Islamic Finance Project

Harvard Law School
Islamic Legal Studies Program

Seventh Harvard University Forum on Islamic Finance
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Integrating Islamic Finance into the Mainstream: Regulation, Standardization and Transparency: A Short Report

The Seventh Harvard University Forum on Islamic Finance, entitled "Integrating Islamic Finance in the Mainstream: Regulation, Standardization, and Transparency", was held on April 22-23, 2006 in Cambridge, Massachusetts. The biennial event was hosted by the Islamic Finance Project (IFP), which is now in its third year as part of the Islamic Legal Studies Program (ILSP) at the Harvard Law School. As with past forums, the Seventh Forum attracted leading academics, *shari'a* scholars, and practitioners in the field of Islamic finance.

Saturday, April 22

Professor Frank Vogel, Director of ILSP, gave the welcoming speech to begin the main events of the Seventh Forum. In setting the tone for the Forum and highlighting the timeliness of the theme, Professor Vogel discussed the events that have taken place in the field of Islamic finance over the past two years since the Sixth Forum. Domestically, U.S. regulators were getting more involved with Islamic finance, as evidenced by the Interagency Forum on Islamic Banking in the United States at the Federal Reserve Back of New York on March 3, 2006. Additionally, several new banks and institutions have begun offering Islamic finance products. Internationally, *sukuk* issuances have significantly increased, Islamic Financial Services Board (IFSB) has issued a new standard on capital adequacy and risk management, and there have been new financial centers established in Qatar, Bahrain, and Dubai that have sections devoted exclusively to Islamic finance, and more research centers that study Islamic finance are being established (e.g., Bank Negara Malaysia, Oxford Centre for Islamic Studies).

Professor Vogel.s welcoming speech was followed by the keynote speech, which was given by former Deputy Prime Minister and Finance Minister of Malaysia, Anwar Ibrahim. The speaker is currently the Distinguished Visiting Professor at Georgetown University and the current Malaysia Chair of Islam in Southeast Asia in the Prince Alwaleed bin Talal Center for Muslim-Christian Understanding. In a speech entitled, "Forging a New Framework for Islamic Finance and Fulfilling the Higher Objectives of the Shari'ah," Anwar Ibrahim began by lauding the achievements of Islamic finance since its resurgence a few decades ago when critics thought it was a system that was impossible to sustain. But while acknowledging its achievements, Ibrahim reminded the audience of the larger framework within which Islamic finance functions: the *shari'a*. Specifically, he stated that there was a need for an expanded discourse with global relevance and impact. It was appropriate, he argued, that we strive not only to be contractually *shari'a*-compliant, but also to attempt achieving the main goals of the *shari'a* (*maqasid al-shari'a*). He encouraged Islamic financial institutions to consider profit-loss sharing as a better alternative (vis-àis the *maqasid al-shari'a*) to debt financing. As Islamic finance grows, he hoped to observe a causally related growth in the commitment to public works, consumer protection regulation, microcredit, education, and community welfare.

After the keynote speech, Professor Samuel Hayes III, Professor Emeritus at the Harvard Business School, moderated the first session, entitled "Governors and Institutions Roundtable." The session was dedicated toward understanding how government bodies and regulatory institutions have dealt with Islamic finance in the past and present, the hurdles they currently face, and solutions they would propose. After a short introductory speech by government officials in which they discussed developments in their respective regions, a roundtable was held in which Professor Hayes asked several leading questions. The participants included Abdulla Al-Attiya (Governor of Qatar Central Bank), Rashed Al-Maraj (Governor of the Bahrain Monetary Agency), Ahmad Jachi (First Vice Governor of the Central Bank of Lebanon), William Rutledge (Executive Vice President of the Federal Reserve Bank of New York), Mohammad Alchaar (Secretary General of AAOIFI), and Pervez Said (Advisor to the Governor of the State

Bank of Pakistan).

The second session, entitled "Revisiting Shari'a Principles," was moderated by Professor Frank Vogel. Nizam Yaquby, a Bahrain-based *shari'a* supervisor, opened the session with a discussion on the prohibition of "two sales in one" contracts, and its implications on modern Islamic finance. Yaqubi argued that a simplistic (and erroneous) understanding of the *hadith* prohibiting "two sales in one" would lead to the prohibition of many present-day contracts, given the prominence of multiple contracts in a single sale transaction. In clarifying its meaning, he stated that the prohibition refers to specific instances where the combination of contracts is used as a legal device to permit or facilitate *riba*, or where the combination leads to any other textual prohibition (e.g., *gharar*). Certain scholars, Yabubi argued, such as Nazih Hammad, believe that in certain cases, combining contracts leads to the relaxation of otherwise strict rules. Islamic finance contracts, such as *ijara*, *murabaha* and *musharaka*, are clear examples of this interpretation. Monzer Kahf, a private consultant and trainer, next spoke about *shari'a* considerations for innovations and risk management in Islamic finance. He discussed risk mitigation methodologies in Islamic Financial products, with specific emphasis on hybrid Islamic financial products in classical *shari'a* literature. Mahmoud El-Gamal, a professor at Rice University, spoke next and analyzed different means of reverse engineering a debt-structure for Islamic banks. liabilities, which would improve corporate governance and regulatory difficulties posed by the current investment account structure (wherein holders of those accounts lack internal corporate protection through representation on the board of directors, and lack legal and regulatory protection as creditors and first claimants to the banks. assets). He then proposed mutuality as a solution to the corporate governance and regulatory problems; mutual banking would be closer to the religious tenets enshrined in the prohibition of *riba*, and thus would strengthen the brand-name of Islamic banking by refocusing it on the nature of finance and its objectives, and away from formal-legalistic contract mechanics. Rafe Haneef, the head of Islamic finance at ABN-AMRO, then presented a paper on *hiyal* and debt, and their roles and impacts on Islamic societies. He first discussed the divergence between the theory and practice of legal stratagems (*hiyal*), and how other legal traditions have dealt with them. He then discussed the role of *qardh* in Islam and whether the use of these stratagems had affected this traditional role of leverage by helping give rise to a debt culture in the contemporary societies. Abdurrahman Habil, head of the legal division of Abu Dhabi Islamic Bank, ended the first session with a presentation on the tension between *maqasid* and *hiyal*, arguing that there was a greater need to interpret the *shari'a* through general principles in order to be in more accordance with the *shari'a*.

The third and fourth sessions were parallel sessions. The third session was entitled, .Legal and Regulatory Challenges. and was chaired by Professor Clement Henry, who is a professor at the University of Texas-Austin. Wafik Grais and Zamir Iqbal, both from the World Bank, opened the session by presenting a paper on corporate governance challenges for Islamic financial institutions, explaining parallel governance experiences of Germany and Japan, and offering some recommendations. Habib Ahmed, an economist at the Islamic Research Training Institute (IRTI), then discussed a measurable method of assessing the risk management framework in Islamic banks, building on the general prescription of the Basel Committee on Banking Supervision. The next speaker was Kilian Balz, a partner at Gleiss Lutz, who explored questions arising in connection with the enforcement of Islamic financing transactions in European courts through analysis of landmark decisions of the London High Court and the Court of Appeals. Kabir Hassan, a professor at the University of New Orleans, and Mehmet Dicle, a PhD candidate from the University of New Orleans, ended the session with a presentation of their paper, which discussed corporate governance standards that are unique to Islamic finance, and the implications that Basel II's guidelines for corporate governance have on Islamic financial institutions.

The fourth session was a collection of select current academic research, and was chaired by Humayun Dar, the Managing Director of Dar Al Istithmaar (London, UK). Taha Abdul-Basser, a PhD candidate at Harvard University, began the session with a presentation on whether *shari'a* experts who consult for Islamic finance institutions consider the aims of the *shari'a* (*maqasid al-shari`a*) in their consultation. Through interviews and academic research, he concluded, among other things, that contemporary *shari'a* experts consider the aims of the *shari'a* and distinguish between legal stratagems (*makh'rij*) and blameworthy legal devices (*h'iyal*). Next, Ali Adnan Ibrahim, a Fulbright Fellow at Washington University in St. Louis, examined mechanisms for and the significance of corporate governance for the industry. After discussing legal and regulatory reforms in Muslim countries that have been taken to improve corporate governance, he discussed potential risks in the reforms process and made some suggestions. Reza Djojosugito, who is legal counsel at the OPEC Fund for International Development, discussed the regulation of sukuks in Indonesia. He distinguished the regulatory needs of conventional financial instruments from that of sukuks, and the reforms that need to be taken in Indonesia in order to regulate sukuks. Philipp Wackerbeck, a PhD candidate at the European Business School in Germany, then presented a paper on the regulation and development of Islamic insurance (*takaful*) markets. Kimmo Hussain, an attorney at a law firm in New Jersey, discussed the challenges of conforming Islamic financial products with United States. state and federal regulatory structures. His analysis focused on the implementation of various Islamic mortgage instruments, with an overview of how federal regulators and shari.a boards have ruled on the legitimacy of certain financial products.

The first day of the conference ended with a banquet. The banquet speech, entitled .The Road Ahead for Islamic Finance,. was given by Jay Collins, the CEO of the Public Sector of Citigroup. After describing the tremendous growth of Islamic finance, he offered ten most critical components of future success: 1) greater standardization and regulatory alignment; 2) increased transparency, 3) simplification of the *shari'a* board process, 4) acceleration of the issuance process, 5) greater outreach to non-Muslim players, 6) encouraging governments to play a greater role in signaling a commitment to Islamic investments, 7) greater liquidity, 8) overcoming the first-mover disadvantage by increasing governments. role, 9) continued innovation, and 10) increased role of international banks in the innovation charge.

Sunday, April 23

The first section of the second day was entitled, .Redefining Islamic Finance,. and chaired by Professor Baber Johansen, a professor at the Harvard Divinity School. Robert Bianchi, a lecturer at the University of Chicago Law School, was the first speaker in this session, and discussed the possibilities for integrating Islamic finance into a more open network of multicultural structures capable of promoting global growth and equity. The next speaker in this session was Javier Jopart, an engagement manager in the Dubai office of McKinsey International. Jopart discussed the impact of regulation on the future of Islamic finance. He stated that there had been much experimentation with the regulation of Islamic finance, and that had resulted in a variety of frameworks. Progress had been made in many of those frameworks and some regulatory concepts are emerging as potential best practices. The regulation, however, had not yet reached the level of completeness or harmonization that existed in the conventional sector. Iraj Toutounchian, a professor at Al-Zahra University in Iran, argued that there was a failure to distinguish the legal differences of money and capital, and that had become the source of many essential confusions and misunderstandings. As a result, Professor Toutounchian argued, Islamic banks are rightly alleged to be operating on usurious activities. Unlike the way the conventional and Islamic banks operate today, the supply of money and the emerging institution could become endogenous to the economic structure, as a result of the elimination of money markets, and yield a stable Islamic system. The last speaker of this session was AbdulKadir Barkatulla, a *shari'a* supervisor and senior imam in London, and he discussed the Islamic perspective on qualitative aspects of business transactions. He argued that the service industry has largely ignored customer relations and other qualitative aspects of business transactions as the need for expedited transactions continues to rise. Going back to *shari'a* principles, Imam Barkatullah stated that the *shari'a* is not only concerned with compliance to the letter of the law but the spirit and philosophy of the law as well, which includes the long term prosperity and health of transacting parties going beyond the lifespan of individuals and to future generations.

The last session of the conference was entitled .New developments in Islamic Finance,. and chaired by Professor Samuel L. Hayes III, professor emeritus at the Harvard Business School. Michael McMillen, a partner at the New York office of Dechert LLP, began this session with a presentation on *sukuk* and Islamic bond issuances, and the path to a viable secondary market. He argued that in order to achieve success in the development of capital markets and secondary markets, to establish balance sheet relief and have continuing capital availability for asset originators, *sukuk* issuances will need to be structured as true securitizations that are broadly distributed across both the Islamic finance and the conventional finance markets. McMillen first discussed the structure of *sukuk* issuances and then the critical elements in the rating process. Rodney Shakespeare, a visiting professor at Trisakti University in Indonesia, argued that free-market finance capitalism will preclude Islamic finance from entering the mainstream, and that there is a need for a supply of Islamic endogenous loans, such as central bank-issued interest-free loans directed at forms of productive capacity and generally administered by the banking system on private property, wide ownership and market principles. M.H. Khatkatay and Shariq Nisar, who are financial consultants based in India, then discussed the need for more than just minimal compliance when ascertaining whether a business in which an Islamic financial institution is providing equity in is not repugnant to *shari'a* norms. They compared different norms set by three organizations, and evaluated them.

The closing remarks were given by Thomas Mullins, the former associate director of the Center of Middle Eastern Studies at Harvard University. He began by explaining the parallel objectives of the Islamic Finance Project and those of Harvard University more generally. He then stated the accomplishments of the Islamic Finance Project, and those who were associated with its success.

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 was given to IFP sponsoring institutions: Arcapita, HSBC Amanah, and Kuwait Finance House, for their support and vision to 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 purpose.