

# Are we resilient or are

Islamic financial products have been Westernised to such an extent it is doubtful whether all can be considered to derive from the true spirit of Islamic finance, contends **Fehmy Saddy**. Islamic finance represents the aspirations of millions of Muslims, and their values must not be compromised

**I**N ADVERTISING THE FIRST ASIA Sukuk Summit 2009, the Hong Kong Monetary Authority offered this quote from the International Monetary Fund: "The Islamic financial system may be in a better position to withstand shocks in the global financial system than its conventional counterpart."

It goes on to say: "Promoting dialogue and exchanges among financial markets and industry professionals is important in addressing some of the key challenges the [Islamic financial] industry faces, such as consensus on international standards and global awareness. Greater transparency and harnessing of standards are therefore demanded to push the industry to the next level of development, and it would not have been possible without the collective efforts of regulators and market players in respective regions."

The above quotes provide rather conflicting views of Islamic finance. On the one hand, the Islamic financial system may be more resilient yet it needs to be pushed to the next level of development for the sake of "greater transparency and harnessing of standards". One may wonder whether the resilience of the Islamic financial system rests on its lack of development, transparency or standards and if this is true, whether the conventional wisdom must apply: "If it ain't broke, don't fix it."

## Immunity

Since the flare-up of the international financial crisis, it has become fashionable to cite the immunity of Islamic finance to financial crises as a testament of its resilience. This is obviously a self-serving argument and an exercise in delusion. Islamic finance, as practised today, places the industry in a more vulnerable situa-

tion than conventional finance.

The real issue is not the intrinsic resilience of Islamic finance, but that the industry has not yet faced the same conditions as conventional finance, à l'Américaine, has faced. Islamic finance will likely traverse a far more dangerous terrain if it continues on its present path.

A few months before the eruption of the American financial crisis on a global scale, conferences and meetings of Islamic and conventional bankers were focused almost exclusively on "structured products". The hallmark of Islamic finance was wholesale structured products. It was almost impossible to draw

**RESILIENCE** Islamic finance is perceived to be immune from the crisis that has affected conventional banking



# we at risk?

those bankers into a discussion on Islamic retail banking, where the acute interest of average Muslims lies. Islamic financial institutions of Gulf Cooperation Council (GCC) countries were loaded with cash from high oil revenues and they needed to “recycle” the petrodollars and pocket substantial fees as fast as they could. The Islamic financial industry went into a gold rush mode, and businessmen with no prior experience in banking went into a frenzy of establishing Islamic investment banks.

Billion-dollar corporate transactions

became common, with little or no scrutiny of their Shariah-compliant aspects. Indeed, the demand for Shariah specialists to approve transactions fast went up sharply, and the fees charged by these specialists increased in inverse relationship to their scarcity.

In the last few years, long before the current global financial crisis, the line between form and substance in Islamic financial products has been blurred. Transactions approved by Shariah boards have differed very little, if at all, from conventional transactions, except for their

labels. Leading law firms in New York and London have designed complicated legal schemes and elaborate corporate structures that insulated those who provided funding to a transaction from the ultimate beneficiaries.

The beneficiaries of Islamic funding are able to use the funds and operate in the same manner as in conventional finance. As long as there is an arm’s length structure approved by a Shariah board, it matters not how the funds are used, leveraged, or secured, and for what purposes they are deployed.

For example, under such an Islamic structure, a \$10bn Islamic facility was structured as an Islamic bond, or suk (plural sukuk) issued by an American petrochemical company engaged in manufacturing petrochemicals, including products used in building chemical weapons. It is plausible that some of the chemicals produced by the American company with Islamic financing might well have been used in manufacturing the phosphorous bombs that were dropped on Muslims in Gaza.

Another example of Islamic financial transactions where form over substance has taken hold is *murabaha* transactions. The London Metal Exchange has become the favourite platform for buying and selling metal contracts and profiting from the difference in prices. This form of contract has since spread to other commodities and other countries. The object of the transaction—the metal or commodity—never changed hands. In fact, this type of synthetic paper transaction, called *tawarruq*, has become the primary tool used by Islamic financial institutions to balance their books.

This instrument is the equivalent of inter-bank borrowing used by conventional banks. Such *murabaha* transactions are also widely used by financial institutions, Islamic as well as conventional, for medium- and long-term borrowing pegged to Libor rates. This form of sham transaction has been criticised by astute Shariah scholars as un-Islamic, yet there is no sign that the practice has lost any of its vigour.

## Risk evaluation

The excitement among Islamic financial institutions about the prospect of making fast and easy money soon went overboard. They found themselves in a fierce competition with each other during a boom



in which triple digit returns over a short period were not uncommon. The treasuries of some Islamic financial institutions had some geese producing golden eggs every single morning.

At a time when conventional banks were toiling to make a single digit profit for their shareholders, Islamic financial institutions were riding high. If Islamic finance is supposed to be the answer to the usurious, greedy and immoral world of conventional banking, one may wonder, how Islamic financial institutions could produce such outstanding financial results in such a short span of time.

Obviously, one easy answer is that GCC governments and wealthy investors deposited large petrodollar funds in these institutions. However, these deposits must ultimately be paid back with returns, and hence may not be counted as profits. The right answer, in fact, is that these institutions have engaged in structuring large transactions with elevated risks which netted them large fees. But what sort of transactions are these that produce such phenomenal returns?

The transaction of the American petrochemical company cited earlier is an example. Perhaps it is one of the better transactions financed by Islamic financial institutions.

## Foundations

Certainly, the American company must have had a track record of profitability and must have drawn up a business plan for the use of the borrowed funds. However, a large number of transactions undertaken in the GCC countries that were structured as sukuk do not have such foundations. It is estimated that 70% of all sukuk issued by corporate entities in GCC countries may not qualify as Shariah-compliant, nor contain the essential elements of security of conventional corporate bonds.

Take, for example, a Saudi company with large land holdings. The company issues a sukuk to finance the development of such lands. Three problems arise from the outset: First, there is no historically based market for such lands, and their valuation is based on pure speculation of their future value after they are developed.

Second, the Saudi real estate mar-

ket is shallow and recent experience has shown a wide fluctuation in real estate prices based on expectations of growth of the Saudi economy, as a function of government oil revenues. Third, and perhaps even more serious, is that land registry in Saudi Arabia is often beset by title disputes. Land ownership is usually based on



**INNOVATION:** Conventional Western and Muslim bankers have taken to “innovative” and “structured” Islamic finance products

ancient papers and dubious contracts that are often subject to challenge by younger Saudi princes acting in their capacity as supreme sovereigns. Facing a supreme citizen in court, even when allowed, almost never yields a positive outcome in favour of a common citizen. Considering the above factors, investors in sukuk are not adequately informed of the risk, and

sometimes even purposely misinformed, thus raising a question of transparency and fraud (*gharar*).

As another example, most corporate entities in the GCC countries issuing sukuk are either family-owned or new corporate entities with limited historical and/or financial records. Even when partially privatised, the family usually maintains management control and cannot be replaced. Furthermore, legal recourse against corporate entities in most cases is limited. Bankruptcy laws are largely deficient and/or unenforceable due to the status of the family and its ties to the political system.

Therefore, investors stand to lose their entire investment in case a sukuk-issuing corporate entity runs into financial difficulties. In fact, Kuwaiti speculative investors have formed the habit of asking their government to bail them out whenever they lose money trading the shares of corporate entities on the stock market. Their argument is usually based on the lack of transparency of these entities.

## Market players

London has seized the opportunity afforded by increased interest in Islamic finance to diversify its financial market, and has presented itself as the undisputed centre of Islamic finance. Considering the historic link between Britain and GCC countries, British bankers and lawyers have become essential players in Islamic finance.

Kuala Lumpur, Bahrain and Dubai, and most recently Hong Kong and Singapore, have been trying to carve for themselves a place in the Islamic financial universe. Driven by its historic rivalry with Britain, even insulated and rather aloof, France has sought to promote Paris as an alternative centre of Islamic finance. But all these aspirant contenders have had to take back seats.

It is natural that British conventional bankers and lawyers have been able to mould and redefine Islamic banking and finance within their own familiar conventional banking culture. All that is needed to convert a conventional financial product into a Shariah-compliant “structured product” is merely to use some legal acrobatic formulation, as noted above.

## The collective regulations of Islamic financial institutions should be entrusted to a centralised authority



In doing so, however, the action has to be legitimised by the collaboration and acquiescence of two other categories of players: Muslim bankers and Shariah advisers. Thus “innovation” in Islamic finance has become a catchword for these market players. At the forefront, some Muslim conventional bankers, largely from the Indian sub-continent, have taken on the role of innovators. Who is better than a pious Muslim trained in conventional banking to interpret Islamic finance and explain Islamic financial products to other devout Muslims?

It follows that conventional British and Muslim bankers have taken up the task of interpreting and redefining Islamic finance through the introduction of “innovative” and “structured” products. However, both need the support of other legitimising players higher than themselves to ensure acceptability of such products by devout Muslims. This is where the Shariah advisers come in.

It is well known that there is no clergy in Islam. A Shariah adviser is someone trained in Islamic law, just as a British lawyer is trained in common law. The only difference is that Shariah is a religiously sanctioned law and, therefore, the Shariah adviser presents himself, implicitly, as the interpreter of God’s law.

### Interpretations

However, interpretations of Islamic law have varied among the four recognised schools of laws, and it makes a difference whether a Shariah adviser relies for his opinions on one school or a combination of the four schools. Therefore, it has become critical for the innovators of Islamic “structured products” to constitute a panel of three Shariah advisers, acting as a Shariah board, to approve such products.

The quality of a “structured product” rests more on the credibility of the Shariah board than on the product itself: “Tell me who your board is, and I will tell you the worth of your structured product.”

In reality, the quality of some products has deteriorated as less-established Shariah advisers have found it expedient to bend the rules occasionally to show “flexibility” when reviewing transactions. The allure of large advising fees has sometimes obscured the need for

more stringent and correct judgment. Just as a small community of American-Jewish rabbis stamp as kosher products ranging from toothpaste to tomato paste, the Shariah advising profession has found a lucrative source of income for little work.

### Centralised regulation

The current global financial crisis is still unfolding and there are indications that carelessness and risk-taking have also affected some Islamic financial institutions. However, the Islamic financial system, in general, has been spared the fallout of the crisis not because of its intrinsic resilience, but due to the steadfastness

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of a few astute and honourable Shariah scholars who have refused adamantly to approve dubious structured products, such as derivatives, sub-prime mortgage syndications, and other products manufactured by faltering Wall Street investment banks.

A leading Shariah adviser has confided to *Islamic Banking & Finance* that he was under tremendous pressure to approve such “innovative” and “structured” products, but that there was no way that he could approve them within Shariah law.

Considering the self-serving interest of market players, regulating the Islamic finance industry should not be left to them and their hand-picked Shariah boards. Shariah boards may still be used, just as a law firm may be retained by

a corporate entity. A Shariah adviser may still serve the same function as a compliance officer in a conventional bank.

Since Islamic banking took off more than 30 years ago, a substantive body of Shariah rules that govern all aspects of financial transactions has been developed. This body of Islamic jurisprudence is sufficient to establish strong foundations for Islamic banking regulations.

There are already several multilateral, authoritative Islamic financial organisations in place with accumulated experience in jurisprudence and accounting that could be used as the standard-bearers of Shariah-compliant transactions.

Therefore, the collective regulations of Islamic financial institutions should be entrusted to a centralised authority similar to the Bank of International Settlements. Members of this centralised authority would include central banks regulating Islamic financial institutions, as well as Islamic authoritative organisations, such as Accounting and Auditing Organisation for Islamic Financial Institutions and Islamic International Rating Agency. This centralised authority would draw a comprehensive code of Islamic banking regulations for the creation of “greater transparency and harnessing of uniform standards”.

The Islamic financial system represents the aspirations of Muslims who constitute one-fifth of the world’s population and embodies their belief in its integrity and compliance with their faith. This system is too precious and too important to leave its

development in the hands of a relatively small group of self-serving Western bankers and their cohorts, who the Hong Kong Monetary Agency calls “market players”.

The resilience of the Islamic financial system cannot be divorced from its established legal and moral principles. The conventional financial system may experience setbacks and recover its grounds with conventional remedies, such as loans and facilities. However, the entire Islamic banking and financial system will be condemned forever if it falls into the culture of greed and opportunism that plagues the conventional banking system. ■

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