Banking* (Edward Elgar 2007); Warde (n 7) 118–22; Massoud Karshenas and Adeel Malik, 'Oil in the Islamic Republic of Iran: Dependence,

banking system was rooted in ideology and followed the revolutionary Islamisation of all of society after Iran's Islamic Revolution of 1979.[12] As a clear break from the policies of the Shah's regime, the banks were nationalised in 1979 and in 1983 banks were given one year by law to eliminate *riba* from their deposits and three years to eliminate it from their other operations.[13] This is how Iranian banks came to hold the world's largest pool of *shariah*-compliant assets.

This, however, was not an all-round success. As Wilson states, 'enacting ambitious Islamic banking legislation to transform a country's entire financial system may have less impact than those who had been ideologically inspired to achieve this goal had hoped'.[14] The transformation had the result of pushing interest-bearing transactions into the black economy, which began to thrive as a result.[15] In this regard Warde notes:

> One of the lessons of the Iranian experiment is that certain religiously-motivated reforms can give rise to even worse religious transgressions. *Riba* may have been eliminated in theory, but a much higher interest rate appeared in disguised form in informal markets. The world of Iranian finance became more speculative than it had ever been before … Some 1,300 Islamic credit funds have become essentially 'usury stores'. Under the aegis of the Bazaar, they were federated into an 'Organisation of the Islamic economy', offering annual 'profit participation' rate in the 25 to 50 per cent range.[16]

Distortions and Distribution' in Paul Collier and Anthony J Venables (eds), *Plundered Nations? Successes and Failures in Natural Resource Extraction* (Palgrave Macmillan 2011).

12 Abbas Mirakhor, 'Islamic Banking: Experiences in the Islamic Republic of Iran and Pakistan' (SSRN 1989) SSRN Scholarly Paper ID 884583.

13 Qanun Amaliyat Banki Bedoon-e Riba (Bahre) [Iran's Usury/Interest-free Banking Law] 1983.

14 Rodney Wilson, *Legal, Regulatory and Governance Issues in Islamic Finance* (EUP 2012) 101 cited in Hayat and Malik (n 2) 65.

15 Tripp (n 9) 141.

16 Warde (n 7) 121 (citations omitted).

By outlawing conventional banking, the state deprives those who would like to conduct their dealings on a conventional basis of state and judicial protection.[17] This segment of the population is effectively disenfranchised in the Islamic Republic.

Moreover, Islamic finance in Iran is prone to the same 'form over substance' criticisms of Islamic finance in general. For example, in Iran, bank deposits in effect receive fixed returns in line with the advertised 'anticipated' rates of return—irrespective of the profits or losses of the banks. These rates are sometimes even called 'interest' on the English websites of these banks—as the poor translators were not well-versed in the nuanced world of Islamic finance smoke and mirrors. Even the Central Bank of Iran is said to conduct monetary policy largely in the same manner as any other conventional central bank.[18]

At the outset of the revolution, it was important for the Iranian government to make a show of Islamising its domestic economy, but it made no attempt to Islamise its international banking and financial operations. Indeed, when France returned the principal amounts paid by Iran to purchase Airbus planes (which would no longer be delivered following the revolution and imposition of sanctions) and withheld the accrued interest reasoning that they were not *shariah*-compliant for the new Islamic Republic, Ayatollah Ahmad Jannati, leading Tehran's Friday prayers, made a demand for the interest payments and said that it is permissible to receive interest from infidels.[19]

Moreover, there has been limited interaction between Iranian and non-Iranian Islamic banks due to a variety of religious and political reasons. Iran is a *shia* theocracy while most

17 A way people overcome this shortcoming is through negotiable instruments, such as cheques, that can be collected through state enforcement mechanisms irrespective of the validity of the debt that underlies them.

18 Hayat and Malik (n 2) 65.

19 Interview with Scholar30, 'Prominent Islamic jurist based in Iran' (19 April 2011).

of the Islamic world is *sunni*. But more important than these theological differences are the political ones. Iran's Middle Eastern neighbours were unhappy with its Islamic revolution of 1979. This was followed by the Iran-Iraq War (1980-88), during which all Persian Gulf countries sided with Iraq, and a harsh international sanctions regime that isolated Iran—only to be somewhat alleviated following the 2016 implementation of the Iran nuclear deal, of which Saudi Arabia and the UAE were strong critics. Racial biases between Persians and Arabs cannot be dismissed as a contributing factor to this situation. Hayat and Malik observe that, 'Ironically, although Iran has the largest share of Islamic banking assets, Iranian scholars are noticeably absent from both the Islamic finance literature and industry events'.[20]

7.1.2 Appeasing Islamists

A concern for the rulers of Muslim countries with conservative populations is to ensure they are viewed as sufficiently Islamic. This allows them to maintain control and more importantly avoid overthrow—a lesson learned the hard way by the Shah of Iran at the hands of Ayatollah Khomeini. Egypt's Anwar Sadat, who carefully cultivated the image of a 'believer-president' and made the *shariah* a principal source of the constitution, found that this was not enough to prevent extremist Islamists from assassinating him.[21] Saudi Arabia also needed to forcibly quell an Islamist uprising that lay siege to the Grand Mosque in Mecca for two weeks, seeking to overthrow the House of Saud for the *bidaa* (innovations) they had allowed in society, distancing it from their puritanical interpretations of Islam.[22] The Saudi king would later discard his royal title of 'His Majesty' for a more humble and Islamist-friendly 'Custodian of the Two Holy Mosques'.

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20 Hayat and Malik (n 2) 65.

21 Muhammad Hasanayn Haykal, *Autumn of Fury: The Assassination of Sadat* (Random House 1983) cited in Warde (n 7) 215.

22 For an engaging account of the siege, its causes and aftermath see Robert Lacey, *Inside the Kingdom: Kings, Clerics, Modernists, Terrorists, and the Struggle for Saudi Arabia* (Arrow 2010) chapters 1–3.

Against this background, Islamic finance presents a great avenue through which states can offer concessions to their Islamist populations. In this context, I use the term Islamists to mean those who call for Islam to play a central role in all aspects of social and economic life. Islamic finance becomes one of the least-costly ways for states to pay lip service to their Islamists.[23] This is because, in practice, the substance of Islamic finance is not vastly different to that of conventional finance.[24] Moreover, almost all states continue to operate on a conventional basis at the central bank and monetary policy levels and in their international dealings—eg, Saudi Arabia deposits its vast petrodollar wealth in interest-bearing accounts.[25]

Banks provide politicians powerful tools to attract support of particular constituents.[26] So it is understandable that governments of Muslim countries would use Islamic banks to attract the support of their Islamists. An example of this, again from Saudi Arabia, is that Islamic banks provide 'loans' with interest rates far below the rate of inflation—effectively losing money.[27] This is because of a monetary policy that prevents domestic banks from investing outside Saudi Arabia without express government approval. So the banks will use

23 See eg Deniz Kandiyoti, 'Concluding Remarks to the Workshop on Law, Religion and Social Order: Unpacking the Promise of Sharia' (Law, Religion and Social Order: Unpacking the Promise of Sharia, Wolfson College, University of Oxford, 17 May 2013) where it is said that women's rights and Islamic finance are the two least-costly avenues through which states give concessions to their Islamist populations without any significant erosion of their power. Of course, there are examples where Islamic finance has suffered government interference as part of a wider crackdown on Islamists, see eg Henry (n 1); Warde (n 7) 217–19.

24 See eg section 5.2.2 (*Legal Fictions*).

25 A form of external rent recycling discussed in Adeel Malik, 'Rethinking the Rentier Curse' in Giacomo Luciani (ed), *Combining Economic and Political Development: The Experience of MENA* (Brill Nijhoff 2017).

26 Charles W Calomiris and Stephen H Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit* (PUP 2015) 82.

27 This is an example of 'oil exporters of the Gulf deploy[ing] their sizeable oil rents to co-opt political support by providing generous welfare' as discussed in Malik, 'Rethinking the Rentier Curse' (n 25).

whatever means necessary, including significant price cutting, to get the money into circulation.[28]

Saudi Arabia is an interesting case that warrants closer examination. Saudi Arabia has an official '*shariah* blindness' policy, whereby the government does not take a stance on which product is or is not *shariah*-compliant.[29] The two important government agencies that are relevant here are the Saudi Arabian Monetary Authority (SAMA), which is the central bank of Saudi Arabia, and the Capital Market Authority (CMA). Neither SAMA nor the CMA, nor any other government entity for that matter, will express an opinion as to a product's *shariah*-compliance. The Saudi government believes that the determination of *shariah*-compliance is something between the product's issuer and the market. The issuer can get its own *shariah* scholars and call the product whatever it likes—of course, no bank in Saudi Arabia, or Turkey,[30] can use the term 'Islamic' in its name.[31]

The Saudi government's concern here is that, once it approves a product or bank as Islamic, it means by implication that the other products and banks are un-Islamic. This is something that the government does not want to mention because the government's position is that 'everything done in Saudi Arabia is *shariah*-compliant. Even the conventional banking done in Saudi Arabia is Islamic'.[32]

This is consistent with the bargain that seems to have been struck between the Saudi government and international financial institutions—as if the government itself or the

28 Interview with Government Official04, 'Legal Counsel at a Leading National Oil Company' (13 May 2015).

29 Discussed with Interview with Regulator03, 'Senior Regulator in Saudi Arabia' (14 May 2015).

30 It is ironic that both religiously conservative Saudi Arabia and secular Turkey have come to the same position. While the Saudi position is out of fear of a backlash from their Islamists, the Turkish position is out of fear of a backlash from their secularists, further discussed in Hayat and Malik (n 2) 66.

31 Warde (n 6) para 1.37.

32 Interview with Regulator03 (n 29).

prominent religious figures affiliated with the government dismissed conventional banks or the Islamic windows through which they provide their *shariah*-compliant products as un-Islamic, given the conservative nature of Saudi society, these banks would suffer a significant loss of market share to the extent that their continued operation in the Kingdom would not be possible.[33] A precedent in this regard would be the 2003 decree of the Indonesian Ulema Council stating that conventional banking practices were not compliant with the *shariah*, which led to many pious Muslims switching from conventional to Islamic banks in Indonesia.[34]

Another concern of the government is that if it seeks to impose a certain *shariah* interpretation it may not be accepted by the population or the market. 'Our opinion is one of many in the market. By expressing our opinion, we do not want to delegitimise other opinions.'[35] I believe a greater fear would be delegitimising themselves. Egypt serves as a cautionary tale in this regard. When the Grand Mufti of Egypt (later the Imam of Al-Azhar), Sheikh Sayyed Tantawi, issued a *fatwa* stating that moderate interest is not forbidden *riba*, it was dismissed domestically and internationally as politically-motivated to support the state's preferred policy. This is despite the traditional pre-eminence of Egyptian Grand Muftis within the Muslim world.[36]

This *shariah* blindness poses challenges from a regulatory and compliance perspective. In addition to Islamic banks, governments must also regulate conventional banks and Islamic windows of conventional banks. This regulation needs to be done in a coherent manner that does not unfairly favour some banks over others. So even if the government

33 Interview with Regulator34, 'Regulator at Multinational Regulatory Body in the Middle East' (15 May 2016).

34 Warde (n 7) 224.

35 Interview with Regulator03 (n 29).

36 For further background on this controversial *fatwa*, see Samer Soliman, 'The Rise and Decline of the Islamic Banking Model in Egypt' in Clement Henry and Rodney Wilson (eds), *The Politics of Islamic Finance* (EUP 2004); Henry (n 1); Tripp (n 9) 129–33; Warde (n 7) 54–55.

does not govern *shariah* issues, it must still oversee the governance of Islamic banks (as it does with conventional banks). This creates a tension between *shariah* blindness and regulation. You can be blind on *shariah* matters, but cannot be blind on governance.

This tension is further exacerbated because Article One of the Basic Law of Saudi Arabia states that, 'God's Book and the Sunna of His Prophet' are the country's constitution. I have been party to very animated discussions between lawyers trying to exclude the *shariah* from the remit of their Saudi law legal opinions but realising they were in effect trying to exclude the constitution that, in theory, pervades and supersedes all of the country's laws.

7.1.3 Consolidating Power

In more pluralistic societies where Muslims form a majority in numbers—but not necessarily financial clout—Islamic finance becomes a means of shoring up support of this politically-significant segment of the population.[37]

Malaysia is a prime example of this policy approach.[38] The United Malays National Organisation (UMNO) governs Malaysia with policies that favour the *bumiputra*[39] majority (67.4%) and are sometimes considered discriminatory to the sizeable Chinese (24.6%) and

37 A form of 'government regulation rent' as discussed in Malik, 'Rethinking the Rentier Curse' (n 25).

38 For a detailed coverage of the Malaysian experience see Iqbal and Molyneux (n 9) 45–46; Sudin Haron and Badrul Hisham Kamaruddin, 'Wealth Mobilisation by Islamic Banks: The Malaysian Case' in Munawar Iqbal and Rodney Wilson (eds), *Islamic Perspectives on Wealth Creation* (EUP 2005); Nienhaus (n 11); Warde (n 7) 125–30; Visser (n 9) 1.5.

39 Literally the sons of the land, which refers to Muslim Malays.

Indian (7.3%) Malaysian minorities.[40] To consolidate their power, the UMNO sends *bumi*-friendly (Muslim-friendly) messages through Islamic finance, amongst other things.[41]

So unlike the Arab model of Islamic finance, which was primarily driven by the oil boom wealth of the 1970s,[42] the Malaysian model was driven by domestic political concerns and a development drive. The Arab model evolved in a decentralised manner as an asset management tool for oil wealth, while the Malaysian model was a top-down state directive focused on 'transforming the country from an agricultural backwater to an industrialised nation'.[43] Given this development priority, Malaysia's approach to Islamic finance is highly pragmatic. Malaysia did not seek to Islamise its entire financial sector, but rather to encourage a dual banking system whereby conventional and Islamic banks would coexist.[44]

Malaysian Prime Minister Mahathir Mohamad (in office 1981-2003) encouraged and supported IBF but requested a new *ijtihad* from the *ulema* whereby they would look at cutting-edge products of global finance and create Islamic equivalents. To avoid bickering and dissent, a National Shariah Advisory Council at the Bank Negara Malaysia (Malaysia's central bank) was set up to have the final say on IBF matters. Through this national *shariah* board, Malaysia has spearheaded an innovative and solution-oriented approach to Islamic finance. This 'can-do' attitude has been often criticised as cutting too many corners and

40 Department of Statistics Malaysia, 'Population Distribution and Basic Demographic Characteristic Report 2010' (2011).

41 Other policies favouring the *bumiputra* include a requirement that the equity of companies (whether local or foreign) wishing to list on the Malaysian Stock Exchange must be at least 30% owned by the *bumiputra*.

42 See eg Adeel Malik, 'The Political Economy of Macroeconomic Policy in Arab Resource-Rich Economies' (Economic Research Forum 2016) 1034.

43 Warde (n 6) para 1.41.

44 Hayat and Malik (n 2) 64.

being religiously controversial and lax.[45] This is to such an extent that Islamic finance in Malaysia is geared toward Muslims and non-Muslims alike.[46]

Observers have also commented that Malaysians are becoming more religiously inclined and if the state was not actively involved in promoting Islamic finance it would feel vulnerable and exposed to criticism from preachers inquiring why Islamic finance was not readily available in a Muslim country.[47] So in Malaysia, there is a defensive element for the UMNO, as well as a strengthening of its political power base.

Thus, in 1983, Malaysia introduced Islamic banking legislation and created Bank Islam Malaysia Berhad (BIMB). BIMB was borne out of the successful Tabung Haji (Pilgrims' Fund), which was established in 1963 by the newly independent government of Malaysia to help Malays—who had newfound political influence—save for the *hajj*.[48] By 2013, 24% of Malaysia's banking assets were Islamic, as were 80% of the shares traded on Bursa Malaysia (the country's stock exchange).[49]

Another example is Indonesia, where over 202 million Muslims, the *primubis*, make up 88% of the country's population.[50] Muslims in Indonesia have historically played a marginal role in the country's political and economic system, which was dominated by the Chinese despite constituting only 3% of the population. Indeed the Chinese had such close ties to

45 Interview with Lawyer47, 'Partner and Global Head of Islamic Finance Practice in Dubai Office of International Law Firm' (8 March 2017).

46 Neville Spykerman, 'More Non-Muslims Using Islamic Finance in Malaysia' (*AsiaOne Business*, 4 November 2015). See also Warde (n 6) para 1.45.

47 Interview with Regulator46, 'General Counsel at Multilateral Institution' (28 January 2017).

48 Details of the fund discussed in section 2.4.2 (*Practical Experiments with Islamic Banking*).

49 Hayat and Malik (n 2) 64.

50 Pew Forum on Religion & Public Life, 'Mapping the Global Muslim Population: A Report on the Size and Distribution of the World's Muslim Population' (2009) 5.

the family of President Suharto (r. 1965-98) that Indonesia came to epitomise 'crony capitalism'.[51]

It was not until the rise of an Islamist opposition towards the end of Suharto's rule that he started courting favour with the Muslim segment of the population—by relaxing restrictions on Islamic dress and making a much-publicised pilgrimage to Mecca in 1991.[52] When Haji[53] Mohammad Suharto returned from the *hajj*, he became the patron of Islamic banking and used the presidential palace to offer shares to the public in the country's first Islamic bank.

In 2003, the Indonesian Ulemas Council (MUI) declared that regular bank financial transactions are not *shariah*-compliant, giving a significant boost to the Islamic sector. The sector received a further boost in the aftermath of the tsunami tragedy of 2004, when Islamic finance stepped into the region, opening as many as 25 branches, to offer finance to people who had no collateral to show for regular bank loans.[54]

As further evidence of this 'consolidation of power' trend, both Malaysia and Indonesia have set national targets for IBF. Malaysia aims to achieve a 40% market share for Islamic banking by 2020 and Indonesia aims for 15% by 2023.[55]

7.1.4 Accommodation

Another policy approach is to accommodate Islamic finance within a dual banking system alongside conventional banking. The benefit of this approach is that it allows states to bring into the formal banking sector a segment of the population that may remain unbanked

51 Warde (n 7) 222.

52 ibid 223.

53 *Haji* is an honourific title for those who have performed the *hajj* pilgrimage to Mecca.

54 Yoichi Iwamoto, 'Islamic Banking Takes Hold in Indonesia' *The Nikkei Weekly* (21 February 2005) cited in Warde (n 7) 224.

55 'Global Islamic Finance Report (GIFR) 2017' (Edbiz Consulting 2017) 39.

otherwise. It is also a nod to multiculturalism and inclusion of an often economically-disenfranchised portion of the population. Finally, it also has economic benefits by way of attracting foreign investment and establishing the jurisdiction as a 'hub' of Islamic finance. In this approach, supply of Islamic finance organically grows to meet an increasing demand and the state provides support as required—often by just 'levelling the playing field'. The United Kingdom and Singapore are two prominent examples of this policy approach.[56]

Banking the unbanked: As more and more Muslims rise out of poverty, more and more of them will require banking services. Many Muslims would prefer to have these services provided in a manner consistent with their faith.[57] The wealthier among them may be able to satisfy their consciences by paying the 'piety premium'—taking more risks for less returns with Islamic banks rather than interest-based conventional ones. For less-affluent Muslims, Islamic banks seem to have a more limited appeal. They may choose to keep their funds in non-interest-bearing accounts, donate the interest to charity, or avoid banks altogether.[58] A pious minority may seek alternatives to non-interest-bearing accounts, but the more risk-averse may prefer to keep the small savings they have under the mattress if it won't be earning competitive market returns.[59]

The government has an interest to provide an Islamic option to bank as many people as possible and prevent them from disappearing into the black economy. The lack of a

56 For a good summary of Singapore's position see Warde (n 7) 132–33. For UK's position see ibid 134; Jonathan Ercanbrack, 'The Law of Islamic Finance in the United Kingdom: Legal Pluralism and Financial Competition' (SOAS 2011).

57 Michael Ainley and others, *Islamic Finance in the UK: Regulation and Challenges* (Financial Services Authority 2007) 3, mentions granting UK's relatively large Muslim community (around 3% of the population) access to financial services consistent with their religious beliefs as a driver for developing the Islamic finance industry in the UK.

58 See Hayat and Malik (n 2) 28 which states that the extent to which the avoidance of conventional banking among some Muslims is a result of *riba* or attributable to other reasons, such as limited access to a banking system, is difficult to ascertain.

59 Henry (n 1).

specially-designed *shariah*-compliant option would result in the financial exclusion of many Muslims, with adverse socio-economic consequences.[60]

Multiculturalism: Islamic finance is also used to demonstrate a commitment to ethnic harmony and multiculturalism.[61] In Singapore, for example, where Muslims make up around 14% of the population, the government issued *sukuk* to show it is mindful of the needs of the Muslim community—even though members of the local Muslim population are not the ones buying the type of *sukuk* being issued to institutional investors.[62]

Business: Countries in this category are also focused on the financial returns of Islamic finance. Following the 2008 financial crisis, the oil-rich GCC and their Sovereign Wealth Funds became a significant source of foreign capital. Certain countries devised strategies to attract these accumulated funds to their shores, including by catering to the needs of the sovereign wealth funds that wanted to invest in a *shariah*-compliant manner.[63] These countries tend to be major international financial hubs and wanted to ensure they had IBF as an item on their menu of financial offerings.[64] To this end, these states must put a framework in place that allows Islamic banks to function. A lawyer notes in this regard that:

> If you want to have an Islamic bank sector, you cannot just license a bunch of banks. You then need to have an environment in which those banks can actually function on a level playing field with conventional banks, which means you have to have tax rules, regulatory rules, central bank rules, and the ability for those [Islamic] entities to fundraise properly.[65]

60 Mehmet Asutay, 'Islamic Banking and Finance and Its Role in the GCC and the EU Relationship: Principles, Developments and the Bridge Role of Islamic Finance', *The EU and the GCC: Challenges and Prospects under the Swedish EU Presidency* (Gulf Research Center 2010).

61 Interview with Regulator43, 'Regulator at the Bank of England' (17 August 2016).

62 Interview with Lawyer06, 'Partner at London Office of International Law Firm' (3 February 2015).

63 Asutay (n 60). See also Hayat and Malik (n 2) 67, where it is stated that, 'Critical observers view such British Islamic finance ambitions as largely targeted toward recycling petrodollars from oil-rich countries in the Middle East'.

64 Warde (n 6) para 1.38.

65 Interview with Lawyer47 (n 45).

This ability to fundraise properly is a key concern for establishing an Islamic finance sector. Conventional banks often meet their prudential regulatory requirements by holding conventional debt securities. Islamic banks cannot hold these interest-bearing conventional debt instruments and thus have significant problems in meeting their regulatory requirements. Governments can help with this by issuing *sukuk* (as the UK did in 2014). *Sukuk,* in general, and government-issued *sukuk*, in particular, are high-quality liquid assets that can help Islamic banks meet their liquidity requirements.[66] Countries seeking to accommodate Islamic finance within their jurisdictions are mindful of these regulatory concerns and take steps to address them. For example, in April 2017, the Bank of England launched a consultation paper to explore the establishment of a fund-based deposit facility as a *shariah*-compliant liquidity management tool.[67]

Another example is that the Malaysian central bank, one of the largest *sukuk* issuers in the world, stopped issuing *sukuk* in 2015 because their issuances were being bought by a wide array of investors who were preventing them from reaching their intended target—the Malaysian Islamic banks that need them for liquidity management purposes. To address this, the Malaysian central bank switched to other *shariah*-compliant instruments that could be better targeted to their Islamic banks.[68]

The UK government's *sukuk* issuance was aimed at providing a benchmark for pricing, enhancing liquidity in the markets, and boosting London's ability to attract further *sukuk* structuring activity.[69] The hope is to eventually turn London into a hub for inward Islamic investments[70] and position the London Stock Exchange as a key global venue for

66 Hayat and Malik (n 2) 46.

67 'Shari'ah Compliant Liquidity Facilities: Establishing a Fund Based Deposit Facility' (Bank of England 2017).

68 TheCityUK (n 3) 23.

69 Ainley and others (n 57) 24.

70 Hayat and Malik (n 2) 66.

sukuk issuances—where over US$50 billion worth of *sukuk* has already been issued.[71] It was hoping that UK corporates would follow suit to give additional liquidity management options for Islamic banks and further foster the sector in addition to the relatively insignificant £200 million *sukuk* issued by the government. This was not to be the case, as corporates could issue bonds through their MTN programmes in a matter of days and at much less cost.[72]

7.1.5 Ignoring the Disenfranchised

In certain countries there is no incentive for the state to be involved in Islamic finance from a domestic political perspective. The UAE is an example of this situation, as the local Emiratis who have political power do not seem to care much about Islamic finance and those who care about Islamic finance—eg the blue-collar workers often from South Asia—have no political say.[73] Of course, there may be other incentives for the UAE to promote Islamic finance, but domestic political pressure is not one of them. An example of this is that both Islamic and conventional finance in the UAE, and Dubai in particular, was focused on the real estate market, which turned out to be massively inflated when the market collapsed during the 2008 financial crisis. Islamic finance was utilised to promote this luxury real estate market that was a priority for the elite and of no relevance to the pious poor. Hayat and Malik make an interesting observation in this regard:

> An ethical concern across all the GCC countries is the reported harsh treatment of migrant workers from poor countries. Many of these workers work in the construction sector and are seen as deprived of essential rights. Although ethics and justice are routinely mentioned in Islamic finance events held in the region, participants carefully avoid mention of the treatment of these construction workers. Visser notes that Islamic banks

71 TheCityUK (n 3) 6.

72 Interview with Lawyer09, 'Partner and Head of Islamic Finance at London Office of International Law Firm' (9 February 2015).

73 Interview with Lawyer47 (n 45).

> 'do not hesitate to finance huge building projects in Bahrain, Qatar and Dubai, where conditions for the workers are reported to be appalling'.[74]

This also ties in to what I have discussed previously in section 5.4.3 (*Class-Divide*) regarding the class of customers of Islamic finance. Islamic finance in these countries caters to the elite—not the poor and pious—who will look closely at the financial returns they may derive from *shariah*-compliant products. The Muslim masses who remain largely unbanked and financially unsophisticated also tend to be disenfranchised in autocratic political systems and cannot influence a change in this situation.

7.1.6 Discouraging Islamic Finance

Some countries, such as Morocco,[75] Egypt, and most importantly Saudi Arabia, have actively discouraged the emergence of Islamic finance within their jurisdictions. The relationship of Egypt and Islamic finance is one marred by mistrust. The state was concerned that any progress made by Islamists in the economic arena would embolden them to make demands in the political arena as well. The state is so heavily involved in the industry that it is believed to shape the sector's discourse and ideology.[76] Indeed, when the Grand Mufti of Egypt issued a *fatwa* stating that 'conventional banks were closer to Islam than Islamic banks',[77] it was dismissed as a government-induced decree devoid of any religious credibility.[78]

Saudi Arabia's relationship with Islamic finance is another special case worth exploring. The Saudi state and wealthy nationals have been active in promoting Islamic

74 Hayat and Malik (n 2) 65 citing Hans Visser, 'Islamic Finance: Aims, Claims and the Realities of the Market Place' (Arab Financial Forum 2012) 33.

75 See Henry (n 1) on how, as Commander of the Faithful, King Hassan II of Morocco was unwilling to permit an Islamic alternative to the conventional banks he indirectly controlled through various conglomerates during his reign (1961-99) as an Islamic alternative would have challenged the Commander's religious authority, as well as discredit his conventional financial institutions.

76 See Soliman (n 36); Warde (n 7) 219–21.

77 Warde (n 7) 221.

78 Interview with Regulator03 (n 29).

finance outside the Kingdom, but have had an awkward relationship with Islamic finance inside the Kingdom. For example, the Saudi King was a founding member of IsDB in the early 1970s, but did not allow any banks to operate on an Islamic basis within the Kingdom until the mid-1980s.[79] Saudi Arabia's awkwardness is understandable when one considers the fact that the ruling family's legitimacy is based on its Islamic credentials, whereas the banking system and the economy are based on Western practices.

Paradoxically, while IsDB is headquartered in Jeddah, the two largest Islamic banking groups, Dar al-Maal al-Islami and Dallah al-Baraka, both owned by prominent Saudis and with a presence around the world, unsuccessfully tried for over a decade to obtain commercial banking licences in Saudi Arabia.[80] Al-Rajhi Banking and Investment Corporation, originally a money-changer but currently the world's most successful Islamic bank, only received its licence in 1985 after a new law prevented money-changers from accepting deposits. Al-Rajhi was licensed as a normal commercial bank but then claimed to be an 'Islamic' rather than a conventional commercial bank.[81] It has not, however, been allowed to use the word 'Islamic' in its name.[82]

The Islamic banking label is not recognised by the state, for fear that if one bank is recognised as Islamic then all others would be un-Islamic by implication.[83] As a result, the religious legitimacy of the state itself would be eroded because it had allowed un-Islamic banks to exist and function—this would pose an unacceptable threat to the state that sees

79 Monzer Kahf, 'Islamic Banks: The Rise of a New Power Alliance of Wealth and Shari'a Scholarship' in Clement Henry and Rodney Wilson (eds), *The Politics of Islamic Finance* (EUP 2004).

80 Henry (n 1).

81 ibid.

82 Michel Galloux, *Finance Islamique et Pouvoir Politique: Le Cas de l'Egypte Moderne* (PUF 1997) 103.

83 Tripp (n 9) 139.

itself vulnerable to Islamists who view it as generally un-Islamic.[84] Thus the official state policy is that *all* banks operating in Saudi Arabia are Islamic.[85]

In addition, the country's vast petrodollar wealth sits in foreign banks generating substantial interest income, making Saudi authorities tread carefully around the issue of *riba*.[86] Tripp states in this regard that, 'The interests of these rulers and of the political class [are] too deeply implicated in the processes of global capitalism to risk taking the radical step of moving towards a national economy founded on strict Islamic principles'.[87]

It is only in the last few years, mostly due to consumer demand, that regulators have allowed Islamic finance to play a growing role so as to maintain the competitiveness of the Saudi financial markets.[88] The Islamic banking label is still not recognised, but regulatory restrictions on establishing IFIs have loosened. Thus, Al-Rajhi is no longer the sole Islamic bank and now shares the market with Bank AlJazira, Bank Albilad and Alinma Bank and a number of non-bank IFIs, as well as a growing number of conventional institutions offering *shariah*-compliant products.[89] Today, 40% of all Saudi accounts are *shariah*-compliant, as is 75% of the retail lending market.[90]

84 Warde (n 7) 216.

85 Interview with Regulator03 (n 29).

86 Peter Wilson, *A Question of Interest: The Paralysis of Saudi Banking* (Westview Press 1991) 112, provides that Saudi banks use euphemisms such as 'special commission income', 'service charges', and 'book-keeping fees' to report interest income.

87 Tripp (n 9) 140.

88 Warde (n 6) para 1.36.

89 Stephen Timewell, 'Saudi Arabia – New Dynamics Bolster Banking' [2005] *The Banker*.

90 For further details on the Saudi experience see Henry (n 1); Tripp (n 9) 139–40; Warde (n 7) 216–17.

7.2 POLICY DRIVERS

In this section I will look at the policy objectives that governments pursue through Islamic finance. States use Islamic finance as one of many tools in their arsenal to meet varied domestic and international political goals.

7.2.1 Rivalries

Islamic finance is not a global or even regional phenomenon. Rather it is particular to each individual jurisdiction, with its own unique legal and regulatory frameworks. The additional legal and tax advice required for cross-border Islamic finance transactions, or even to use a previous deal as a precedent, is said to be Islamic finance's largest driver of cost.[91] For example, foreigners are allowed to own property and assets in Bahrain, but not in Kuwait. The UAE does not allow foreign ownership of property, except in the Dubai International Financial Centre (DIFC). This lack of regional (let alone global) harmony, adds to the standardisation problem discussed in section 5.2.1 (*Standardisation*). Some would go so far as to say that, 'It can't really be said that there is an Islamic finance industry'.[92] The stakeholders 'need to decide whether they want Islamic finance to be a regional product or a national product—one industry or a series of individual industries?'[93]

This jurisdiction-specific approach is exacerbated by the rivalries between the various Islamic finance centres, with each wanting to assume the mantle of leadership and ensure others do not carry it for too long. Iran is a clear example of this: Despite Iran holding the world's largest share of Islamic banking assets, Iranians are often excluded from the Middle East's Islamic finance literature and events. Indeed, there is very little cross-border

91 Interview with Islamic Banker08, 'Board Director & CEO of Leading Islamic Bank' (12 February 2015).

92 Interview with Regulator03 (n 29).

93 Interview with Regulator34 (n 33).

cooperation anywhere—a Saudi Islamic bank will tend not to invest in a project in Turkey or Qatar nor will a Qatari bank invest in a project in Saudi Arabia.[94]

Even non-Muslim countries in Europe (such as the United Kingdom and Luxembourg) and Asia (such as Singapore and Hong Kong) want to stake their claim as a 'hub of Islamic finance'.[95] The UK, hosting the ninth World Islamic Economic Forum in 2013, did not shy away from vying for position alongside the traditional Islamic financial powers.[96] Opening the forum, then-Prime Minister David Cameron said, 'London is already the biggest centre for Islamic finance outside the Islamic world … I want London to stand alongside Dubai and Kuala Lumpur as one of the greatest capitals of Islamic finance anywhere in the world'.[97]

Another way this rivalry plays out is how states brand and market themselves. For example, when Malaysia held itself out as the global capital of Islamic finance,[98] Dubai followed suit by claiming to be the global capital of the Islamic economy, which covered not only Islamic finance but all things *halal*.

There is also intense rivalry between states as to who will host the various multilateral institutions active in this sector. Saudi Arabia hosts the Islamic Development Bank (IsDB). Turkey, a relative latecomer to the sector, now hosts the World Bank's Global Islamic Finance Development Center. AAOIFI was Bahrain's claim to leadership, so Malaysia set up IFSB as an alternative that it would host and be most closely associated with.

94 Interview with Lawyer01, 'Senior Partner at London Office of International Law Firm' (3 February 2015). This was raised as an issue even prior to the heightened tensions between the neighbours that led to Qatar's blockade in 2017.

95 Interview with Government Official04 (n 28).

96 Adam Withnall, 'David Cameron Unveils Plans to Make London a Mecca for Middle East' *The Independent* (29 October 2013).

97 David Cameron, 'World Islamic Economic Forum: Prime Minister's Speech' (*GOV.UK*, 29 October 2013).

98 Christine Ennew and Nafis Alam, 'Islamic Finance Goes Global, but Malaysia Still Leads the Way' (*The Conversation*, 18 September 2014).

An insider aware of the intense push-and-pull going on between states during these deliberations sheds light on these dynamics as it related to the International Islamic Liquidity Management Corporation (IILM). Initially, Bahrain had attempted to set up a liquidity management body for Islamic finance but had failed. Then Malaysia, under the stewardship of Zeti Akhtar Aziz, Governor of the Bank Negara Malaysia, succeeded in establishing IILM as a supranational body formed by 12 central banks and monetary authorities. The insider said:

> Saudi Arabia tried very hard to derail the IILM project when it was being launched in 2010. Bahrain did not join as it did not want to acknowledge Malaysian leadership in an area where it had failed. SAMA signed up to the articles at the very last minute when they had failed to dissuade everyone else from joining. Then they worked very hard to derail it from the inside. They were pulling on the strings of brotherly ties with Kuwait and UAE behind the scenes and were trying to get them on their side. Malaysia and Turkey were trying very hard to keep people together on the other side. Eventually Kuwait, UAE, and Qatar said to the brother Saudis that they are comfortable with the risks and will stay with the organisation.[99]

The Saudis eventually quit IILM in 2013 with no public explanation.[100] Insiders believe that the Saudis wanted to frustrate Malaysia, and had this sentiment that 'we are more Muslim than you'.[101]

7.2.2 Status Symbol

In addition to getting ahead of rivals, becoming a hub garners additional reputational rewards. It places you in the driving seat of the industry's development, or at least gives you a seat alongside other drivers. But most of the gains are less tangible and have more to do with pride and prestige.

Islamic finance offers many of the developing countries that claim supremacy in it the chance to be a world leader in something. This is a source of immense national pride. This

99 Interview with Regulator46 (n 47).

100 Al-Zaquan Hamzah, 'Saudi Arabia Quits IILM Islamic Finance Corporation' *Reuters* (4 April 2013).

101 Interview with Regulator46 (n 47).

outlook and desire for hub status is not limited to Islamic finance alone. For example, an insider told me about Qatar Airways that:

> They don't really care what it costs to run that airline, because if they don't have it they are nothing and are not connected to anybody. They feel like they need to get connected in every way, including financially, with the rest of the world. Jumping on a shiny new bandwagon of *sukuk* early on and getting connected to international financiers—maybe that is what was attractive to them.[102]

This ambition has also led Qatar to own—through Islamic financing, of course—stakes in some of the UK's crown jewels, such as Chelsea Barracks and The Shard.[103] As well as buying the loss-making Islamic Bank of Britain and renaming it Al-Rayan Bank—'for them it's not about bottom line, it's about grabbing market share and image'.[104]

Another incentive for becoming a hub is the bragging rights of attracting expat talent to your shores, particularly from Western financial centres.[105] The same desire that drives these countries to build the world's tallest building or largest artificial island also makes them want to issue the largest *sukuk*, or do the biggest Islamic project financing. The prestige boost countries get from hosting the Formula One World Championships (Bahrain) or the FIFA World Cup (Qatar) is sought to be replicated by hosting international institutions such as the World Bank's Global Islamic Finance Development Center (Turkey) and the Islamic Development Bank (Saudi Arabia).

7.2.3 Financial Rewards

Of course there are also financial rewards to being a hub. Attracting talented lawyers and bankers from around the world does not only give you bragging rights, but also a cadre of

102 Interview with Scholar23, 'Prominent Islamic Finance Academic Based in US/Saudi Arabia' (12 February 2016). This comment was made before the Qatari blockade of 2017, presaging the isolation Qatar would have faced without a national airline.

103 For further discussion of sovereign wealth funds and this 'pattern of prestige acquisitions' see Malik, 'Rethinking the Rentier Curse' (n 25).

104 Interview with Lawyer13, 'Senior Associate and Islamic Finance Specialist in London Office of International Law Firm' (31 March 2015).

105 As can be seen in the scramble by Dublin, Frankfurt, and Paris to attract London's talent post-Brexit.

highly-paid, high-flying professionals who will keep your economy buzzing by renting luxury apartments, dining in world-class restaurants, and buying other expensive goods and services. Indeed, a colleague who was an Islamic finance specialist in the Saudi market supplemented his tax-free income with an interest-free loan to buy a brand-new red Ferrari whilst still an associate—because, hey, why not?

The UK also benefits from being a hub of Islamic finance in the Western world, with 25 of the over 200 international law firms in London having dedicated Islamic finance units and the majority of Islamic contracts being governed by English law. This creates a market for professional services offered by financial intermediaries, insurance providers, asset managers, and over 30 international law, consultancy, and accountancy firms. Moreover, Islamic finance education and training is offered by four professional institutions and nearly 70 universities and business schools.[106]

7.2.4 Market Signalling

States sometimes make strategic statements to publicise their entry into the Islamic finance sector. This is especially the case for jurisdictions that may not be obvious choices for Islamic finance transactions. The *sukuk* issuances of Luxembourg, Hong Kong, and South Africa in 2014 can all be cited as examples in this regard. These issuances were less about fundraising and more about signalling to the market that these places are open for Islamic finance business.[107]

In this way, states hope to gain a reputation as a jurisdiction of choice for Islamic finance transactions. The underlying regulatory frameworks of these countries may not be any better suited to Islamic finance than other similarly developed jurisdictions, but states

106 TheCityUK (n 3) 3, 8.

107 Interview with Lawyer09 (n 72).

may be more successful in winning the Islamic finance business through their strategic market signalling. A former lawyer involved in structuring these transactions tells me:

> Most asset managers and investors are pretty simple. They will say, 'Oh! Luxembourg issued a *sukuk*, so Luxembourg must be a good place to do Islamic deals'. Or at least better than other places that have not issued a *sukuk*. That is not really strictly true. Luxembourg is no easier than the Cayman Islands, for example. It's more of a signalling point.[108]

So once you have done these types of deals in the past, you will gain a reputation for being best placed to do them again in the future. This is an important way in which states drum up business for their domestic Islamic finance institutions and service providers.[109]

Market signalling can also be used to promote inward and outward trade. For example, the UK government is keen for the Middle East to consider it a market of choice. Even though the UK has been working with the Middle East for decades, the US still seems to be their preferred choice—the markets are based on the US dollar and US citizens get preferential treatment in such things as visas.[110] In response to this, the UK made an effort to signal that its markets are open to Middle Easterners with an appetite for Islamic finance—much more so than the US. To this end, UKEF wrapped the US$916 million Emirates Airline *sukuk,* the world's first ECA to do so, and the UK government itself issued a £200 million *sukuk*—again, the first non-Muslim sovereign to do so.[111]

It is important to note that in most of these instances the governments do not really need the money they raise through Islamic finance transactions—they are more focused on achieving a signalling objective. This becomes clear when one looks at the size of the *sukuk* issuances. For example, when you look at the UK government, who had more than £1.5

108 Interview with Regulator46 (n 47).

109 Interview with Islamic Banker32, 'Junior Islamic Banker Based in Dubai' (11 February 2016).

110 For example, typically, the longest visa issued to a UK passport holder for Saudi Arabia is 180 days, whereas US citizens can get five-year visas.

111 Interview with Lawyer47 (n 45).

trillion gilts outstanding at the outset of 2017,[112] a £200 million *sukuk* issuance is a drop in the ocean. Indeed, the £200 million issuance was more than ten times over-subscribed, with orders totalling around £2.3 billion,[113] showing there was market demand for a larger issuance, had the government been interested in raising more money.

7.2.5 Source of Income

Sometimes, given the religious sensibilities of a population, Islamic finance may be the best means of raising funds from domestic sources.[114] For example, when continuously low oil prices meant the Saudi national oil company, Saudi Aramco, needed to raise public funds for the first time in its corporate history in April 2017,[115] it issued a Saudi riyal-denominated *sukuk* on the Saudi stock exchange, not a US dollar-denominated bond internationally. When I asked a lawyer familiar with the matter why a *sukuk* was preferred to a bond, he said:

> I think we need to stand back and not make the mistake of seeking to impose our bias on a fact situation, for which there may be some completely other reason … If you are Saudi Aramco and you want to raise debt … you go for the lowest hanging fruit of investors. Where is the largest institutional group of investors who are happy to invest in Saudi Aramco with almost no public information? They are in Saudi Arabia. So what's the bond market like in Saudi Arabia? It's non-existent; they only issue *sukuk*. So you do a *sukuk*. But you don't do it because you're Islamic. You do it because your target investment base is Islamic; or they are not even that Islamic, they want an Islamic format because that is an instrument that is recognised and enforceable within the Saudi domestic market.

Alternatively, when the Saudi government wanted to raise funds internationally for the first time, it issued a massive US$17.5 billion conventional bond.[116] Similarly, Turkey also

112 UK Debt Management Office, 'Size of Gilt Market' (*UK Debt Management Office*, 29 April 2017).

113 TheCityUK (n 3) 11.

114 Interview with Lawyer01 (n 94).

115 Of course, prior to that, the company would have borrowed money from financial institutions by way of loans, but those are very private and have no public interface.

116 Archana Narayanan, 'Saudi Aramco to Price Islamic Bond in $10 Billion Debt Push' *Bloomberg.com* (28 March 2017).

continues to issue both bonds and *sukuk* because the target investor base is different for each.[117]

A trend can be seen where Muslim states, particularly those with conservative populations, want to raise funds domestically or offer stocks to the public through IPOs, they will do so in a *shariah*-compliant manner. In Indonesia, for example, when the state needed to raise funds, it first issued international bonds and then decided to tap the domestic market through a retail *sukuk* programme aimed at its Muslim population. The government viewed this as a nice, stable source of funding.

Even internationally, when governments of non-Islamic countries issue *sukuk*, they are hoping to tap into the wealth of Muslim investors around the world.[118]

7.2.6 Islamic Identity

Similar to what is seen at the individual level, Islamic finance is sometimes used by states as a display of their Islamic identity. Nowhere has this been more evident than in Iran and Pakistan, where these two Islamic Republics have attempted to make their entire banking systems Islamic (with varying degrees of success).

As discussed in section 5.4.1 (*The Pious*), Islamic identity has become a source of pride in the post-colonial context. This was further boosted in the aftermath of the 9/11 attacks, where it was felt that Islam was under attack.[119] Evidence of this turn to Islamic finance and Islam more generally as a source of identity and pride can be seen in Malaysia where products that are often said to be Islamic in name only are given Arabic names to bolster their Islamic credentials.[120] Another example is Qatar ordering the closure of Islamic finance

117 'Building the Turkish Sukuk Market: One Step at a Time' (*White & Case LLP*, 2016).

118 Ennew and Alam (n 98).

119 See section 3.2 (*Post-9/11 Period (2001-2008)*).

120 Interview with Regulator03 (n 29).

windows of conventional banks.[121] This move was generally supported by most customers as they viewed the Islamic windows as lacking sufficient Islamic identity and cultural affinity with Muslims.[122]

States are mindful that, financial returns being equal, even their non-practising Muslim populations prefer Islamic finance.[123] But the returns must be comparable, as most customers are only willing to defer their rational economic interests up to a point that is not too painful.[124] Yet, Islamic finance forms a pervasive business culture in many conservative Muslim countries. It can almost be seen as a default starting point for retail transactions.[125]

7.2.7 Absence of Religious Concern

A trend that is notable in its absence is the lack of religious concern for Islamic finance at the state level. In other words, Islamic finance is effectively used as a substitute for Islamic economics[126] and a means of maintaining the status quo rather than an alternative to it. Hayat and Malik say in this regard:

> Rather than embodying Islamic economic ideals in enduring institutions, Islamic finance is sometimes used as a substitute for a more radical overhaul of the economic system. Islamic banking is largely made to fit in the existing legal, regulatory, and tax regime that is designed for conventional finance.[127]

So while Islamic economic thought serves as the intellectual backdrop for the Islamic finance industry,[128] it has received limited official support at the state level. Governments do

121 Robin Wigglesworth, 'Islamic Directive Shocks Qatari Banks' *Financial Times* (14 February 2011).

122 Interview with Islamic Banker11, 'Prominent Islamic Banker' (22 April 2015). See also 'GIFR 2017' (n 55) 38.

123 Interview with Lawyer09 (n 72).

124 Interview with Regulator46 (n 47).

125 Interview with Government Official04 (n 28).

126 For a discussion of the difference between Islamic finance and Islamic economics see Vogel and Hayes (n 4) 29ff.

127 Hayat and Malik (n 2) 22.

128 See Ainley and others (n 57) 4–5.

not seem aware or interested in the ideals espoused by Islamic economics—relegating to mere slogans calls for genuine profit-and-loss sharing, elimination of interest-bearing debt, harmony with the natural and social environment, and social justice in the realm of banking and finance.[129] Islamic economic concepts are not fully understood or exploited, especially in the areas of economic development, social and economic justice, human welfare, inclusion, access to finance, and public policy.[130] Again, Hayat and Malik say:

> Use of the principles of Islamic economics and finance as a basis for constructing an alternative financial system has thus found limited official support. Just as human beings do not always behave like the economic man (*Homo Economicus*), Muslims do not always act like the Islamic man (*Homo Islamicus*). Similarly, just because a country has a Muslim-majority population does not mean those entrusted with its economic policy find inspiration and direction from Islamic economic thought.[131]

On a practical level, this mentality of the state has implications. When approving deals for the private sector, regulators tend to prefer conventional finance, as it is something they are more familiar with. Approving a *sukuk* may take weeks, but a conventional bond can be issued within 24-48 hours (as bonds are standardised but *sukuk* is bespoke).[132] Also, the government does not concern itself with distributing resources in accordance with Islamic principles of social justice, but merely regulates the operations of individual businesses active in the Islamic finance sector.[133] This means that there is not much focus on the institutional requirements for creating an Islamic economic system—one that is not

129 Asutay (n 60).

130 Zamir Iqbal and Abbas Mirakhor, *Economic Development and Islamic Finance* (World Bank Publications 2013).

131 Hayat and Malik (n 2) 23. See also Mehmet Asutay, 'Conceptualisation of the Second Best Solution in Overcoming the Social Failure of Islamic Finance: Examining the Overpowering of Homoislamicus by Homoeconomicus' (2007) 15 IIUM Journal of Economics and Management 167; Karen Horn, 'The Forgotten Dignity of Homo Economicus' (*CapX*, 24 February 2015).

132 Interview with Islamic Banker08 (n 91).

133 Islamic Finance Project, 'Islamic Finance, Petrodollar Recycling, and Economic Development: A Report on the Panel Discussion' (2009).

dependent on the motivations of individuals but also on institutions that can shape those motivations.[134]

Of course, there must be an element of self-selection for the people who end up in the governmental departments responsible for regulating Islamic finance and they may personally hold strong religious convictions, but the policy set by senior policymakers is not religiously-motivated. An insider told me, 'I wouldn't say the people running these things were particularly religious. I saw that clearly in places like Qatar and UAE. The senior people were thinking like bankers would do anywhere'.[135]

Another practical implication of the state's disregard for religious concerns becomes evident when a deal they are trying to do hits a *shariah* roadblock. As discussed in section 5.3.2 (*Bankers*), the state will lean heavily on the Islamic bankers to get their *shariah* scholars to approve the transaction. Very few banks and scholars can withstand this type of coercion (indeed many scholars are appointed for their acquiescence for this very reason).

7.3 POLICY IMPLEMENTATION

Now that I have mentioned the various drivers of government policy in the Islamic finance realm, I will look at how state go about implementing such policies.

7.3.1 Kick-starting the Industry

The state plays a critical role in kick-starting the Islamic finance sector. Governments cannot just license a few institutions as Islamic banks and hope that the market will take care of the rest. States will need to set up the regulatory framework for these Islamic banks to allow them to function alongside their conventional peers.

When the regulatory framework is not sufficiently developed to accommodate Islamic finance, crude solutions may be adopted to get transactions over the line. An example of

134 Hayat and Malik (n 2) 15–16.

135 Interview with Regulator46 (n 47).

this is when Qatar issued its first *sukuk* in 2003. Qatar's regulations were not ready to accommodate a *sukuk* issuance, so the then-Emir of Qatar issued a one paragraph decree stating that all the contracts underlying the *sukuk* were enforceable.[136]

As a next step, states must ensure that the Islamic banks have competitively-priced, high-quality liquid *shariah*-compliant products available to them so that they can meet their capital adequacy requirements.[137] Islamic banks, unlike conventional banks, cannot invest in treasury bills, gilts, or other high-quality government-issued conventional debt instruments. Islamic banks have no choice but to buy *shariah*-compliant instruments for meeting their regulatory obligations.[138]

Without high-quality *shariah*-compliant instruments for Islamic banks to invest in, they will not be able to survive as functioning banks.[139] Islamic bankers complain that, in the absence of such products, they have resorted to depositing cash with their central banks receiving no interest or return, putting them at a significant disadvantage compared to their conventional peers.[140] Most often the state has no choice but to provide these products itself. Indeed, states issue 45% of the world's *sukuk*, with a further 20% issued by state-connected entities. Only 35% of *sukuk* is issued by private sector corporations.[141]

A further step the state sometimes takes is granting Islamic banks exclusive access to certain deals or markets. Iran would be an extreme example where conventional banking in its entirety has been outlawed; but there are more limited examples, such as in 2011, when the Qatar Central Bank required the closing of all Islamic windows of conventional banks

136 ibid.

137 Interview with Islamic Banker40, 'Islamic Banker Based in London' (17 August 2016).

138 Interview with Islamic Banker44, 'CEO of Islamic Bank Based in London' (17 August 2016).

139 Interview with Regulator27, 'Regulator' (15 May 2015).

140 Interview with Islamic Banker08 (n 91); Interview with Islamic Banker25, 'Senior Islamic Banker' (24 October 2014).

141 TheCityUK (n 3) 22.

and banned them from any future operations in the country.[142] This provided the Islamic banks a big boost[143]—some believing it was a move to create an uneven playing field in favour of the domestic Islamic banks.[144] Malaysia also requires that anything done by the government be done in a *shariah*-compliant manner.

Governments hope that private entities will follow their lead and engage in the Islamic finance sector. To start this process, the state-connected companies are often leaned on to engage in Islamic finance transactions where there is no financial reason to do so.[145] Examples of this are plenty, eg Saudi Aramco issuing a *sukuk* for its Sadara project which could have been fully-funded from conventional sources[146]—clearly intended to make Saudi Aramco a market leader in developing the Saudi capital markets.[147]

Another couple of examples would be Petronas (the Malaysian national oil company) issuing a *sukuk* when it was already flush with cash and did not even need to raise funds through conventional means;[148] and UKEF (the UK's export credit agency) providing cover for a US$916 million Emirates Airlines *sukuk* issuance.[149] Another interesting example would be the establishment by the UAE government of two Islamic mortgage companies (Amlak and Tamweel) to provide *shariah*-compliant solutions—particularly for securitisation—for the property market.[150] The intention behind these efforts was for

142 Hayat and Malik (n 2) 10.

143 'S&P: Qatar's Islamic Banks on Fast Track to Growth' (*Gulfbase,* 19 September 2013).

144 Interview with Islamic Banker11 (n 122).

145 Interview with Lawyer14, 'Partner and Global Co-Head of Islamic Finance Practice in Dubai Office of International Law Firm' (11 February 2015).

146 Interview with Government Official22, 'Practice Head at Leading National Oil Company' (4 November 2013).

147 Interview with Lawyer15, 'Partner with Islamic Finance Specialisation in London Office of International Law Firm' (30 April 2015).

148 Interview with Islamic Banker11 (n 122).

149 Interview with Regulator43 (n 61).

150 Interview with Regulator46 (n 47).

Islamic finance to gain enhanced credibility following state-sponsored transactions and for other corporates to take notice and follow suit.[151] This would in turn provide more liquidity and depth to the Islamic finance sector.[152]

The state hopes to set a framework of incentives and regulations that fosters the entry of a large number of players, a broad variety of instruments, and a deep and liquid Islamic money market.[153] Oftentimes there is no immediate economic benefit for the state in setting up these frameworks or providing *shariah*-compliant products. Indeed, the desired short-term economic benefits in most instances can be more readily achieved through, for example, issuing a bond rather than a *sukuk*. So the state's drive in developing an Islamic finance sector is in pursuit of the policy objectives discussed in section 7.2 (*Policy Drivers*).

It may be harder to convince private actors who do not share the state's political objectives to engage in Islamic finance. A lawyer says in this regard, 'With independents it will be that much harder as they respond to shareholders to whom they have to justify getting involved with a more expensive instrument—when they have alternatives that are cheaper and probably easier to sell.'[154] Another lawyer said this of the UK experience:

> The UK government was hoping that UK corporates would follow [their *sukuk* issuance] and then there would be lots of these issuances that the Islamic banks could buy for regulatory purposes. Because if the government sets the tone then others follow, but the truth is that that hasn't happened. Because it's so easy to issue a bond if you're a corporate. Unless you have a huge policy pressure to do [Islamic finance], you won't do it, because it's untested. It involves lawyers charging a lot of money and accountants getting comfortable. When you just have a big GMTN programme, *khalas*, you just issue.[155]

151 Interview with Lawyer13 (n 104).

152 Interview with Lawyer32, 'Senior Associate and Islamic Finance Specialist in London Office of International Law Firm' (19 August 2016).

153 Iqbal and Molyneux (n 9) 45.

154 Interview with Lawyer13 (n 104).

155 Interview with Lawyer47 (n 45).

This private sector reluctance has also had an impact on lowering *shariah* standards to make Islamic products more competitive and attractive—a 'race to the *shariah* bottom', if you will. There is intense competition from conventional banks as well as between the Islamic banks themselves. If an entity (private or public) is not obligated to raise funds in a *shariah*-compliant manner, the Islamic banks will have a hard time winning that business if they insist on a strict *shariah* interpretation. The customers will just go to a conventional competitor or an Islamic bank willing to lower its standards.[156]

7.3.2 Levelling the Playing Field

Many industry participants look to the government to put in place the frameworks required to foster the industry and address the challenges arising from trying to 'fit the square peg of Islamic finance into the round hole of conventional banking regulations'.[157] When asked if Islamic finance requires government support, a prominent Islamic banker responds:

> Absolutely. As governments are the source of legislation, they are the ones that can facilitate or create hurdles. If they want to facilitate, they will produce the required laws. Governments have to give a fair chance to Islamic banks like they have given conventional banks.[158]

So the market is looking to state intervention to address regulatory challenges and ensure Islamic finance is not unduly disadvantaged compared to conventional finance.[159] This process is often called 'levelling the playing field'.

The most important component of this process is ensuring neutral tax treatment between conventional and Islamic finance—as tax treatment can make or break a country's Islamic finance industry.[160] A general theme that has emerged in my interviews is that,

156 Interview with Lawyer24, 'Partner and Head of Department in London Office of International Law Firm' (6 March 2016).

157 See Ainley and others (n 57) 16–18; Hayat and Malik (n 2) 45–48.

158 Interview with Islamic Banker08 (n 91).

159 Of course some—usually secular—governments are also concerned about giving particularly favourable treatment to Islamic finance—or any form of finance for that matter.

160 See section 4.5.3 (*Tax*).

'*shariah*-compliant financing can be very difficult in jurisdictions that have extensive tax regimes. It works better when you have a minimalist approach to taxation'.[161] A senior lawyer at the Islamic Development Bank says in this regard:

> We have done many transactions in many countries. The tax issue is key. The challenge we face is whether the legal regime of the country in question has an Islamic finance law. If not, it would be difficult to deal with issues such as tax. When you are doing a *murabaha* or *ijara* transaction, your first sale will have a tax component and your second sale will have a tax component and the profit you make will also have a tax component. An Islamic finance law can take each product and deal with its tax implications and take away any possibility of double taxation.[162]

A further criticism of government regulation is that, through preferential tax treatment of interest, they have encouraged debt over equity and hampered the emergence of true profit-and-loss sharing instruments.[163]

In some cases, such as the UK, the approach to Islamic finance is one of 'no obstacles, but no special favours'.[164] Since the early 2000s the UK government has implemented tax and legislative changes aimed at removing obstacles to the development of Islamic finance—the most significant first step being the removal of multiple payment of Stamp Duty Land Tax on Islamic mortgages in the Finance Act 2003.[165] A further example is that the UK's 2007 budget provides that *sukuk* is to be granted the same tax status as conventional debt instruments, and that the income to *sukuk* investors is to be treated as interest income.[166]

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161 Interview with Lawyer06 (n 62).

162 Interview with Regulator02, 'Senior Legal Counsel at the Islamic Development Bank' (14 February 2015).

163 Harris Irfan, *Heaven's Bankers: Inside the Hidden World of Islamic Finance* (Constable 2014) 187.

164 Howard Davies, 'Islamic Finance and the UK Financial Services Authority' (Conference on Islamic Banking and Finance, Bahrain, 2 March 2003).

165 Ainley and others (n 57) 8.

166 Hossein Askari, Zamir Iqbal and Abbas Mirakhor, *Globalization and Islamic Finance: Convergence, Prospects and Challenges* (John Wiley & Sons 2010) 22.

Sir Howard Davies, then-Chairman of the Financial Services Authority (FSA)—since restructured as the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA)—said that, provided Islamic banks met the FSA's regulatory requirements, the UK had 'a clear economic interest in trying to ensure that the conditions for a flourishing Islamic market are in place in London'.[167] However, while the FSA was happy to see Islamic finance develop in the UK, it would not have been appropriate, nor legally possible, to adopt specifically-tailored standards to allow it to do so.[168] A regulator focused on Islamic finance at the Bank of England tells me, 'We aim to level the playing field. We have no preference for Islamic finance. We just provide a framework and if we are doing our job properly, you wouldn't even notice us and the markets can just get on with it'.[169] It can be said that the UK government has been largely successful in this and has set up a regulatory system that has been called 'the envy of the world, even the Muslim world'.[170]

Levelling the playing field is not only limited to neutral tax treatment, although that is most important. It also addresses issues such as the regulatory definition of products, the role of *shariah* scholars, and financial promotions.[171] Product definitions are important to determine what regulatory treatment is appropriate. Is it appropriate to classify a *mudaraba*, an ostensibly profit-and-loss sharing product that theoretically puts capital at risk, as a 'deposit' that benefits from a deposit protection scheme? Is an 'Islamic mortgage' where the property is co-owned by the Islamic bank and the customer really a 'mortgage' for regulatory purposes? Should the mutual pooling of risk in a *takaful* be regulated the same as a conventional insurance? Is a *sukuk*, which represents an undivided proprietary interest in

167 Davies (n 164).

168 Ainley and others (n 57) 11.

169 Interview with Regulator43 (n 61).

170 Interview with Islamic Banker11 (n 122).

171 Ainley and others (n 57) 12.

assets, the same as a conventional bond that represents a debt claim against the issuer? The list can go on.

Regulating the *shariah* scholars is also a significant challenge for secular regulators and those who have a policy of *shariah* blindness. A regulator at the Bank of England tells me, 'We regulate the financial aspects of Islamic finance not the Islamic aspects. We do not approve the credentials of the scholars, we leave that to the market and the customers'.[172] This also ties into the discussion on financial promotions and advertising. In the UK, the focus is on disclosure. If an institution makes a claim to *shariah* compliance, the basis on which that statement is made needs to be disclosed to the customer in a way that is 'clear, fair, and not misleading'.[173] Then it is a matter for the customer's conscience whether that is sufficient. This reflects the regulatory objective to protect consumers. This is important in two respects: first, that Islamic finance products tend to be relatively new and their structures more complex than their conventional counterparts; and second, customers of Islamic products may be inexperienced in the use of financial services—indeed some may have been previously unbanked—which reinforces the need to have any promotion of the products include a statement of the risks as well as the benefits.[174]

7.3.3 Using State-connected Entities

An important way that states (particularly in the Middle East) promote Islamic finance is by taking stakes in Islamic banks or creating special relationships with them.[175] These relationships are mutually beneficial. The Islamic banks are awarded lucrative government

172 Interview with Regulator43 (n 61).

173 ibid.

174 Ainley and others (n 57) 14.

175 It must be said that these special government relationships are not unique to Islamic banks and can often be seen with conventional banks as well. See eg Malik, 'The Political Economy of Macroeconomic Policy in Arab Resource-Rich Economies' (n 42).

deals and the governments find a willing customer for their products (such as *sukuk* issuances). It is a win-win.

The way this works in practice is that the government may spend months negotiating and structuring a deal with a number of entities. As the deal approaches close, a number of relationship banks (both conventional and Islamic) will sign up to the deal as it has been negotiated. The Islamic banks also get involved with structuring these government deals so that they have a good-quality *shariah*-compliant product to buy for their own books. A lawyer involved with these deals says, 'There is a whole song and dance about placing the [government-issued] product, but it ends up on the balance sheet of the Islamic bank [that has structured it]—a lot of it doesn't go very far, and goes to the bank itself'.[176] Indeed, given the selling restrictions and minimum holding amounts often imposed on government-issued products, it becomes clear that its intended audience are institutional investors (with whom the government typically enjoys a special relationships).[177]

Given its policy objectives, the government may mandate certain headline-grabbing transactions be done in a *shariah*-compliant manner with a particular Islamic institution. For example, when the Dubai government intended to acquire the British global ports operator, Peninsular and Oriental Steam Navigation Company (P&O) in 2005, it appointed Deutsche Bank as its sole adviser but stipulated the deal be done in a *shariah*-compliant manner with the involvement of the government's flagship institution, Dubai Islamic Bank, in which the Dubai government held a stake.[178] Of course, a further consideration for the recent slow-down of the Islamic finance sector in the GCC has been the continued slump in oil prices.

176 Interview with Lawyer32 (n 152).

177 Interview with Lawyer14 (n 145).

178 Irfan (n 163) 88.

Less oil money means fewer projects, which in turn means there is less business to award state-connected enterprises.[179]

Another reason that Islamic banks get involved with government transactions is to gain visibility and relevance in the market. As discussed in section 7.3.1 (*Kick-starting the Industry*), the private sector is less willing to engage in Islamic finance as it does not have the same policy considerations as the government. If Islamic banks fail to convince government entities to deal with them, they will struggle to stay in business. They use this as leverage to get themselves on government deals, saying 'if you refuse to give us business, we—and the Islamic finance sector along with us—will fail, and you will fail to achieve your policy objectives in this space'.[180] An example of this is adding a (often small) *wakala* tranche, to an already fully-funded deal to ensure the local Islamic banks who prefer funding under a *wakala* tranche can be involved.

A further way that the state can support an Islamic bank (usually one in which the state has a stake) is by making it the default destination for salary payments to government employees—as was the case with Kuwait Finance House, for example.[181]

Another reason governments like using relationship banks is that they are more able to lean on them (and therefore their *shariah* boards) to push through deals with dubious *shariah*-compliance.[182]

179 See eg Malik, 'The Political Economy of Macroeconomic Policy in Arab Resource-Rich Economies' (n 42); Adeel Malik, 'Beyond the Resource Curse: Rents and Development' in Ishac Diwan and Ahmed Galal (eds), *The Middle East Economies in Times of Transition* (Palgrave Macmillan 2016); Malik, 'Rethinking the Rentier Curse' (n 25).

180 Interview with Lawyer14 (n 145).

181 Henry (n 1).

182 See section 5.3.2 (*Bankers*).

7.4 THE GEOPOLITICS OF ISLAMIC FINANCE

What are the international objectives pursued by states in the Islamic finance sector? As mentioned, Islamic finance is not a global or even regional phenomenon. The international scene is characterised by intense competition rather than cooperation and collaboration. States use Islamic finance as another means of getting ahead of their rivals, and promoting themselves as a hub for the industry, with the prestige and status that may bring.[183] States, and the Islamic banks they host, do not have an international political agenda for the most part. Indeed, it is said that, '[Islamic] banks, by virtue of being part of an existing power structure, have a strong status quo orientation'.[184] This means that Islamic finance is not used to support humanitarian causes, such as alleviating poverty or providing relief to Muslim refugees.

In addition to states and Islamic banks, multilateral bodies dedicated to Islamic finance (such as the IsDB and AAOIFI) and international organisations (such as the World Bank and the IMF) are also involved in the global Islamic finance sector. I will explore their role below.

7.4.1 Multilaterals Dedicated to Islamic Finance

There are numerous multilateral entities dedicated to Islamic finance. Hosting these institutions is a source of prestige for states, and also gives them the most benefit from the organisation and the most influence over it.[185]

The Saudi-based Islamic Fiqh Academy, an arm of the Organisation of Islamic Cooperation (OIC) with 57 member states, issues *fatawa* dealing with contemporary issues, including those relevant to Islamic finance. The prominent standard-setting bodies are the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions

183 See sections 7.2.1 (*Rivalries*) and 7.2.2 (*Status Symbol*).

184 Warde (n 7) 214.

185 Interview with Regulator46 (n 47).

(AAOIFI), established in 1990 for *shariah* accounting and auditing standards, and the Malaysia-based Islamic Financial Services Board (IFSB), established in 2002 for regulatory and supervisory standards.[186]

These bodies reflect different approaches—the latter has a more Malaysian influence and the former an Arab influence—which allows them to articulate 'schools of thought' of sorts amongst scholars in a public way. This is helpful for the lawyers and bankers involved in the industry, as they get insight into the thinking of the scholars in the relevant jurisdictions through these agencies. Practitioners treat these standards as mere starting points for discussion and an articulation of the aspirational 'gold standards'. The practitioners will modify and most often diminish and diverge from these standards on a deal-by-deal basis, as required, to strike a commercial deal.[187] Despite these commercial realities, many commentators view the role of these standard-setting bodies as positive, and their issuance of practise directions and standards have helped instill investors with the confidence to invest in *shariah*-compliant products.[188]

Perhaps the most important multilateral body in Islamic finance is the AAA-rated Islamic Development Bank (IsDB).[189] For IsDB, the role of governments is key. IsDB encourages governments to set clear policies and strategies on where they want to go with their Islamic finance sector.[190] Without such a policy position, IsDB struggles to assist countries to foster an effective Islamic finance sector—with the changes often required to tax, land registration, and liquidity management provisions.

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186 TheCityUK (n 3) 21.

187 Interview with Lawyer47 (n 45).

188 John Dewar and Mohammad Munib Hussain, 'Islamic Project Finance' in John Dewar (ed), *International Project Finance: Law and Practice* (2nd edn, OUP 2015).

189 For further details see section 3.1.4 (*Regulatory & Research Institutions*).

190 Interview with Regulator02 (n 162).

Even though IsDB participates in the standard-setting meetings of AAOIFI and IFSB,[191] it has its own *shariah* board that can be more permissive when IsDB is going into jurisdictions that have not done Islamic finance before.[192] This is because IsDB has a mandate to promote Islamic finance, and sometimes strict adherence to *shariah* standards is not conducive to doing so.

A further important function fulfilled by IsDB is that it can take Islamic finance into areas that bankers and their lawyers will not go, as it does not make financial sense for them to do so. As a development finance institution, committed to South-South cooperation,[193] IsDB's decisions are not exclusively driven by profit. IsDB is more focused on developing its member states (most of which are developing countries) and promoting Islamic finance—objectives not shared by profit-seeking private sector participants. Of course, IsDB will look at the financial viability of the projects it invests in, but that is because it believes there is a strong link between financial viability and development impact.[194]

> Clearly bankers will be doing something if there is a monetary incentive and lawyers can only do it if they are paid to do it. But a multilateral like IsDB can actually go [to governments] and say, 'let us help you create an Islamic finance industry, let us look at your legislation, let us help you think about why you should do Islamic finance', and they'll have the conversation about policy. They'll talk about the banking sector. They have a group of experts, and the money to back it up.[195]

Accordingly, IsDB has established numerous entities, such as Islamic banks and insurance companies, around the world to promote Islamic finance. In the early stages of these businesses, IsDB's *shariah* committee helps them achieve *shariah*-compliance by reviewing

191 ibid.

192 Interview with Lawyer47 (n 45).

193 Islamic Development Bank, 'Islamic Development Bank Group in Brief' <http://www.isdb.org/irj/go/km/docs/documents/IDBDevelopments/Internet/English/IDB/CM/Publications/IDBGroupBrief2013.pdf> accessed 11 May 2017.

194 Interview with Regulator02 (n 162).

195 Interview with Lawyer47 (n 45).

deal documentation and general 'hand-holding' until these entities can stand on their own feet and engage their own *shariah* board.[196]

It is also worth noting that IsDB cannot finance more than 33% of a project. Thus, when it receives a mandate to syndicate, IsDB usually approaches other like-minded development finance institutions such as the International Finance Corporation (IFC), European Bank for Reconstruction and Development (EBRD), Asian Development Bank, African Development Bank, and the Arab Fund for Economic & Social Development. Commercial banks are also approached, but IsDB does not have relationship banks. The commercial banks join IsDB syndications after doing their own feasibility studies on a case-by-case basis. Sometime these banks are not even Islamic banks, but agree to participate under the IsDB umbrella based on the strength of the underlying project.[197]

7.4.2 International Organisations

International organisations, such as the World Bank[198] and the International Monetary Fund (IMF), have also gotten involved in the Islamic finance sector.

This is often done to enhance the credibility of these institutions by demonstrating that they are able to cater for the needs of all their members and are on top of all financial trends. It also informs their discussions with governments and aid agencies and other actors in this space.[199]

In addition to enhancing their credibility, Islamic finance has policy implications for some of the countries with which the international organisations seek to work. For example,

196 Interview with Regulator02 (n 162).

197 ibid.

198 See eg Askari, Iqbal and Mirakhor (n 166) 24, where it is stated that, 'The International Finance Corporation (IFC)—the private sector arm of the World Bank—has executed several *shariah*-compliant transactions. In 2007, Multilateral Investment Guarantee Agency (MIGA)—one of the agencies of the World Bank Group—provided its first-ever guarantee for *shariah*-compliant project financing, worth US$427 million'.

199 See eg 'Islamic Finance and the Role of the IMF' (*EIN Presswire*, 19 March 2015).

if a developing Muslim country is having a financial crisis, part of the problem can be that the state is not collecting enough taxes. This could be because a vast portion of the population is unbanked, so the government has no insight into their earnings for taxation purposes. Amongst the unbanked could be many conservative Muslims who avoid the conventional banking sector because they view it as inconsistent with their religious beliefs. The international organisations may be able to provide aid and advice to these Muslim governments on how to restructure their banking sector to allow for *shariah*-compliant options that can bring more funds within a regulated framework that can be taxed by the state.

A further reason why international organisations get involved with Islamic finance is that, oftentimes, certain individuals at these organisations take a keen interest in the topic and develop a specialisation surrounding it. 'Individuals who have an interest and knowledge also create an impetus in the organisation.'[200] Although, some observers comment that Islamic finance would not have sparked the interest that it has if the Middle East did not have such an out-sized geopolitical significance—given the regional turmoil and its vast oil-generated wealth. 'Imagine if the Gulf wasn't interested in Islamic finance and it was just a Malaysian product, would [the international organisations] have the same level of interest?'[201]

7.5 CONCLUDING REMARKS

The political economy of individual countries contributes to the overall shape of Islamic finance[202]—providing insight into how faith, capital, and power converge in any given jurisdiction. Looking at the role of the state in shaping Islamic finance, I can make some observations. Official interest in Islamic finance varies significantly, from full Islamisation to

200 Interview with Regulator46 (n 47).

201 Interview with Lawyer47 (n 45).

202 Hayat and Malik (n 2) 63.

active discouragement. The policies pursued are not mutually exclusive, and it is common to see the focus of states shift over time, leading to sometimes contradictory policies. States can use Islamic finance to appease their Islamists and consolidate their power. In some non-Muslim majority states, Islamic finance is accommodated as a way of generating business, but also as a means of financial inclusion and banking the unbanked. Still, in most countries the market share of Islamic finance is less than a quarter of the entire banking sector.

States use Islamic finance as one of their many tools to achieve varied domestic and international political objectives. Domestically, Islamic finance can be both a source of identity and a source of income. On the international scene, the industry is characterised by intense rivalry rather than collaboration. States use Islamic finance as another means of getting ahead of their rivals. This means that there has been no effective collective effort made for Islamic finance at the international level by Muslim-majority countries through such platforms as the Organisation of Islamic Cooperation. There are multilateral bodies dedicated to Islamic finance as well as international organisations involved in the sector, however, these have also functioned to maintain the status quo of global finance.

My research has not turned up evidence of any government having committed to a policy of offering a genuine alternative to conventional finance. Islamic finance is not focused on supporting humanitarian causes, such as providing relief to refugees from the Muslim world or alleviating poverty in Muslim countries. So while Islamic economics is the intellectual backdrop of Islamic finance, governments do not seem aware or interested in the ideals espoused by it. Without significant political will, the domination of conventional finance is unlikely to be challenged by Islamic finance—even in Muslim-majority countries—for the foreseeable future.[203]

203 ibid 67.

CHAPTER 8: CONCLUSIONS

8.1	**SUMMARY**	8.3.7	DAMNED IF YOU DO, DAMNED IF YOU DON'T
8.2	**CIVIL COMPROMISE & GAME OF ISLAMIC BANK BARGAINS**	**8.4**	**WAY FORWARD**
8.3	**OTHER KEY FINDINGS**	8.4.1	RUN ISLAMIC FINANCE AS A CHARITY
8.3.1	INDIVIDUAL-DRIVEN	8.4.2	AAOIFI/ISDB THINK TANK FOR PRODUCT DESIGN
8.3.2	REVOLVING DOOR	8.4.3	ALLIANCE WITH ETHICAL
8.3.3	CUSTOMERS & GOVERNMENT CONNECTIONS	8.4.4	AN ALTERNATIVE TO BANKING
8.3.4	ISLAMIC LAW, NOT ECONOMICS	8.4.5	FRESH THINKING BY A NEW GENERATION
8.3.5	CLASS DIVISIONS	**8.5**	**LIMITATIONS & FUTURE RESEARCH**
8.3.6	COMPETENCE COMMITMENT DISCONNECT	**8.6**	**FINAL REMARKS**

'The Islamic finance industry needs to move from halal (permissible) to tayyib (wholesome). The industry is getting obese on halal junk food.'

– Islamic scholar

8.1 SUMMARY

From its humble beginnings in the 1960-70s, Islamic finance is now an established niche within the global financial order. Most major financial institutions are somehow involved in the industry—with dedicated professionals specialising in the sector from East to West, Malaysia to America. With the globalisation of Islamic finance following the September 11th attacks and the 2008 financial crisis, non-Muslim countries such as the United Kingdom, Hong Kong, and Singapore are also vying for a seat at the table of an industry that nearly doubled in half a decade.

It has not all been good news, however. Despite significant growth, Islamic finance is still considered to be far below its true potential. Critics believe that IBF has not achieved much by way of development and social outcomes. Genuine profit-and-loss sharing arrangements—considered the ideal form of Islamic finance—have not gained any real traction. IBF has not been very effective in bringing into the formal banking sector even the

'pious'—the devoted who have shunned *riba*-based conventional banks—let alone the unbankable poor.

Even though Islamic finance is considered the preferred way of banking for Muslims—a quarter of the world's population—it only accounts for just over 1% of global financial assets. This is while over 75% of adult Muslims do not have a bank account and only 7% have access to formal financing. This underscores the significant potential for Islamic finance to achieve greater financial inclusion for Muslims. Moreover, the customer base of Islamic finance need not be restricted to Muslims—non-Muslims may be attracted to Islamic finance as well if they come to believe that it has a genuine ethical premise.

In chapters 2 (*Origins*) and 3 (*Current State*), I have shown the various interpretations that have been applied to the sector at different times and in different places. This helps show that the current state of IBF was not inevitable, but is rather the outcome of the cooperation and competition of numerous stakeholders throughout the history of various countries. These chapters show that IBF was not an inherent or embedded feature of Islamic civilisation simply waiting to be revealed or revived. Rather, the emergence of IBF is located in the rise of Islamic revivalist movements and their eventual accommodation by the state. Far from being a latent element of Islamic culture, IBF is instead an 'invented tradition' created and accommodated by the state and a coincidence of social, commercial, religious, and political forces.

In chapter 4 (*Islamic Project Finance*) I demonstrate that modern IBF has come to be dominated by a legalistic and transaction-based approach. Islamic economic concepts and objectives are largely absent from IBF discourse. Islamic finance has not sought to provide solutions for economic development, social and economic justice, human welfare, inclusion, access to finance, and public policy.

In chapter 5 (*Faith*) I have examined the role of 'Islam' in Islamic finance. Amongst all the actors in the IBF industry, the *shariah* scholars play the most-nuanced role. They have a variety of considerations to balance against each other: their desire to earn significant financial reward, to earn and maintain a robust reputation, to strive to serve the will of Allah, and to shape the IBF industry. Despite the common 'scholars for dollars' accusations, my research suggests that it is not accurate to say *shariah* scholars disregard *shariah* for personal financial gain. They are neither the cause of nor cure to the industry's ills. Most genuinely strive to create a compromise between the restrictions of Islamic law and the requirements of finance in today's world, in a way that allows Muslims to benefit from banking and finance without violating their religious beliefs.

Another key constituent covered in chapter 5 (*Faith*) are the customers of IBF. Islamic banking would not have existed if classical Islamic law did not appeal to most Muslim populations. The growth of IBF is driven in part by the desire of Muslims to apply Islamic law to their daily lives. There is a feeling amongst many Muslims that classical Islamic law has never been given a fair chance in modern times. Most Muslims would prefer Islamic finance when it is available to them at a comparable cost to conventional finance. Many more Muslims would opt for IBF if it were not financially detrimental to do so.

In chapter 6 (*Capital*) I have examined the impact of financial incentives on IBF. Conventional institutions initially entered the IBF industry to help Islamic banks manage their liquidity, but ended up being the industry's dominant force, to the extent that the Islamic banks had to replicate their actions to survive. Islamic finance, whilst having some tangential benefits, is seen as having not fulfilled its originally-stated promise and has remained largely irrelevant to the Muslim masses. Proponents had argued that Islamic banking would achieve superior allocative efficiency, equity, stability, and growth compared to its conventional counterpart. Failing to achieve these lofty goals, IBF has retained merely

a shallow formalistic adherence to the *shariah* through optics and terminology and has marketed itself as a niche in global finance—which has itself been discredited post-financial crisis.

In chapter 7 (*Power*) I examine the role of governments in shaping the Islamic finance industry. Most industry observers agree that government support is crucial to the industry's sustained functioning. State support is often required even at the micro-level, as it may not be enough for the state to provide macro-level policies for the industry. Official government interest in Islamic finance varies significantly, from full Islamisation to active discouragement. Different states have different policies depending on factors such as their demographics, the religiosity of their population, and their autocratic or democratic nature. States can use Islamic finance to appease their Islamists and consolidate their power. In some non-Muslim majority states, Islamic finance is accommodated as a way of generating business, but also as a means of financial inclusion, and banking the unbanked. On the international scene, states use Islamic finance as another means of getting ahead of their rivals and promoting themselves as a hub for the industry. No government appears to have committed to a policy that offers a genuine alternative to conventional finance.

8.2 CIVIL COMPROMISE & GAME OF ISLAMIC BANK BARGAINS

My dissertation set out to explore Islamic law's ability to adapt to challenges posed by modernity—through a process I called 'civil compromise'. Islamic finance has emerged from the negotiation between Islamic law and modernity in the banking and finance sector. The very existence of the Islamic finance industry shows that Islamic law is not static and that its religious commands are capable of adjustment to modern realities. Thus, it is clear that Islamic finance is an example of civil compromise in Islamic law.

What is less clear is whether it is a successful example. The test for successful civil compromise is whether the outcome achieved is deemed by the majority of society to be

Islamic, modern, and just. If found to be successful, Islamic finance would help maintain Islam's appeal and applicability in today's society by showing that it has viable solutions to modern-day challenges in the banking and finance sector.

My research shows that serious question marks hang over how 'Islamic' or 'just' IBF is in its current form. Thus, it cannot be said that Islamic finance passes the 'Islamic, modern and just' test. IBF is a work in progress, and while it has made some significant strides, most industry observers agree that it is not there yet and has a long way to go. So those who hold up Islamic finance as a universal panacea or dismiss it outright as a fraud have both got it wrong. It is neither. It is, rather, a complex myriad of incentives and aspirations of a multitude of stakeholders muddled together across numerous geographies and evolving incrementally and constantly.

My dissertation showed that there are religious, commercial, and political factors at play in Islamic finance, but none are so decisive as to dominate the industry on their own. Indeed, the shape of the Islamic finance industry has emerged as a result of the way the elite stakeholders have cooperated and competed in pursuit of their self-interests in the 'Game of Islamic Bank Bargains'—referred to here as the 'Game' for short.

It pays to play the Game as (almost) everyone's a winner. A senior Saudi regulator looks at this situation in resignation and tells me:

> Everyone is happy, the customer wants to feel as if he is obeying God and putting a scholar between himself and the hellfire. The scholar is paid handsomely by the banks to give the *shariah* approval. The bank gets additional business from the government and from piety premiums paid by a captive audience. And the government gets a boost to its reputation. Everyone is happy. There is no motivation to change. Those who are unhappy are swimming against the tide.[1]

The industry may not be an all-round success, but the elite stakeholders create coalitions and cooperate amongst themselves in ways to ensure their primary interests are met. The

1 Interview with Regulator03, 'Senior Regulator in Saudi Arabia' (14 May 2015).

stakeholders are not to be 'blamed' for what happens as a result of such coalitions. Such apportioning of blame would be a convenient allocation of responsibility for the state of the industry to the moral failings of a stakeholder group. This would be problematic as, first, there is no agreement as to which stakeholder group is at fault, and second, my research suggests that each stakeholder group is acting rationally in pursuit of its interests within a framework of religious, commercial, and political considerations that are, more than anything, a result of historical circumstances.

So what are these interests? Below I set out the key interests for each of the main stakeholders.

Shariah scholars: The scholars have an obvious financial incentive in the form of the significant income they derive—said to be in the 'hundreds of millions of dollars'. However, the scholars also have religious and reputational concerns to contend with. Scholars resolve this state of cognitive dissonance by claiming that they are creating a compromise between the restrictions of Islamic law and the modern requirements of finance. It will have a significant adverse reputational impact on the scholars to come out and say conventional finance is not actually forbidden—and those who have tried have been vocally discredited and quietly ostracised from the industry and relegated to largely irrelevant academic circles.

On a practical level, scholars are under significant pressure from the commercial teams at the financial institutions that employ them to approve deals for significant clients (eg any state-connected entity that has a special relationship with the institution). Scholars thus sometimes guide lawyers to remove controversial provisions to side-letters which will not be reviewed or approved by the *shariah* board, so they will not be seen as approving something forbidden that may damage their reputation. Other times, they will justify such controversial approvals in terms of necessity (*dharurah*) and expediency (*maslaha*). You can clearly see how the Game is played from observing these interactions between the scholars

and the bankers that employ them. Scholars are aware of the role they play in the Game and will not try to overplay their hand by strictly insisting on compliance with the spirit as well as the letter of the *shariah*. They understand that there are bigger forces at play. They know that they need to play along, or will be asked to leave the table for someone who will.

Lawyers and bankers: Again the main incentive of IBF lawyers and bankers (both conventional and Islamic) is financial. IBF launches careers of specialists in the sector, who charge premium fees for their expertise. The lawyers and bankers market their services to a somewhat captive customer base (which often includes the state-connected entities—themselves incentivised to engage in the sector in pursuit of political objectives). This allows IBF to compete with conventional banks to some extent despite its relative inefficiency. Several conventional banks have also set up Islamic finance windows and are engaged in the sector to access the liquidity in the Muslim world and offer a world-class service to what they see as anachronistic clients. These institutions make no secret of the fact that they are mere money-making businesses, not 'religious' or 'charitable' institutions. The reality is that IBF has had almost no benefit for the general public, or for poverty-alleviation, or the redistribution of wealth in the Muslim world.

Governments: Of the stakeholders, governments have the largest variety of incentives—both domestic and international. Domestically, IBF can be demanded by their constituents and states must support Islamic banks to meet this market demand. IBF is often the avenue of choice for Muslims wanting to reassert their Islamic identity—especially in times when there is a perception that Islam is under attack (such as after 9/11).

Moreover, banks are powerful tools in the hands of politicians in attracting the support of particular constituents. Islamic banks are effective in attracting the support of Islamists that form a politically significant segment of the population in many Muslim countries.

In addition to being a source of identity for the state, IBF can also be a source of income. Given the religious sensibilities of certain populations, Islamic finance may sometimes be the best means of raising funds from domestic sources. IBF is also a means through which states seeks to bank the unbanked and bring into the formal banking sector a segment of the population that avoids conventional banking on religious grounds.

Internationally, it is important for states to be recognised as a hub, for the reputational and financial rewards that flow from achieving that status. Also important is getting ahead of other rivals that want to claim the mantle of Islamic finance for themselves. Most of the international gains are less tangible and have more to do with pride and prestige—such as the bragging rights of attracting expat talent to your shores and benefiting from the efficiency and liquidity their institutions provide. Of course there are also financial rewards to being a hub. Attracting highly-paid professionals will keep your economy buzzing with activity as they rent luxury apartments, dine in world-class restaurants, and buy other expensive goods and services.

Customers: My research indicates that about a third of IBF customers engage with the sector out of a sense of religious conviction. They respect and defer to the *shariah* scholars and accept their assessment on the Islamic nature of the products offered by Islamic banks. This group is often aware of the shortcomings of the industry but believe that even if IBF is not 100% Islamic, it is the least worst option available and that the industry is in need of support in its infancy/adolescence. The remaining two-thirds only engage in the sector when it is financially-neutral to do so. There are instances where, given the various government incentives, IBF is in fact cheaper than conventional finance. A limited minority also engage in IBF as a means of diversifying their investment holdings or out of an interest in the perceived ethical nature of IBF.

The above shows that all of the main stakeholders of the Islamic finance industry are 'winners' who achieve their key interests. But who are the losers? The pious poor and Muslim masses. This group is not catered for in the IBF industry because they have no chips in the Game.

IBF is an elite product aimed at financially-savvy consumers who will scrutinise its returns compared to conventional counterparts. The Muslim masses remain unbanked by these financial institutions who have no interest or incentive to cater to the unbankable poor. Banks (Islamic or otherwise) are not in the business of poverty-alleviation or wealth-redistribution. They are more involved in massive infrastructure projects, sovereign *sukuk,* and financing the acquisition of crown jewels in European capitals. Those who can afford the elite IBF products tend not to care a great deal about their *shariah*-compliance, and the pious poor who care tend not to be able to afford it—in short, those who can afford it, don't care, and those who care, can't afford it.

In a democratic system, the impoverished masses would potentially be able to use their numbers and votes to influence government policies in a way that would cater to their needs. However, given the autocratic nature of many Muslim countries the masses are largely disenfranchised and have no way of influencing government policies in their favour. They cannot even vote with their feet and leave the Islamic finance institutions and deprive them of their business because they are largely unbanked anyway. So those who are unhappy with the state of the industry have no means of redress, as they have no political or financial sway over the stakeholders.

To pass the 'Islamic, modern and just' test of successful civil compromise, Islamic finance will need to show more tangible benefits and relevance for the Game's losers.[2] Once it is touted as a genuinely useful product by Friday prayer leaders around the Muslim world

2 Some suggestions for this are included in section 8.4 (*Way Forward*).

(and in Muslim communities of the non-Muslim world), can Islamic finance lay claim to being both Islamic and just. The current outcome of Islamic finance is just a subset of the global financial order. It has not fulfilled any Islamic economic principles or its claimed social justice objectives. As stated by Mahmoud El-Gamal, 'To quote Ibn Khaldun, "what matters in the end is the outcome"; if the outcome of Islamic finance isn't growth with justice, then it's not Islamic'.[3]

8.3 OTHER KEY FINDINGS

In addition to my dissertation's main finding—that the way the Game is currently played has not produced an 'Islamic, modern and just' outcome—there are certain other key findings worth highlighting.

8.3.1 Individual-Driven

I have found that much of IBF is driven by individuals. When you have quality people you get quality results, otherwise you get caught up in incompetence and petty rivalries. So, much more than the strength of the institutions involved, Islamic finance is shaped by the strengths and interests of the individuals involved.

An interesting example in this regard is how Luxembourg became a leading European centre for Islamic finance when Yves Mersch was the Governor of the Central Bank of Luxembourg (1998-2012). Mersch was married to a Malaysian economist Tengku Khatijah Ahmad, and they together spent a lot of time in Malaysia and were close to Zeti Akhtar Aziz, Governor of the Bank Negara Malaysia (2000-2016). So when Governor Zeti launched International Islamic Liquidity Management Corporation (IILM) in 2010, Luxembourg became one of its founding shareholders (and only European member). When Mersch left the Central Bank of Luxembourg for the European Central Bank his

3 Islamic Finance Project, 'Islamic Finance, Petrodollar Recycling, and Economic Development: A Report on the Panel Discussion' (2009).

replacement was lukewarm on Islamic finance and, as a result, Luxembourg's involvement with IILM—and Islamic finance more generally—cooled off.[4]

8.3.2 Revolving Door

Related to the previous section is the fact that many key individuals involved in the industry move in and out of various roles—sometimes being called 'poachers turned gamekeepers' in the process. For example, one of my interviewees started his career at the Saudi Arabian Monetary Agency (SAMA) as a regulator (after receiving his masters in law from a top US university). Then he moved into private practice at the Riyadh office of an American law firm where he worked on Islamic finance transactions as a lawyer. He then joined the Capital Market Authority (CMA) as a regulator of *sukuk*. Afterwards he became the Head of the Legal Department of the investment banking arm of one of the Saudi Islamic banks and is now the Corporate Secretary of that bank. All of this movement in and out of the public and private sector has occurred in less than ten years.

Another industry participant, this time more senior but again from Saudi Arabia, started his career as a lawyer with the World Bank after receiving a masters in law from a US university (preceded by a bachelors in law from Saudi Arabia). Afterwards he went into private practice at the New York office of a prominent American law firm and after two years set up the Riyadh office of that firm where he worked on Islamic finance transactions (among other things). He then became the Saudi government's representative to the World Bank and shortly afterwards was appointed to a prominent regulatory position.

A further example on the *shariah* scholarship side is an interviewee who started his legal education in Saudi Arabia and went on to receive further degrees from the UK and US. He then joined a US law firm in the Middle East and advised a number of public sector entities as both in-house and outside counsel. He then became the *shariah* supervisor of the

4 Interview with Regulator46, 'General Counsel at Multilateral Institution' (28 January 2017).

Islamic Development Bank, only to return to private practice as a partner at another US law firm. He has also been a member of the Shariah Standards Committee of AAOIFI and various other regulatory bodies. He now sits on the board of a number of Islamic banks in the Middle East and is President and CEO of a *shariah* consultancy that advises numerous public and private entities around the world (mostly in the US).

Individuals fulfilling numerous roles as lawyers, bankers, regulators, and *shariah* scholars, sometimes simultaneously, show the fluid nature of the Islamic finance industry and the intermingling of faith, capital, and power in this space.

8.3.3 Customers & Government Connections

On the business side, my research has shown that IBF would not be able to function alongside (let alone compete with) conventional banking without government support and a loyal customer base. This comparative advantage must be borne in mind by the proponents of the industry who sing its praises and point to its staggering growth.

8.3.4 Islamic Law, Not Economics

While Islamic economic thought serves as the intellectual backdrop of Islamic finance, it is almost completely absent from the industry. Islamic economics is concerned with phenomena at the state, macro, and social levels, rather than the behaviour of individuals. On the other hand, Islamic law's perspective is micro, formal, legalistic, and transaction-based[5]—ie it hopes to regulate the activities of individual businesspeople. This latter approach has come to dominate IBF to such an extent that Islamic economics has been largely ignored as a distinct discipline.[6]

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5 See eg Frank Vogel and Samuel Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Kluwer Law International 1998) 29–31.

6 Discussed in Mehmet Asutay, 'A Political Economy Approach to Islamic Economics: Systemic Understanding for an Alternative Economic System' (2007) 1 Kyoto Bulletin of Islamic Area Studies 3.

Accordingly, at the state level, governments do not seem aware of or interested in the ideals espoused by Islamic economics in areas such as economic development, social and economic justice, human welfare, inclusion, access to finance, and public policy. They merely regulate the operations of individual businesses active in the Islamic finance sector, rather than concern themselves with distributing resources in accordance with Islamic economic principles of social justice. This means that there is not much focus on the institutional requirements for creating an Islamic economic system—one that is not dependent on the motivations of individuals, but also on institutions that can shape those motivations. As a result, Islamic finance practices have effectively substituted institutions embodying Islamic economic ideals. Islamic finance maintains the status quo, while Islamic economics would have hoped to provide an alternative to it.

8.3.5 Class Divisions

An interesting pattern that has emerged from my research is a correlation between socio-economic class and the consumption of Islamic finance products. Most of the intellectual and economic elite tend not to be consumers of IBF. The financially-unsophisticated lay Muslims seem to be the ones buying into IBF products, in part, as a matter of religious devotion. This disconnect is particularly stark when one considers that the IBF practitioners—the Islamic bankers, lawyers, regulators, and scholars—who put these IBF products together rarely consume them themselves. Given their superior knowledge and insight into how these products work, the practitioners recognise that they are engineered to achieve a certain economic output and are largely devoid of any divine substance. This means, the practitioners are benefiting—often handsomely—from the IBF industry, while it is the lay consumers that are paying a piety premium to 'put a scholar between themselves and the hellfire'.

Of course, it is telling to remember that many IBF practitioners are not Muslim. Even the Muslim practitioners, in true Islamic finance style, will find clever solutions from amongst the rich offerings of *fiqh* to justify their avoidance of Islamic finance products. At the elite level, it becomes a calculation of the financial elements in the equation, devoid of any religious concerns. The debates about IBF being 'form over substance' or mimicking conventional finance is not something that is happening at the lay-person level, especially in Muslim-majority countries.

8.3.6 Competence Commitment Disconnect

'We need to be proficient. That is the Islamic way. The Prophet said, "When slaughtering a sheep, sharpen your knife and do it quickly".'

– Islamic banker

A further interesting finding is that it is not the norm to find practising Muslims in the IBF industry. Indeed, many of the practitioners are not Muslim at all, and merely view this sector as another financial product in which to gain a specialisation. On the other hand, some practising Muslims actively shun involvement in the IBF industry. These Muslim practitioners are happy to be involved in the conventional finance industry, as it makes no claim to religious goodness. They do not want to be seen as aiding and abetting an IBF industry that is, in their view, misappropriating the name of God as a marketing ploy whilst being completely devoid of any religious merit.

The industry still suffers from what I call a 'competence commitment disconnect'. Those committed to Islamic principles, lack the expertise for coming up with truly alternative financial products. And those with the competence and expertise for financial innovation, lack buy-in into the underlying Islamic principles. In other words, those who can, don't care; and those who care, can't.

8.3.7 Damned If You Do, Damned If You Don't

The Islamic finance industry just cannot seem to do anything right. Most customers want fixed returns with capital guarantees, but will criticise the Islamic banks for offering it. The shareholders of the Islamic banks are looking to maximise their profits, not run a religious charity. This puts pressure on the bank's management to adopt policies and create products that are competitive with their conventional equivalents. Management in turn puts pressure on the *shariah* scholars to come up with these products. If the scholars do not play along, many of the current players in the Islamic finance industry would exit the sector as a genuine profit-and-loss sharing model is too risky for them and not desired by their customers either. If the scholars do try to modify the transactions to enhance their *shariah*-compliance, they will get push-back from the precedent-loving lawyers who will say these constant changes are driving up transaction costs. Islamic finance seems to be stuck in a damned if you do, damned if you don't loop.

8.4 WAY FORWARD

As we have seen, the state of the Islamic finance industry is the result of how stakeholders have pursued their self-interest in the Game of Islamic Bank Bargains. This section explore ways in which the incentives of various stakeholders can be changed to produce a different outcome—one that moves the Islamic finance industry away from a purely formal and legalistic approach towards one that also incorporates principles from Islamic economics.

Given that the incumbents are 'winners' in the Game, they are not incentivised to address the shortcomings of the industry on their own and cannot really be blamed for failing to do so. On the other hand, the Muslim masses and the pious poor who are the 'losers' lack the financial and political sway to change the outcome of the Game in a way that takes account of their interests as well.

The losers of the Game must shift the self-interest nexus of the winners so that their long-term interests as the Muslim public are not sacrificed for the (mostly financial) short-term interests of the incumbents. The losers will need to coerce the incumbents to give added weight to their non-financial interests, such as highlighting political objectives for state officials, reputational impact for the *shariah* scholars, or targeting incumbents who have 'made their money' and are close to retirement. The incumbents will surely take serious convincing as the cost of forgoing financial incentives will be certain and immediate while the benefits will be prospective and postponed. Thus, the best bet of the losers would be to affect change through creating coalitions with other unhappy constituents. These include:

Disenchanted insiders: There is a palpable mood of introspection in the industry and many insiders I have spoken to, particularly those who are retired or have otherwise left the industry, will admit in private that they are disappointed with the state of IBF and even with the role they have played in it. They will often describe IBF as a work in progress and frame their involvement as a means to an end—the only way the industry could survive and eventually break through to something genuine. This group of insiders can be valuable allies to those looking to create a change in the industry.

The not-so-poor pious: Another constituency that can be a key coalition ally are the devotees that genuinely care about *shariah*-compliance and have the means to be bankable. A critical mass of bankable pious customers can be a real force behind the industry and cannot be ignored by the government or its regulators. Unlike the pious poor, this group will have enough financial and political clout to influence policy decisions.

Excluded elites: There are certain elites who are not given a seat at the table of the Game, but remain relevant to it. The main categories of these excluded elites are academics and the 'real' Islamic scholars. There are many prominent academic scholars who are vocal critics of the industry and write prolifically on its shortcomings. Their writings tend not to have much

impact on the industry's practice, but they can provide important intellectual ammunition to the coalition seeking to challenge the current state of the IBF industry as well as suggest alternatives to it. The other significant category of excluded elites are the Islamic scholars who are not IBF specialists but are experts in Islamic law more broadly and teach in seminaries and lead Islamic communities and Friday prayers around the world. This group is generally well-respected by the Muslim masses and has a true following. The endorsement of this group would go a long way towards popularising a genuine IBF alternative among the Muslim masses.

Idealistic new entrants: Every year a new cadre of fresh-faced young graduates enter the workforce with their idealism intact and ambitions to make the world a better place—where banking and finance cares more about ethics, the environment, social justice, and poverty alleviation. They will not yet be tainted by capitalistic logic and will view its 'greed is good' mantra as discredited in light of the financial crisis. This group can be a fertile ground for grassroots recruits that can eventually plug the 'competence commitment gap' of the IBF industry.

A coalition made up of the Muslim masses and the other unhappy constituents set out above can go a long way towards breaking the stalemate of the industry and address the concerns of the losers of the current Game. It would also make IBF more just and Islamic—meaning more representative of the views of the Muslim masses and the pious poor—and thus more likely to be hailed as a successful instance of civil compromise.

But what would this new order look like? Many actors within IBF are exploring options to keep the hope and promise of Islamic finance alive and keep it relevant as a potentially viable industry. In the following sections I will explore some of these ideas.

8.4.1 Run Islamic Finance as a Charity

As we have seen, Islamic finance practitioners often complain that there are genuine profit-and-loss sharing instruments available, but not many people are interested in them, thus the Islamic banks do not offer them. As a possible solution, an institution (or a group of institutions), backed by deep-pocketed sponsors with a religious/political commitment to a genuine experiment in Islamic finance, can begin to operate on a wholly Islamic basis, with no compromises on *shariah*-compliance for the sake of cost-efficiency or competing with the conventional. The sponsors can view their investment as 'a *sadaqa* (a charitable act); a ticket to Paradise'.[7]

More likely, these sponsors would be governments that are less concerned with the bottom line and are instead seeking to support the industry as a matter of international branding and/or in pursuit of domestic political objectives (such as consolidating power amongst their Muslim masses and pious poor). The not-so-poor pious would make up the bulk of the institution's customer base. Disenchanted insiders and *shariah* scholars concerned with their reputations (or their afterlife)[8] would take on roles in running the institution, assisted by idealistic new entrants. The project would be supported intellectually by academic scholars and promoted and supported morally by Islamic scholars and imams at Friday prayers.

If there is a critical mass of people who are willing to engage with this institution, it will show that there is a demand for genuine *shariah*-compliant products. Otherwise, it would be clear that even the many critics of Islamic finance are not willing to put their money where their mouth is and shun fix returns and capital guarantees in favour of real profit-and-loss sharing.

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7 Harris Irfan, *Heaven's Bankers: Inside the Hidden World of Islamic Finance* (Constable 2014) 271.

8 See eg Interview with Shariah Scholar31, 'Prominent Shariah Scholar' (12 December 2011).

8.4.2 AAOIFI/IsDB Think Tank for Product Design

Another option would be for existing multinational bodies that are not driven by commercial concerns, such as the Islamic Development Bank, IFSB and AAOIFI, to act as think tanks for designing products that are truly Islamic and not reverse-engineered conventional ones.[9] These products can then be used as a basis for standardisation across the industry. In this regard, IsDB president, Ahmad Mohamed Ali, said in 2015 that, 'This will require the sector to go back to the drawing board and develop genuine Islamic finance products that are not only profitable but support socio-economic development'.[10] Steps have already been taken in this regard at the IsDB, but adherence to their standards (and with those set by AAOIFI) remains for the most part voluntary.

8.4.3 Alliance with Ethical

A further solution would be for Islamic finance to take up the mantle of ethical finance. As explained in section 6.2.5 (*Religious & Ethical Interest*), there can be much potential overlap between ethical finance and Islamic finance. At a time when capitalism has come under increased pressure to become more humane and compassionate, Islamic finance can present itself as an option for not only Muslims, but also non-Muslims.

To achieve this, Islamic finance should turn away from headline-grabbing deals, seen as cherry-picking the crown jewels of Western capitals with no social impact. For example, Masraf Al-Rayan, a Qatari Islamic bank, provided £1.3 billion *shariah*-compliant financing to a vehicle belonging to the Qatari Investment Authority (Qatar's sovereign wealth fund) to purchase the iconic Chelsea Barracks from the UK Ministry of Defence to turn them into luxury flats, hotels, and spas.[11] Qatar now also owns—through Islamic financing—a stake in

9 See eg Irfan (n 7) 281–83.

10 Bernardo Vizcaino, 'Islamic Finance Looks to Outgrow Bad Habits as it Expands' *Reuters* (1 February 2015).

11 David Oakley, 'Islamic Finance behind Barracks Project' *Financial Times* (3 March 2008).

the Shard, another London landmark.[12] A further example would be the acquisition of Aston Martin—the favourite sports car of James Bond—through a bond, an Islamic bond, by two Kuwaiti financial institutions.[13] Critics complain that this is not the impact that Islamic finance should be having:

> [Islamic finance] is making the rich richer. It is helping capitalists, not the poor of Africa, Indonesia, or elsewhere. Islam is not just for Muslims, it's here to help everybody. I haven't seen any benefit of Islamic finance for the general public or for poverty alleviation or the redistribution of wealth. Islamic finance is concentrated in the heart of not even London, but the City of London. It's in the financial centre of Manama and Dubai. But people in Nepal and Haiti should be helped by Islam. Islamic finance should be helping Greece [during its financial crisis]. The European countries and economies that are failing are great fertile ground for Islamic finance because they are desperate and don't have any solutions. The Western world has let them down. We should have gone in. The IsDBs of the world and the rich and affluent Muslims should have helped them. It would have been the best *dawa* [invitation] to Islam. You would be bringing back Islam to Western civilisation by helping those countries. But we didn't; we just continued issuing more and more *sukuk*.[14]

Those who believe in Islamic finance's ethical mission say that, instead of financing the acquisition of crown jewels, a better use of Islamic funds would have been to invest in sectors that would have had a higher social impact, such as education and health care. If Islamic finance can be seen as able to provide solutions for these sectors, it would have significant growth throughout the Muslim and even non-Muslim world. IBF would also be well-served by learning how some Western institutions have incorporated corporate social responsibility and corporate governance within their systems to strive towards a more ethical outcome.

Today, the ethical finance brand is more appealing to consumers than the Islamic finance brand. This is especially true in the West, even among Muslim populations. The head of marketing of an Islamic bank said, 'When we said Islamic banking was based on

12 Ed Hammond, 'Construction: Investors Transform UK Horizon' *Financial Times* (11 May 2011).

13 Gillian Tett, 'Islamic Bonds Used to Buy 007's Wheels' *Financial Times* (London, 16 March 2007).

14 Interview with Shariah Scholar05, 'Shariah Scholar' (12 May 2015).

ethical standards, acceptance grew from 4% to 21%'.[15] This Islamic bank presented its banking model to a focus group of non-Muslims without mentioning to them that it is Islamic. The group's feedback was overwhelmingly positive and someone commented that this is 'banking as it should be', which became the bank's tagline.

8.4.4 An Alternative to Banking

'When my grandparents arrived in the UK, if they accepted to do their Friday prayers in churches, they would have never built their own mosques'

– Islamic scholar

An increasingly significant trend has started whereby it is viewed that banks were never the right platform for Islamic finance. This trend has the backing of some giants in the industry, such as Sheikh Saleh Kamel, founder of the al-Baraka Group and chairman of the Council of Islamic Banks, and Iqbal Khan, founding Chief Executive Officer of HSBC Amanah. In this view, it is almost impossible for banks to avoid debt-like instruments. Thus, it is best to avoid banking altogether—Islamic or otherwise. 'They are all doing the same thing, they have the pressure of the balance sheet, interbank rates, and all of these things.'[16] 'If I lose my cat, it makes sense to look on the roof—but not if I lose my camel. Those who are looking for equity solutions in banking are looking for their camel on the roof.'[17] Speaking at a conference, Mehmet Asutay says in this regard:

> Emancipation and empowerment are the Islamic objectives for economic activity. Banking is an imposition—a short-term solution—but it has become 'the end of history'. It has some relevance for a portion of society, but has no relevance for the wider [Muslim] society. It has an institutional logic that Islamic banking cannot function within. You need a change of paradigm. Institutional innovation is required for the non-bank *shariah*-compliant financial institutions. It remains to be seen if the capital holders in the Muslim

15 Interview with Islamic Banker53, 'Head of Marketing at Middle Eastern Islamic Bank' (21 February 2018).

16 Interview with Shariah Scholar05 (n 14).

17 Interview with Shariah Scholar58, 'Shariah Scholar' (21 February 2018).

> world are ready for this as well. The interests of other stakeholders will need to be considered and banks are not suited to do that.[18]

In the current paradigm, Islamic banks can never be as efficient as conventional ones. Then why should they continue to play that game? Those looking to change the status quo in Islamic finance can cede and abandon the banking sector and focus their energies on using Islamic finance principles in another sector of the market. Private equity and venture capital, the proponents of this view believe, are a more suitable platform for Islamic finance as they are naturally profit-and-loss sharing. 'Establishing a thriving venture capital industry is crucial not only for further evolution of the Islamic finance industry, but also for the long-term development of ailing economies in the Muslim World.'[19]

Another method would be to provide trade finance using a true *murabaha* as a merchant, and not a money lender. When dealing as a money lender, debt-like mechanisms become unavoidable for liquidity management purposes and meeting the regulatory requirements of the fractional reserve-based lending system. Microfinance and SME finance are also viable options and certain amount of success has been achieved in this regards.

FinTech has also become a sphere of heightened interest and activity. New technologies may create non-bank opportunities that will give financial access to low-income populations. As both Muslim populations and technology grow, a market gap may emerge that is better serviced by new providers rather than banks.

8.4.5 Fresh Thinking by a New Generation

Another solution would be bridging the 'commitment competence disconnect' by training a new cadre of finance professionals who are committed to the principles underlying Islamic finance. These new entrants, untainted by capitalist logic, could apply fresh thinking to

18 Mehmet Asutay, 'Islamic Finance's Overreliance on the Banking Model' (How Ethical is Islamic Finance?, London, 21 February 2018).

19 Saqib Rashid, 'Islamic Finance and Venture Capital: A Practical Approach' in Munawar Iqbal and Rodney Wilson (eds), *Islamic Perspectives on Wealth Creation* (EUP 2005).

develop true alternatives to conventional finance—not based on interest. With the mushrooming of Islamic finance education, a critical mass of young bright minds could be turned to the question of coming up with a functional solution for a more acceptable form of finance.

The proponents of this view believe that the incumbent *shariah* scholars are not best incentivised to fundamentally shift the industry:

> Islam has never been run by a fixed group of people. The [*shariah*] scholars don't have the right to run [Islamic finance]. If they are not producing results, then they are not worthy of this position. As a Muslim population we close our eyes when it comes to the scholars. Islam doesn't have a papacy, so we shouldn't treat scholars like demigods.[20]

Despite the uninspiring state of the industry, many practitioners are hopeful for a better future. 'Millennials want a better world. They want banks that are ethical and transparent. They believe they have power and they will use it in accordance with their values.'[21]

An Islamic banker expresses this desire as follows:

> I still think it's a real struggle and it's a work in progress, but that there is a sense of hope and I'm optimistic that the next generation would do better than my generation. I think my generation acquiesced too much and as a result we've ended up not really moving the industry in the direction that I would liked to have seen it go. I think if we can impart that sense of idealism to the next generation, we may have a chance in succeeding and creating a true ethical alternative to the conventional financial system.[22]

8.5 LIMITATIONS & FUTURE RESEARCH

As set out in section 1.3 (*Research Question*), in my dissertation I have used Calomiris and Haber's 'structural narratives' approach, which helped me provide evidence about the factors and incentives that are most important in shaping the Islamic finance industry.

20 Interview with Scholar29, 'Prominent Islamic Finance Academic Based in US/Egypt' (21 November 2012).

21 Interview with Islamic Banker59, 'Head of Retail at Islamic Bank in the UK' (21 February 2018).

22 Interview with Islamic Banker11, 'Prominent Islamic Banker' (22 April 2015).

These narratives are by nature premised on individual experiences and specific events. They do not and cannot cover all subsets of the IBF industry across all geographies where it is present. I have explored the experiences of certain countries in certain sectors of the IBF industry (primarily Islamic project finance and capital markets), but an in-depth review of more sectors across more geographies would not be possible in a doctoral project of this length and scope.

While specific narratives cannot, by their inherent nature, be fully representative, I have sought to identify common themes—connecting them across jurisdictions and from the perspective of various stakeholders—to make a general statement of the field. That statement would be that the way the IBF industry's main stakeholders (representing faith, capital, and power) have pursued their primary self-interests in the Game of Islamic Bank Bargains has disenfranchised the Muslims masses and pious poor. Additionally, certain other key findings have emerged from these narratives as well. These are not the only findings that emerge from these narratives—they just happen to be the most obvious and important ones that hold true across geographies and the experience of a variety of stakeholders.

Inevitably, my dissertation and the inferences I have drawn from my narratives have been based on the judgments I have made. Indeed, all causal inferences—whether derived from narrative or statistical analyses—depend on *a priori* judgements about channels of influence. Readers should evaluate such judgements first on the basis of their internal logical coherence, and second on their applicability to other cases or the same cases in different times. Had my research been focused on other sectors of the Islamic finance industry, such as Islamic microfinance, the stakeholders and their interests and incentives may have well been different and the Game may have played out in a different way.

Moreover, Islamic finance is an area of constant innovation and change. It can also be impacted by external factors—eg the price of oil can significantly impact the Middle East's

IBF market. Just by way of example, when I started this doctoral project in 2013, the price of oil was over US$100 a barrel. Now in early 2018 it is around US$60 a barrel. This is not to mention the tectonic shifts in the geopolitics of the Middle East during this time, with such highlights as the emergence (and defeat) of ISIS, the wars in Syria, Yemen, and Iraq, the nuclear deal with Iran, the blockade of Qatar, and the assumption of power by Mohammad bin Salman in Saudi Arabia. With this constant change in the landscape where IBF is most active, the incentives of the stakeholders and the bargains they strike are also susceptible to change.

Finally, my suggestion for future research outside of the IBF industry would be to see how this concept of civil compromise plays out in other areas of Islamic law, such as Islamic family law and women's rights. Indeed, any area of human rights would provide fertile ground for further study. Researchers could seek to identify what factors are promoting or hindering civil compromise in that sphere. For example, how have law, faith, capital, and power converged to prohibit women from driving in Saudi Arabia[23] but permit them to pilot fighter jets in the UAE. What other factors are at play? Does the outcome pass the 'Islamic, modern and just' test?

8.6 FINAL REMARKS

This dissertation assesses how Islamic finance fares as an example of 'civil compromise' in Islamic law. By focusing on the Islamic project finance sector, my research examines how the industry's main stakeholders cooperate and compete to bring about this compromise through the Game of Islamic Bank Bargains. I found that there are religious, commercial,

23 Indeed, as a further example of the fast pace of change in the Middle East region, by the time this dissertation was submitted for examination, Saudi Arabia had indicated that it would lift the ban on women driving in June 2018. This itself could provide fertile ground for research into how the bargaining position of the various stakeholders has changed to result in the lifting of this long-standing ban.

and political factors at play, but none are so decisive as to dominate the industry on their own.

The industry is a work in progress, and while it has made some significant strides, it is still a niche in the global conventional financial order rather, than an alternative to it. It has fallen short of fulfilling its originally-stated social justice aspirations, but has provided a previously unavailable form of banking and finance for Muslims to transact, at least formalistically, in accordance with widely-believed tenents of their faith. Thus, those who hold up Islamic finance as a universal panacea or dismiss it outright as a fraud have both got it wrong. It is neither. It is, rather, a complex myriad of incentives and aspirations of a multitude of stakeholders muddled together across numerous geographies and evolving incrementally and constantly.

So where does this leave the industry? I would say with some successes on the macro-level (ie it has the right idea) and still struggling on the micro-level (ie it has the wrong implementation). Its most important shortcoming is that it has not yet earned the acceptance of the majority of Muslims. The state of the industry is the result of how the stakeholders (the *shariah* scholars, lawyers, bankers, government officials, and customers) have pursued their self-interest in the Game of Islamic Bank Bargains.

I have identified the 'winners' and 'losers' of the Game, and what religious, commercial, and political factors have influenced this outcome. As we have seen, it pays to play the Game as (almost) everyone's a winner. The losers—the disenfranchised Muslim masses in autocratic states and the unbankable pious poor—lack the political and financial clout to influence a change in policy. Without a shift in approach, IBF may be stuck in a state of stalemate. Many actors within the industry recognise this and are exploring options to keep the hope and promise of IBF alive and keep it relevant as a potentially viable industry.

I have shown what may incentivise the incumbent 'winners' to guide the Islamic finance industry away from a formal and legalistic approach towards one that also incorporates principles from Islamic economics—from *halal* (permissible) to *tayyib* (wholesome). I set out how the 'losers' can create coalitions with other unhappy constituents to sway the outcome of the Game in their favour by shifting the self-interest nexus of the winners so that their long-term interests as the Muslim public are not sacrificed for the (mostly financial) short-term interests of the incumbents.

In this way it can be hoped that an Islamic, modern, and just finance industry can emerge through a new convergence of faith, capital, and power.

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