Sixth Harvard University Forum Islamic Finance
harvard Law School - May 8-9, 2004

Islamic Finance: Current Legal and Regulatory Issues: A Short Report

The Sixth Harvard University Forum on Islamic Finance was held at Harvard Law School on May 8 & 9, 2004. The Sixth Forum was held with a gap of two years, which was the result of the reformation that Harvard Islamic Finance Information Program (HIFIP) now known as Islamic Finance Project (IFP) has been through. IFP is the continuation of HIFIP, which was established by the Center for Middle Eastern Studies in 1995. IFP is now part of the Islamic Legal Studies Program (ILSP) at Harvard Law School. It aims to study the field of Islamic finance from the legal and *shari'a* points of view by analyzing contemporary scholarship, encouraging collaboration among scholars within and outside the Muslim world, and increasing the interaction between theory and practice in Islamic finance.

Saturday, May 8

As Forum Chairs welcoming address, Professor Frank Vogel, Director of ILSP stressed the importance of the fast growing field of Islamic finance and cited the waiver of double stamp duty by the Bank of England in the Islamic home financing scheme offered by HSBC in UK as an example of the increased understanding of Islamic finance among western regulators as well other developments such as the work of Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB).

In a well received keynote speech the Forum's keynote speaker Under Secretary of the U.S. Treasury John B. Taylor spoke on "Understanding and Supporting Islamic Finance: Product Differentiation and International Standards." (http://www.ustreas.gov/press/releases/js1543.htm). He commented that the developments in Islamic finance are of great interest to the U.S. Treasury and it looks forward to the lively discussions on new product development and differentiation and on recent legal and regulatory issues that have emerged as the Islamic finance industry grows. He stressed the importance of transparency and disclosure and stated that as with conventional financing, Islamic financing will benefit from transparency, good governance and an internationally-accepted regulatory framework that will govern this important form of financing. He also said that in order to better understand Islamic finance the US treasury has developed a scholar in residence program.

Islamic Development Bank (IsDB) President, Ahmad M. Ali delivered the Sixth Forum Address on "Development of the Islamic Financial Industry and the Need for Regulation and Supervision." He emphasized that effective supervision is a must for the Islamic financial institutions and it requires formulation and adaptation of standards in the areas of risk management, disclosure and transparency, accounting and auditing, internal control systems and corporate governance that can match international standards yet are able to cope with the special needs of the Islamic financial industry. He commended the work done by IFSB and AAOIFI amongst many others that are working towards developing the required paraphernalia of Islamic banking. He further pointed out that the infrastructure required for an efficient running of the Islamic financial industry is by no means complete and that IsDB will continue supporting capacity building for regulation and supervision of the Islamic financial industry.

The address of Ahmed M. Ali was followed by a session on "Regulatory Challenges to Islamic Finance", which was moderated by Professor Samuel L. Hayes of the Harvard Business School. Mr. Usman Ahmed of Citibank who was representing Mr. Mohammed E Al. Shroogi, CEO of Citibank, spoke about the legal and regulatory challenges facing the *sukuk* market. He said that '*Sukuk*' bond is essentially an 'interest-free' variant of a conventional bond that is structured to comply with Islamic investment principles. The way it is done is that the investor-returns are based on profits derived from assuming the risk related to ownership of underlying assets, rather than pure interest income.

Abdulkader S. Thomas of Shape Financial Corporation spoke about the problems facing Islamic banks in the US. He observed that pre-September the Eleventh Federal banking regulators were facilitating the infrastructure of banking in the United States in a manner, which would inevitably lead to the establishment of an Islamic bank in the United States. However, following September the Eleventh there is a lot of skepticism about Islamic finance and Islamic banks have been discouraged from applying for licence for which he cited the examples of Amana and Kahazana. M. Nejatullah Siddiqi, a distinguished researcher in the field of Islamic economics, analysed the tension between ethics and efficiency vis-à-vis the tension between *maqasid* (objectives) and juristic derivations. He suggested that to resolve these tensions it would be desirable that economists/social scientists are involved in the debate instead of treating them as a purely legal/juristic issues. Mr. Pervez Said, director of Islamic banking department of the central bank of Pakistan briefed the participants about the market-based regulatory framework that has been setup for the support of Islamic banking industry in Pakistan. He discussed the approach adopted which is based on setting up a comparable and compatible parallel system to that of existing financial services in which the pace and scope of change is to be determined by users. He said that the idea is to avoid a knee jerk reaction so that the transition is seamless.

The second session of the day was entitled "Legal Trends and New Challenges", which was moderated by Professor Frank Vogel. It covered the legal developments taking place in the field. Kilian Balz of Gleiss Lutz discussed the Islamic financing transactions in the European Courts in the light of the recent English cases of Symphony Gems and Beximco. He discussed with the participants as to how *shari'a* compliant agreements can be drafted which are enforceable in non-Islamic environment. He said that reference to *shari'a* in the agreement must be specific enough for the court it the agreement is to be enforceable. Husam Al-Khatib of the Royal bank of Scotland suggested that Islamic banks should use arbitration for enforcing their agreements. He proposed that a permanent court of arbitration shall be setup by the Islamic banks which will provide flexibility and transparency and will tie in easily with existing regulatory and financial intuitions. Michael McMillen of King & Spalding discussed structuring securitized *shari'a*-compiant real estate acquisition financing in the light of a deal in South Korea.

Several papers, questions and discussions in this and the following sessions revolved around the question of form vs. substance. If an instrument synthesizes the risk and reward profile of a conventional instrument, how "Islamic" is it? On the other hand, if all the components of a product are independently permissible, how could the combination of these components be considered impermissible? Umar F. Moghul of Ahmed & Moghul LLP said that following the letter does not necessarily imply following its purposes/ rationale whereas fulfilling the purpose/ rationale may necessitate breaking away from old modes or forms. He said that simply complying with the letter of Shair'a is far easier than taking into account the purposes and rationale.

The first two sessions were followed by two parallel sessions on graduate research. The first session was moderated by Ibrahim Warde. Mr. Walid Hegazy's presentation was about *fatwas* (Islamic legal opinions) and the fate of contemporary Islamic finance. He essentially raised three points. Firstly, that Islamic finance *fatwas* are given without consideration of the maqasid of *shari'a* and on the basis of narrow legal rules. Secondly, the issue of conflict of interest i.e. that the Islamic finance fatwas are issued by *muftis* (Experts of Islamic law) who are employed by the Islamic financial institutions. Thirdly, that this procedure may result in a system of *hiyal* (in general terms: system based on exceptions) where the original *maqasid* of *shari'a* are lost. Nizam Yaqubi who is a *shari'a* scholar disagreed with Walid and raised several points against his conclusions. With respect to the point of conflict of interest he said that the Higher Council of Islamic banks has collected over 6000 fatwas and ninety percent of them are consistent. Over a hundred *muftis* gave these *fatwas* from various parts of the world often without knowing each other, which suggest that the issue of conflict of interest is not real as otherwise there should have been a greater inconsistency in the *fatwas*. He further said that it might be beneficial for Walid to read these *fatwas* and analyse how many of these are against the *maqasid* of *shari'a*. He further urged Walid to include in his study the difference between *hiyal* and *makharij* and to discuss permissible *hiyal* and impermissible *hiyal* as well as the difference between *talfiq* (patching) and *ikhtiyar* (choice).

Agreeing with Nizam Yaqubi, Usman Ahmed of CitiIslamic said that his experience suggests that the conflict of interest argument does not hold true in the real world and if it were to be so then same goes for lawyers, auditors and others. He said that his experience has been that many of the transactions and the deals that they have sent to their *shari'a* boards did not make it past the *shari'a* board or have come back to them many times until they were compliant with *shair'a* and once passed they have not been disputed by *shari'a* scholars from other boards. Adding to the comments of Usman Ahmed, Rushdi Siddiqui of Dow Jones Islamic Index said that in his experience too the *shari'a* scholars have proved to be very careful and the issue of reputation risk makes a huge concern for the *shari'a* scholars. Walid said that he was not casting doubt on the integrity of *shari'a* scholars but rather is merely pointing out towards the conflict of interest that does exist.

His paper was followed by a presentation on Islamic banking and the politics of international financial harmonization by Kristin Smith of the Harvard University. Nicolas Hardy of Ecole des Hautes Etudes en Sciences Sociales discussed the role of *shari'a* scholars as a gateway between legal systems and Islamic banking as an example of legal pluralism. He said that a consequence of this legal pluralism would be the incorporation of *fatwas*, rulings and guidelines within state law (positive law). Abdul Rehman Syed of the University of Chicago delved into the philosophical justification of Islamic finance and made a case for Islamic finance as a universalist paradigm for social ethics based on appeals to faith and reason.

Fahim Khan of IsDb moderated the parallel session on graduate research. Aamir Rehman of Harvard Business School discussed the establishment of *shari'a* compliant endowments in the United States. He said that Muslim endowments in the US are fast growing and while the realization of the need for endowments exist they are generally poorly managed. He observed that the service providers targeting Islamic endowments would need to invest in cultivating endowment clients, focus on service, develop multiple revenue streams from single client as well as recognizing positive externalities. Mansoor Shakil of Harvard Law School analysed the risks facing Islamic banks and the impact of Basel II on their future. He discussed the risks characteristics of Islamic banks and said that Islamic banks face risks, as do other banks albeit, at times, different in nature, and this warrants their regulation and supervision to protect the depositors and prevent systemic risk. However, the system shall be adapted to match the distinct characteristics of Islamic banks. He further discussed Basel II and said that the bank regulators shall take into consideration the functioning of Islamic banks and the creation of a level playing field for Islamic banks vis-à-vis the conventional banks. On the other hand the Islamic banks need to consider separating the demand deposits from investment deposits to reduce the risks that they face. Tarik Dahir of the Columbia Business School analysed the *shari'a* compliant hedge funds. He said that the need for medium-term investment vehicles as well as the received wisdom of portfolio diversification, higher returns and the ability to profit in bull and bear market suggest that Islamic finance shall now be looking into the possibility of hedge funds. Abu Umar of the University of Western Sydney shared the legal and regulatory issues facing Islamic banks in Bangladesh. He said that Islamic banks in Bangladesh face legal constraints that limit their ability to compete with conventional banks and therefore, Islamic banks in Bangladesh should have their own banking Acts to provide legal support to the parties concerned.

Sunday, May 9

The second day of the Forum was as exciting and rewarding as the first day. Professor Sameul Hayes, Professor Emeritus, Harvard Business School, in his introductory remarks said that he sensed from the discussions that have ensued in this conference that it is paramount in Islamic finance that the investments that are made are in line with the social and ethical teachings of Islam as well as an emphasis was made on greater harmonization with the prevailing financial system. At the same time there was this general consensus that the principles of Islam must be preserved, which appeared to be a sine quo non. The question that then comes is how is this balance to be achieved. He quoted one of the speakers who stated, "These principles must be applied to the mosaic of contemporary human experience." He observed that this was the critical caveat.

Mr. Ahmad Jachi, First Vice Governor of the Central Bank of Lebanon, discussed the experience of Lebanon with Islamic banking. He shared his thoughts with the participants on working towards a stable Islamic financial system. He said that they started off without having a clue what Islamic banking is. He raised the issues of monetary policy, payment system, intra-day liquidity vis-à-vis Islamic banking and emphasized that these need to be resolved to achieve a stable Islamic financial system.

The first session discussed financial, regulatory and contractual issues in Islamic finance. Nicholas Foster of the University of London explored the concept of owing and owning in Islamic and western law within the general area of ownership rights. He compared the different approaches of the three traditions, discussing the possible reasons for and consequences of the difference with a focus on the consequences for financial transactions and Islamic finance. Imran Usamni of Meezan bank discussed the treasury operations for Islamic banks. He also emphasized the need for a greater interaction of *shari'a* scholars and finance professional for the development of smooth and practicable *shari'a* compliant systems and procedure. Rafe Haneef of HSBC Amanah Finance examined the key products currently available in Islamic finance market. He further examined the reasons behind the lack of profit-sharing based solutions in the Islamic finance industry, highlighting relevant issues and hurdles. Michael Gassner who is an international real estate agent briefed the participant on the regulatory framework of Germany and the opportunities there for structuring *shari'a* compliant financial products as well as the ways to do it. Kabir Hasan and Mannan Chowdhury from the University of New Orleans discussed in detail Islamic banking regulation in light of Basel II. They said that in light of increased financial innovation and considering the diversity of instruments offered in Islamic finance, the need to improve transparency of bank operations is particularly relevant for Islamic banks.

Governance of Islamic banks is made more complex by the need for these banks to meet a set of ethical and financial standards that are defined by the *shari'a* and the nature of the financial contracts that are used by banks to mobilize deposits. Effective transparency in this area will greatly enhance the credibility of Islamic banks and reinforce the confidence of depositors and investors.

The last session of the conference covered the hot issue of corporate governance in Islamic finance. Nejatullah Siddiqui moderated the session. Salman Younis of Kuwait Finance House discussed in detail the importance of risk management by Islamic banks. He observed that the impact of market dynamics and stakeholder dynamics pose a challenge to strengthen the Risk Management infrastructure of Islamic financial institutions. Ibrahim Warde of Massachusetts Institute of Technology spoke on corporate governance and the Islamic moral hazard. He suggested that Islamic moral hazard may be dealt with through a better understanding of the issue, common standards and norms as well as increased due diligence. Rushdi Siddiqui and Yusuf Tala Doleranzo of Dow Jones Islamic Index prepared a paper, which was presented by Rushdi Siddiqui. He examined corporate governance from western and Islamic perspectives for public and private companies. He suggested that effective corporate governance would reduce costs, lift profits, and attract the best human assets towards Islamic finance. Saiful A. Rosly, M.M Sanusi and N.M. Yasin from the International Islamic University of Malaysia presented a study on the legal documentation of Islamic financial products in Malaysia. They said that thus far in Malaysia, cases involving Islamic banking and finance have not tested the fundamental basis of Islamic contracts, instead being concerned with procedural law. They said that under the current regime it is immaterial that the contract is *shari'a*-based as the applicable law and principles are the same as if the case involved conventional banking. However, at the end of the day, Islamic banking and capital markets in Malaysia are customer driven. Institutions offer Islamic products because the customers want Islamic products. As such, they expect them to be fully compliant and valid in accordance with *shari'a*. If these products are not seen to be fully Islamic, and the documentation does not support their purported compliance with *shari'a*, the sellers of the products and the drafters of those contracts may find themselves exposed to the risk of civil action.

The forum was concluded by Nazim Ali, Director of IFP remarks by thanking the faculty, staff, students and volunteers for their help and assistance in organizing the Forum. Special recognition were given to IFP sponsoring institutions: First Islamic Investment Bank, Kuwait Finance House, Citi Islamic Investment Bank and HSBC Amanah Finance for their support and vision in continuing the existence of Islamic Finance activity at Harvard. A collection of papers presented in the Forum will be published as a monograph for wider dissemination purposes.