Recent Developments

Forthcoming Changes in the Shari’ah Compliance Regime for Islamic Finance. By Scott R. Anderson

I. INTRODUCTION

Three decades ago, many saw Islamic finance as something of an oxymoron. Religious prohibitions on the collection of interest (riba) and speculative investment (gharar) seemed to stand in clear tension with modern economic practices, limiting Muslim consumers’ ability to engage in worldwide financial markets. But subsequent years of innovation have yielded financial instruments and services that are able to reproduce many of the benefits of conventional finance without violating the tenets of Islamic law, or shari’ah. Increasingly popular among Muslim and non-Muslim issuers alike, these Islamic financial products are estimated to be worth as much as $822 billion worldwide, making them a significant part of the global financial system. This rapid growth has not come without controversy. Critics have charged that ostensibly shari’ah-compliant products often mimic conventional financial products too closely, compromising the ethical principles served by riba and gharar restrictions. These disputes over shari’ah compliance have at times deterred Muslim consumers from purchasing disputed products and limited how broadly the products can be effectively marketed across the Islamic world.

This Recent Development examines the plan that one prominent organization, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), has recently put into motion to address these problems, wherein it assumes an unprecedented regulatory role in reviewing the shari’ah compliance of products industry-wide. To place this plan into perspective, Part II provides background on interpretive debates within Islamic finance, while Part III describes the industry’s current decentralized system for ensuring shari’ah compliance. Part IV details the AAOIFI’s plan and considers how it reflects other actions that the AAOIFI has taken to address recent shari’ah compliance controversies. Part V concludes that, while the AAOIFI’s new authority should help promote convergence in shari’ah compliance standards, it may also slow innovation and ultimately fragment Islamic financial markets if applied too aggressively. To avoid this outcome,

1. For a more complete description of these restrictions, see Frank E. Vogel & Samuel L. Hayes, III, Islamic Law and Finance: Religion, Risk, and Return 71-93 (1998). Other Islamic principles encourage trade by mutual consent, promote commercial probity, emphasize the freedom of contract, and prohibit participation in immoral activities such as the production of alcohol or pornography. See id. at 53-69.
2. The term shari’ah technically refers to God’s infallible divine law, while the rules that imperfect individuals develop in attempting to divine and interpret shari’ah are referred to as fiqh. While most Islamic finance rules should properly be defined as fiqh, see id. at 23-24, this piece refers to them collectively as shari’ah.
the AAOIFI should retain its historical commitment to gradual change and consensus-building as it approaches its new responsibilities.

II. DEBATING SHARI’AH COMPLIANCE

Understanding the significance of the AAOIFI’s recent actions requires some basic background on the interpretive debates surrounding shari’ah compliance. At its core, modern Islamic finance is built upon several “nominate contracts,” including cost-plus sales (murabaha), leases (ijara), advance purchases (salam), silent partnerships (mudaraba), and full partnerships (musharaka). Each of these types of contract is accepted as legitimate under Sunni Islamic doctrine, either because it appears in the religion’s holy texts or because it has been clearly approved of by prior generations of Islamic scholars. Contemporary scholars often justify these contracts on the more pragmatic grounds that they link investors’ returns to tangible assets, encourage risk-sharing, and otherwise discourage riba and gharar in a manner consistent with shari’ah.

Modern financiers have found ways of using these nominate contracts that simulate many of the characteristics of conventional financial products, allowing them to capture Muslim consumers in what some cynically call “shari’ah arbitrage.” For example, through a murabaha contract, a consumer may ask a bank to make a purchase on his behalf on the condition that he later repay the cost plus an additional fee. If this fee is benchmarked to prevailing interest rates, then the transaction has the same economic effect as a conventional interest-bearing loan. While the bank retains ownership and its associated risks until repayment, use of the item purchased can be provided through an accompanying ijara lease or other arrangement. Complex products, such as so-called “Islamic bonds,” or sukuk, often use several layers of nominate contracts, alongside special purpose corporate entities and other measures. In the case of sukuk, these help simulate the fixed payments and reliable returns on principal provided by conventional debt instruments.

Defenders of shari’ah arbitrage typically rely on a classical formalist approach to Sunni Islamic jurisprudence, which gives great precedential weight to previously approved legal structures and practices. Because each

4. See Vogel & Hayes, supra note 1, at 138-50, 181-200. While Shi’a Islam has its own interpretive approach to Islamic finance issues, this analysis limits itself to the more prevalent branch of Sunni Islam. For a brief comparison of Sunni and Shi’a approaches, see Mahmoud A. El-Gamal, Islamic Finance: Law, Economics and Practice 19-20 (2006).
5. See El-Gamal, supra note 4, at 17-19.
7. El-Gamal, supra note 4, at 75.
8. See Vogel & Hayes, supra note 1, at 140-45. For additional examples along these lines, see El-Gamal, supra note 4, at 3-7.
nominate contract has been accepted as shari’ah-compliant in the past, these individuals argue that even complex arrangements of them must be compliant as well, so long as they conform with the previously approved forms.11 Many critics, however, maintain that shari’ah compliance should be judged by a product’s functional impact on society as compared to shari’ah principles of social justice and risk sharing.12

Sunni Islam has little formal hierarchy for resolving such doctrinal disputes. 13 Consequently, this formalist-functionalist tension and other interpretive debates play out between Islamic scholars whenever they debate the shari’ah compliance of particular products, often leading to divergent interpretations. 14 For some, this lack of clear standards raises fears that scholars may at times neglect their obligation to interpret in good faith, and simply use whatever bundle of authorities allows them to justify their preferred outcome.15 Such concerns are particularly relevant to lay Muslim consumers, who are generally seen as lacking the authority and expertise necessary to determine independently the legitimacy of scholars’ rulings.16

III. MANAGING SHARI’AH COMPLIANCE RISK

Where Islamic scholars disagree on the shari’ah compliance of a given product, consumers often limit themselves to products approved by their local scholars or simply avoid disputed products altogether. As disagreements over shari’ah compliance hinder products’ sales and overall economic performance, both reactions expose banks, state treasuries, and other financial institutions that deal in Islamic financial products to what one scholar calls “shari’ah compliance risk.”17 To reduce this risk, these Islamic financial institutions have worked to find ways to minimize public disagreement and collaborate toward commonly accepted standards.

Most of the responsibility for ensuring shari’ah compliance lies with panels of Islamic scholars and finance experts called shari’ah supervisory boards. Located within Islamic financial institutions, these boards work with an institution’s staff to develop, review, and supervise financial products to ensure that they abide by shari’ah requirements. Ultimately, it is these boards’ approval that signals to Muslim consumers that a given product is shari’ah-compliant. To convince as broad a swathe of Muslim consumers as possible to

13. Several prominent pan-Islamic organizations, such as the Organization of the Islamic Conference, address contentious subjects in Islamic law through treatises and collective rulings. While their opinions are widely respected, they are also rare and not necessarily authoritative. See MOHAMMAD HASHIM KAMALI, SHARI’AH LAW: AN INTRODUCTION 255-57 (2008).
14. See Vogel & Hayes, supra note 1, at 34-41.
15. See id. at 36-38 (describing concerns over patching, or talfiq).
17. See DeLorenzo, supra note 11, at 397.
accept the board’s position, most try to include scholars with widely recognized religious qualifications from a diverse array of jurisprudential perspectives.\textsuperscript{18} That said, the rapid growth of the Islamic finance industry has created a shortage of qualified Islamic scholars in recent years, stretching scholars’ availability and forcing some institutions to rely increasingly upon lay experts.\textsuperscript{19}

While shari’ah supervisory boards have become prevalent, the fact that they are paid and maintained by the same institutions that they supervise raises concerns regarding their independence and reliability. Consequently, some groups have also worked to establish standards that can be applied as a neutral benchmark across institutions. The Bahrain-based AAOIFI is the oldest and most prominent of these organizations, as it has spent nearly two decades developing the industry’s most widely accepted standards on shari’ah compliance and other topics. Another prominent organization is the Islamic Finance Services Board (IFSB) in Malaysia, which generates similar standards with a special emphasis on the complex banking, capital markets, and insurance sectors. Both groups incorporate Islamic scholars, industry members, and regulators into the standards-generating process through various conferences and working groups.\textsuperscript{20} While some nations have mandated the implementation of these or similar standards, they remain largely voluntary.\textsuperscript{21} That said, market pressures have promoted their widespread implementation.\textsuperscript{22}

But in spite of these efforts, this system sometimes still yields different perspectives on particular products, particularly along regional lines.\textsuperscript{23} Most notably, scholars in the Persian Gulf have repeatedly criticized their Southeast Asian counterparts for approving certain controversial but market-friendly products. Despite this disapproval, Muslim consumers in Southeast Asia have generally followed the opinions of their local experts and continued to treat these instruments as legitimate.\textsuperscript{24} While not widely disruptive, this disagreement underscores the uncertainty surrounding shari’ah compliance and helps explain why some argue that even stronger standards are needed.

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\item \textsuperscript{18} See id. at 399-402.
\item \textsuperscript{19} See Alexia Garamfalvi, Islamic Scholars Play Role in High Finance, LEGAL TIMES (Wash., D.C.), Apr. 30, 2007, at 13.
\item \textsuperscript{21} See Tarek S. Zaher & M. Kabir Hassan, A Comparative Literature Survey of Islamic Finance and Banking, FIN. MARKETS, INSTITUTIONS & INSTRUMENTS, Nov. 2001, at 155, 185-187 (surveying regulatory approaches to Islamic finance).
\item \textsuperscript{22} See DeLorenzo, supra note 11, at 401.
\item \textsuperscript{23} See Bianchi, supra note 16, at 575-76.
\item \textsuperscript{24} See EL-GAMAL, supra note 4, at 86-89 (describing the two regions’ different approaches to salam, or futures). But see Liau Y-Sing & Tom Freke, As Scholars Quibble, Shariah Banks Eye Convergence, REUTERS, Apr. 17, 2009, http://www.reuters.com/article/idUSTRE53G14X20090417 (“Malaysia shows signs of tempering its market-driven approach to please cash-rich but conservative Middle East investors.”).
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IV. THE AAOIFI’S PROPOSED NEW REGULATORY ROLE

The AAOIFI’s aspiration to “homogenise the market” through its new regulatory authority reflects these calls for more unified shari’ah compliance standards.25 As Secretary-General Mohamed Alchaar described in August 2009, the AAOIFI intends to review “products and services offered by the industry for [shari’ah] compliance” to help fill the “huge gap in the market relating to credible compliance screening.”26 Alchaar describes this new role, which is pending approval by the AAOIFI’s Board of Trustees, as a temporary one that will cease when permanent screening mechanisms are developed. That said, the AAOIFI has said that it will conduct its screening “market-wide, regardless of the geographic distribution of products,”27 implying that it will review even those products whose issuers have chosen not to implement the AAOIFI’s ostensibly voluntary standards. And while Alchaar emphasized that the AAOIFI would first work with institutions to address shari’ah compliance concerns, he made clear that it would go public with its concerns if necessary.28 Though Alchaar does not say so explicitly, this threat of public censure and its market consequences appears to be the stick with which the AAOIFI will enforce its determinations.

This interpretation is informed by the AAOIFI’s actions during a recent controversy surrounding the shari’ah compliance of certain types of sukuk. In an influential 2007 paper, the Chairman of the AAOIFI’s Shari’ah Board, Sheikh Muhammad Taqi Usmani, argued that sukuk that guaranteed purchasers interest-free loans and repurchase agreements in cases of missed payments or default were not shari’ah-compliant, as they effectively tied an investor’s returns to the creditworthiness of the issuer instead of the value of the underlying assets in violation of gharar restrictions.29 Later that year, Usmani made public statements that as much as eighty-five percent of the world’s sukuk could be shari’ah-noncompliant due to these and other measures, triggering an intense controversy.30 After several months of debate, the AAOIFI confirmed much of Usmani’s analysis and issued new sukuk guidelines prohibiting these practices.31 Tellingly, these guidelines also admonished the shari’ah supervisory boards that had permitted such activities, reasserting their duty to “make sure that the operation complies, at every
stage, with [shari’ah] guidelines and requirements.” 32 As Alchaar later described, these actions effectively “wrecked the market”33 for sukuk, leading to a decrease in overall issuances and a dramatic shift toward less controversial ijara-based sukuk structures. As institutions feared that consumers would react negatively to the AAOIFI’s public censure, they rallied market forces that effectively curbed the offending practices and triggered a more widespread reevaluation of sukuk standards by issuers.34

Meanwhile, as the Islamic finance industry struggled through the ensuing global financial crisis, many more voices joined the call for more effective shari’ah compliance, arguing that close imitation of conventional finance had exposed the industry to unnecessary and unethical risks.35 For individuals interested in advancing such a system, the AAOIFI—respected for its widely accepted standards and now demonstrably able to enforce its stance through market forces—no doubt seemed increasingly well-suited to do so. Hence, this growing consensus around the need for better regulation and recognition of means by which it could be achieved together seem to be likely motivators for the AAOIFI’s most recent actions.

V. IMPLICATIONS FOR THE ISLAMIC FINANCE INDUSTRY

Thus far, responses to the AAOIFI’s proposal have been reservedly optimistic. Some industry leaders have welcomed its proposal as a “very good move” toward more uniform shari’ah compliance standards.36 Most agree that shared international standards will reduce the shari’ah compliance risk facing many products and create larger and more efficient consumer markets by allowing institutions more easily to market their products in different countries and regions. That said, others have expressed some reservations. While the AAOIFI’s existing standards are widely accepted, this is in part because they leave significant space for interpretation and innovation in application. Reviewing actual applications of these standards will require the AAOIFI to take a stronger stand on certain interpretive disputes, foreclosing opportunities for innovation and triggering new resistance.37

Yet there are signs that some influential figures within the AAOIFI feel that such a strong stand is necessary. Most notable among them is Sheikh Usmani. In his 2007 paper on sukuk, Usmani noted that Islamic scholars’
leniency on many matters of shari‘ah compliance had been intended to permit the industry to innovate and grow in its difficult early years, when it had to compete directly with conventional finance. But now that the industry has come into its own, Usmani argues, Islamic institutions should “cooperate among themselves for the purpose of developing authentic products that . . . serve the higher purposes of Islamic law” more than economic interests.  

Usmani saw his position on sukuk as a reflection of this need to push the industry toward higher standards, a need that has been echoed in postfinancial crisis rhetoric.  

The AAOIFI’s new regulatory authority could be a potent tool for those wishing to push Islamic finance out of its infancy and toward more rigorous standards. But employing it too aggressively will deter innovation and thus make Islamic financial products increasingly inefficient compared to conventional products. As this efficiency gap increases, marginal Muslim consumers willing to purchase conventional ones if they offer significantly better terms may effectively get priced out of the Islamic market. Not only would this weaken the impact of the AAOIFI’s censure, but some institutions might also find it more profitable to buck the AAOIFI and adopt less demanding standards that capture these marginal consumers. Ironically, this could result in the very outcome that the AAOIFI is intended to counteract: fragmentation along interpretive and regional lines.  

VI. CONCLUSION  

By strategically applying its new regulatory authority, the AAOIFI can encourage continued convergence, gradually advance more demanding shari‘ah compliance standards, and eliminate particularly problematic industry practices. But using the threat of public censure to impose new standards too aggressively could injure innovation and efficiency, and create new fault lines within Islamic financial markets. Consequently, the new regulators at the AAOIFI must be careful in approaching their new responsibilities, and do so with the respect for gradualness and consensus-building to which the industry owes much of its success thus far.

38. Usmani, supra note 29, at 14. The AAOIFI’s official sukuk standards similarly encourage Islamic financial institutions “to increase true partnerships based on profit and loss sharing in order to achieve the objectives of the Shari‘ah.” AAOIFI, supra note 30, at 4.  

39. See, e.g., al Nasser, supra note 35.  

40. See Bianchi, supra note 16, at 575-76.