GLOBALIZATION OF ISLAMIC FINANCE LAW

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I. INTRODUCTION

Some economic historians have stated that "economics has had many siblings," some of which have come and gone as quickly as they have appeared, while other systems, such as Keynesian, Marxian, and Classical economics have lasted decades and even centuries.[1] The question of the day is what type of economic model will the newly resurrected Islamic economics—"economics' latest sibling"—be?[2] A historical "flash in the pan," or does it have the potential of some staying power? This article explores this question and, more specifically, whether the subset of Islamic economics, an Islamic finance and banking system, will survive within the context of the global arena of international finance and banking regulation and law.

The paper eventually concludes that while elements of Islamic economics may survive and even thrive, the prospects of the survival of Islamic finance and banking as a system are slim. Islamic banking will, in all probability, survive as a specialized banking service rather than a system. This article goes further to assert that this new revival of Islamic financing does not only function inefficiently within modern economic development, but also does not comply with, at the very least, the spirit, and in some cases the letter, of *Quranic* law, which is Islamic law or *Shari'ah.* Islamic financing as it is currently being conducted is simply not efficient enough in a market economy when competing with Western-style commercial and investment banking. Moreover, there are not enough customers for banks to incur the costs of engaging a "full-out effort" to create an Islamic banking system. Thus, this article concludes that the current revival of Islamic financing and banking is limited to providing only ad hoc Islamic financial services and banking products.

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[1] Sher Khan, *Islamic Banging*, June 6, 2005, http://www.faithfreedom.org/oped/SherKhan50606.htm.

[2] *Id.*

A. ISLAMIC ECONOMIC LAW AND TEACHINGS[3]

Unlike most other major religions, Islam explicitly affords detailed economic guidelines (i.e., laws) for creating a successful and just economic system.[4] It is generally accepted that the central economic tenant of Islam is to develop a prosperous economic and egalitarian social structure in which all people (men and women) can maximize their intellectual capacity, preserve and promote their health, and actively contribute to the economic and social development of society.[5] Economic development and growth, along with social justice, are critical elements of an Islamic economic legal system (or for that matter, most other types of economic systems). It is presumed in most cases that governments and individuals are obligated to use their reason to formulate and implement strategies that enhance, and simultaneously eliminate factors hindering society's intellectual development, economic progress, and social freedom.

While Western thinkers have advocated the separation of church and state in all aspects of governance and law since Jesus of Nazareth is said to have declared, "render unto Caesar the things which are Caesar's, and unto God the things that are God's," in the case of Islam this is somewhat problematic.[6] Islam, unlike other major religions, gives its followers detailed guidelines, rules, and regulations for an economic and social system.[7] Nothing is Caesar's; it all belongs to God. The details of an Islamic economic legal system are delineated through a number of channels—the *Quran*, the *Sunnah,* the *Ijma*, which are the collection of the consensus of *mujtahids* (i.e., *ulema* or religious scholars), and *Qiyas* (i.e., opinions based on religious doctrine and analogy).[8] These details include, but are not limited to: competition; taxation; government finances; the behavior of financial institutions; social and economic

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3 This section is based on Scheherazade Rehman & Hossein Askari, The Economic IslamicityIndex (EI^2), (Mar. 2007) (paper presented at the Middle East Economic Association's 11th Annual International Conference, Dubai, UAE, on file with the author) and HOSSEIN ASKARI, MIDDLE EAST OIL EXPORTERS: WHAT HAPPENED TO ECONOMIC DEVELOPMENT? (2006).

4 John Thomas Cummings, Hossein Askari & Ahmad Mustafa, *Islam and Modern Economic Change*, *in* ISLAM AND DEVELOPMENT, RELIGION AND SOCIOPOLITICAL CHANGE 25, 26 (John L. Esposito ed., 1980).

5 ASKARI, *supra* note 3.

6 *Matthew* 22:21 (it is believed that Jesus Christ of Nazareth gave this answer to the question of whether it is lawful for Jews to pay taxes to Caesar).

7 ASKARI, *supra* note 3.

8 CUMMINGS ET AL., *supra* note 4, at 26.

expenditures affecting poverty; income distribution and the like; private ownership; rule of law and sanctity of contracts; land tenure; wage policy; natural resource management, including depletable resources; and inheritance.[9]

Before engaging in this brief treatment of Islamic economics and its accompanying law, it may be useful to address the broader and often-asked question of whether Islam discourages economic progress. This may be largely answered by a quote by the International Monetary Fund Executive Director, Abbas Mirakhor:[10]

> [W]e have cited considerable evidence that Islam not only does not rule out economic progress, but that it clearly endorses several of the basic factors cited frequently by Western commentators as essential in historic economic transformation—private property, recognition of the profit incentive, a tradition of hard work, a link between economic success and eternal reward. Thus Islam seems unlikely to rule out rapid economic growth or even the construction of a strong system more or less capitalist in essence. On the other hand, Islamic principles cannot readily, if at all, be reconciled with economic "progress" that is contradicted by blatant economic and social injustice in the context of general social welfare.[11]

An important addendum to the above quote is that Islam also endorses and encourages competition, institutions, the rule of law, and a level playing field, all of which are increasingly seen as the critical foundation for sustained economic growth and prosperity.[12] Moreover, hard work, not subsidies, is given special attention in Islam: "Work, however, is not only performed for the purpose of satisfaction of needs and wants, but it is considered a duty and an obligation required of all members of society."[13]

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9 *Id.*

10 Abbas Mirakhor received the Islamic Development Bank's (IDB) 2003 prize in Islamic economics with Mohsin Khan. *Abbas Mirakhor and Mohsin Khan Named Joint Winners of IDB Prize*, 32 IMFSURVEY 249, 250 (2003), https://www.imf.org/external/pubs/ft/survey/2003/090803.pdf.

11 *See generally,* Abbas Mirakhor, *The General Characteristics Of An Islamic Economic System*, *in* ESSAYS ON IQTISAD: ISLAMIC APPROACH TO ECONOMIC PROBLEMS, 45-46 (Baqir Al-Hasani & Abbas Mirakhor, eds., 2003).

12 ASKARI, *supra* note 3, at 28-30.

13 *Abbas Mirakhor and Mohsin Khan Named Joint Winners of IDB Prize*, *supra* note 10, at 62-63.

B. ISLAMIC JURISPRUDENCE AND FINANCE

Islamic law is, in a sense, a mixture of the workings of the Civil Law tradition, based on a "code," the *Quran*, and the Common Law tradition, based on the opinions of judges who rely on precedents in opinion, interpretation, etc., to decide what is prohibited or what is permissible. Islamic law is, of course, divinely inspired and revealed, and therefore not given to changes by man, as are the laws in the other two traditions.[14] The laws in both a Civil Law society and a Common Law society are made by human beings, and therefore changeable by them. Not so in divinely revealed *Shari'ah*, the revelation of which has been interpreted to some extent, but not changed.[15] Essentially, this is a tall order in finance law since we need to bridge the gap of one thousand years of jurisprudence development to meet today's modern financial needs. At about AD 1000, the *ulema* declared that enough interpretation had taken place, and most schools of Islamic law did not develop their jurisprudence any further, despite radical changes in societies thereafter. This is further complicated by the fact that we are still debating whether we are dealing with the science or philosophy of law within a structure of a body or system of laws which is different in different countries (e.g., countries with a Civil Law tradition or Common Law tradition). Moreover, we are faced with the question as to whether we are looking at, "what you are not allowed to do," that is, forbidden practices, or, "what you are allowed to do," that is, things that are neither forbidden nor prescribed, in our process of developing financial instruments and services.

It is clear today that one must apply a great deal of caution in Islamic financial jurisprudence, since its revival has evolved upon a slippery slope, during a difficult time in history. Essentially, Islamic banks have to be *Shari'ah*-compliant and therefore need a *Shari'ah* Supervisory Board of Advisors comprised of qualified Muslim jurists who decide (in edicts or *fatwas*) which financial products and services are *Shari'ah*-compliant and which are not.[16] There is clearly a moral hazard here as individual banks are self-selecting their own *Shari'ah* Supervisory Board of Advisors. Moreover, larger banks have an advantage as they can afford to hire well-known Muslim jurists on their

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[14] *See* Frederick V. Perry, *Shari'ah, Islamic Law and Arab Business Ethics*, 22 CONN. J. INT'L L. 357 (2007).

[15] *Id.*

[16] *Anything But Conventional?* BANKER MIDDLE EAST, Jan. 2004, at 16-17.

Shari'ah Supervisory Board of Advisors and, therefore, have their *fatwas* carry more weight on the suitability of their financial products and services.[17]

Furthermore, the fact that the financial products and services which are eventually delivered to market do not have a single, unified governing standard of rules, laws, or guidance, other than one thousand year old edicts, is a serious problem. This is especially true in non-Muslim countries that tend not to have a federal *Shari'ah* Supervisory Board for the financial industry and, as such, the field is open to varying interpretation of *Shari'ah*. Even in Muslin countries, there are tremendous differences of opinion and standards that are not systematically used across financial markets. For example, the Kuwait Finance House issued *fatwa* #361, which stated that exchange or redemption of bonds in a different currency is forbidden even though it is a common practice in all financial markets.[18] Only recently have there been talks of global standardization of what is and is not acceptable under Islamic finance law and universal standards for the best practices for supervision and accounting in Islamic finance.[19]

C. ADAPTATION OF ISLAMIC ECONOMIC AND FINANCIAL PRINCIPLES AND LAW[20]

While it is difficult in a short paper to capture the essence of Islamic economics (principles, guidelines, policies, justice, etc.) in sufficient detail, nonetheless, we can identify fifteen fundamental Islamic economic principles. These variables touch upon the central elements of an Islamic economic system: (a) achievement of economic justice and sustained economic growth, (b) broad-based prosperity and job creation, and (c) adoption of Islamic economic and financial practices. Although attempting to measure economic performance within the context of any religion is difficult, it is somewhat easier with Islamic economic principles as compared to, for example, Catholic or Christian economic principles. The reason being that the official book, the *Quran*, is much more explicit than the Bible about the principles, rules, and regulation

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17 Will McSheehy & Shanthy Nambiar, *Islamic Bond Fatwas Surge on Million-Dollar* Scholars, BLOOMBERG NEWS, May 1, 2007, http://www.bloomberg.com/apps/news?pid=20601109&sid=a.DsH16oTM6U&refer=home.

18 *See* Kuwait Finance House, http://www.kfh.com/index.asp (translation by author).

19 *Anything But Conventional?*, *supra* note 16.

20 This section is based on Rehman & Askari, *supra* note 3.

that govern all facets of the public and private of human life and society (i.e., prayer, self-discipline, legal jurisdictions, individual rights, economic structure, taxation, commercial and personal contracts, and financial dealing, among many others).[21] The following are the fifteen fundamental Islamic economic principles based on the Rehman-Askari "Economic Islamicity Index:"[22]

1. Equal economic opportunities for all members of society;
2. Economic equity;
3. Economic freedom;
4. Personal property rights and sanctity of contracts;
5. Job creation for all that can and want to work and equal availability of employment;
6. Equal availability of education;
7. General economic prosperity;
8. Poverty prevention and reduction;
9. Basic needs fulfillment of food, shelter, clothing and rest;
10. Alms giving to charity;
11. Taxation to meet the unfulfilled needs of society and to address social issues generally;
12. Appropriate management of natural and depletable resources to benefit all members of current and future generations;
13. Abolition of corrupt practices;
14. Establishment of a supportive financial system and financial practices that include the abolition of interest;
15. The effectiveness of the state in achieving the above.

D. ISLAMIC BANKING LAW

Under Islam, the establishment of a supportive financial system and financial practices that include the abolition of interest is an essential and fundamental tenant of Islamic economics and law.[23] Most are familiar with the issue of the prohibition of interest, commonly known as *riba* in Islam, but Islamic banking also encompasses four other key criteria.[24] Essentially there are five basic principals of Islamic Banking:

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[21] This is true of Judaism as well because of the Torah's explicit instructions of daily personal, financial, and commercial life.

[22] Rehman & Askari, *supra* note 3.

[23] MAHMOUD A. EL-GAMAL, ISLAMIC FINANCE: LAW, ECONOMICS, AND PRACTICE 135 (2006).

[24] "Riba" is an Arabic word meaning "interest" (ربا). In Hebrew it is known as "Ribit".

> (1) Any predetermined payment over and above the actual amount of principal is prohibited; (2) the lender must share in the profits or losses arising out of the enterprise for which the money was lent; (3) making money from money is not acceptable; (4) *gharar* (uncertainty, risk, or speculation) is also prohibited; (5) investments should only support practices or products that are not forbidden.[25]

Such prohibitions include alcoholic beverage production or sale, investment in real estate for a casino, etc.[26]

E. PROHIBITION OF INTEREST

The fundamental reason for the prohibition of interest in Islam is that the depositor should not profit unduly from the hard work and risk bearing of others.[27] To a Western-trained economist, a competitively determined market interest rate serves an indispensable function in a market economy. Interest rates affect savings and investment and efficiently allocate capital from where it is plentiful to where it is scarce. In competitive markets, this allocation of capital is achieved most efficiently; namely, capital is attracted to where it will earn the highest rate of return ("ROR"). Moreover, interest rates offer policymakers an important instrument for macroeconomic management. Although Islam prohibits interest (*riba*), it encourages profit and return from investment where the investor takes calculated risk.[28] Thus financial institutions can offer an investor a share of their annual profits (and losses) in proportion to the investor's deposit (the share of an individual's deposit relative to total assets of the bank). This rate of return to the investor is different from interest in two important ways: *a priori* its size is unknown (there are no guarantees); and the investor has to take more of a risk (in a Western system the depositor takes less of a risk because the capital of the financial institution's stockholders is first at risk before the capital of the depositors).

Clearly, well-managed institutions will develop a better track record, offer historically higher returns, and thus attract more capital than poorly managed institutions. Thus, profit rates of Islamic institutions can serve the same function as Western interest rates in attracting savings

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[25] *Principals of Islamic Banking and its Application in Australia*, http://www.geocities.com/RainForest/7813/0831_isl.htm.
[26] *Id.*
[27] ASKARI, *supra* note 3.
[28] EL-GAMAL, *supra* note 23, at 62.

and allocating capital efficiently. In the case of macroeconomic management, policymakers can look at rates of return of financial institution as an indicator of financial liquidity and can issue "participation" bonds (carrying no fixed rate of interest but an average of private sector rates of return) to finance budgetary shortfalls.

II. HISTORICAL EVOLUTION OF ISLAMIC BANKING

A. HISTORICAL TRADITION OF USURY

It is difficult to discuss Islamic banking systems without a thoughtful discussion of the origins of the prohibition of *riba* or "interest-free" banking and its genesis—*usury*. The origins and evolution of *usury* are extremely interesting from the perspective of many disciplines—economics, religion, law, etc. *Usury* is derived from the Medieval Latin term *usuria*, which means "interest" or "excessive interest," and originally meant charging a fee for the use of money.[29] It was actively banned and shunned well before the emergence of the Abrahamic religions of Judaism,[30] Christianity, and Islam, all of which prohibited *usury* as well.[31] The legal origins on the ban of *usury* can be traced back to the Code of Hummurabi in 1760 BC.[32] It is also frowned

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[29] THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 1895 (4th ed., 2006).

[30] The Torah and later sections of the Hebrew Bible criticize interest-taking, but interpretations of the Biblical prohibition vary. One common understanding is that Jews are forbidden to charge interest upon loans made to other Jews, but allowed to charge interest on transactions with non-Jews, or Gentiles.

[31] C.H. BECKER, TRANSLATION OF CHRISTENTUM UND ISLAM (1909), *reprinted in* CHRISTIANITY AND ISLAM 67 (Lenox Hill Pub. & Dist. Co. 1974).

[32] The Code of Hammurabi (also known as Hammurabi's Code or Codex Hammurabi), was written ca. 1760 BC in ancient Mesopotamia. *See*, MARC VAN DE MIEROOP, KING HAMMURABI OF BABYLON: A BIOGRAPHY 99-111 (2005). The new code was not only Babylonian law, but also one of the first written codes of law in recorded history. The Code was created by Prince Hammurabi (ca. 1810 BCE – 1750 BCE), a first dynasty king of the city-state of Babylon who inherited the throne from his father, Sin-muballit, in 1792 BC. Hammurabi believed himself to be specially chosen by the gods (i.e. the sun god Shamash) to convey the law to his people. The Code contained 275-300 laws written on 12 tablets. It is often cited as the first example of the legal concept that there are some basic laws that no one can change, not even a king. It is also very specifically structured so that each crime is given a specific punishment. These punishments were the bases of the modern day "eye for eye, tooth for tooth" philosophy. The code also serves as one of the earliest examples of the ideas of "presumption of innocence," and that evidence must be presented against an accused. The fact that the law was written was important in itself because it implied that they were indisputable.

upon in Hindu law which predates 400 BC,[33] and even Plato spoke out against *usury*.[34] This tradition carried into the Judeo-Christian-Islamic prohibition. It was, however, in Western Christianity, around AD 1220, when the prohibition of the practice of *usury* experienced its first serious challenge by a canonist named Hispanus.[35] Hispanus put forth the notion that, "although *usury* was prohibited, a lender could charge a fee if his borrower was late in making repayment."[36] The period between the date on which the borrower should have repaid and the date on which he did repay was termed [by Hispanus] 'interesse' which literally means that which is 'in between is.'"[37] This distinction became important because it wasn't very long before many European money lenders took advantage of this loophole. They soon devised a legal ploy, known as *Contractum Trinius*,[38] to bypass the cannon law ban of *usury*, a law the Church aggressively tried to uphold.[39] *Contractum Trinius* was essentially a three-part contract which allowed the following, "the lending party would invest money with a merchant on a profit and loss sharing basis, insure himself against a loss of capital, and sell back to the merchant any profit above a specified amount."[40] It was an amalgamation of three separate contracts, each individually acceptable to the Church, but which together generated a fixed rate of return, i.e., an interest-bearing loan in all but name. The fast spreading and widespread practice of *Contractum Trinius* (i.e., *usury*) by European merchants in the Middle Ages began to

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33 Wayne A.M. Visser & Alastair MacIntosh, *A Short Review of the Historical Critique of Usury*, 8 ACCT., BUS., & FIN. HISTORY 175, 176 (1998).

34 *Id.* Usury (in the original sense of any interest) was denounced by a number of spiritual leaders and philosophers of ancient times, including Plato, Aristotle, Cato, Cicero, Seneca, Plutarch, Aquinas, Muhammad, Moses, Philo and Gautama Buddha. *Id.*

35 Information on Vincentius Hispanus, http://faculty.cua.edu/Pennington/1140i-p.htm.

36 *Id.*

37 Tarek El Diwany, *Subverting The Islamic Ban on Usury*, FINANCIAL TIMES (London ed.), July 14, 2006.

38 Latin for a three-part contract of good faith. *See*, Tarek El Diwany, *Islamic Banking Isn't Islamic*, ISLAMIC FINANCE.COM, http://www.islamic-finance.com/item100_f.htm.

39 Canon law is the ecclesiastical law of the Roman Catholic Church. It is complete legal system which encompasses courts, lawyers, judges, a fully articulated legal code and principles of legal interpretation. *See Canon Law*, CATHOLIC ENCYCLOPEDIA, http://www.newadvent.org/cathen/09056a.htm.

40 For example, Person A invests $100 in Person B for twelve months. Person A would then sell back to Person B the right to any profit over and above $30, for a fee of $15 to be paid by Person B. The result of these three simultaneously agreed contracts was an interest payment of $10 on a loan of $100 made by Person A to B over the course of twelve months. Finally, Person A would insure himself against any loss of wealth by means of a third contract agreed with Person B at a cost to Person A of $5.). *See* Tarek El Diwany, *Step by Step You Shall Follow Them*, ISLAMIC FINANCE, May 2002, http://www.islamic-finance .com/item117_f.htm.

place undue pressure on the Catholic Church's doctrine which banned such money practices.[41] Eventually, the Church yielded to this commercial pressure. The School of Salamanca rewrote the doctrine, and interest-bearing loans became legal in many Protestant countries, starting with England under Henry VIII.[42] In Islam and Judaism, it remains prohibited.

B. "ISLAMIC CONTRACTUM TRINIUS?" MODERN DAY ISLAMIC FINANCE, USURY, AND RIBA

Is the current manner in which Islamic banks manage *riba* becoming a modern day Islamic *Contractum Trinius*? Islamic banks function very similarly to regular commercial banks in that they must fix their financial rate of returns ("ROR") at the onset for most of their businesses (which is essentially prohibited under *Shari'ah*). Currently, many money lending institutions making loans to the Muslim community are adopting the same approach used in the Middle Ages to defeat the *usury* prohibition in Islam. In essence, the modern day practice of avoiding *riba* is similar to the *Contractum Trinius*[43] as can been seen in, for example, Islamic *murabaha* contract.[44] This Islamic mortgage financing contract looks very much like *Contractun Trinius* (two separate contracts for one project so it becomes *Shari'ah*-compliant).[45] *Murabaha* works essentially as follows: in the Western financial tradition, if a person wishes to finance the purchase of an item, he or she

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41 The Ancients and the Scholastics, http://cepa.newschool.edu/het/schools/ancients.htm (last visited Sept. 16, 2007) [hereinafter Ancients & Scholastics]; Virkam Modi, *Writing the Rules: The Need for Standardized Regulation of Islamic Finance*, 29 HARV. INT'L REV. 38, 38 (2007).

42 Ancients & Scholastics, *supra* note 41. The School of Salamanca (the University of Salamanca) was a renaissance school of thought on "humanism" created by Spanish theologians based on the intellectual and pedagogical work of Francisco de Vitoria. The School of Salamanca, http://cepa.newschool.edu/het/ schools/salamanca.htm (last visited Sept. 16, 2007).

43 *See* El Diwany, *supra* note 38.

44 *Murabaha* is:

> Technically a contract of sale in which the seller declares his cost and profit. This has been adopted as a mode of financing by a number of Islamic banks. As a financing technique, it involves a request by the client to the bank to purchase a certain item for him. The bank does that for a definite profit over the cost which is settled in advance. Some people have questioned the legality of this financing technique because of its similarity to *riba* or interest.

Institute of Islamic Banking and Insurance, http://www.islamic-banking.com/shariah/ sr_murabaha.php (last visited Sept. 16, 2007).

45 For a discussion of a *murabahah* contract used frequently by two major institutions during the 1990's see El Diwany, *supra* note 38.

goes to the bank and asks for a loan at a set rate of interest, which is paid back over time. The bank typically gets a lien on the item until it is paid off. With *murabaha*, the bank buys the item and then "sells" it to the customer at cost plus. The "plus" is the bank's profit, and works the same as a rate of interest. The customer, who does not have the money to pay immediately for the total value, plus profit, of the item, pays over time. The payments include the principal amount of the purchase price, plus the profit, in installments. This has exactly the same effect as a traditional equipment financing loan, where the principal plus the interest are amortized and paid back to the bank over the life of the loan. Understanding this, a bank that offers these products does not tend to make the text of such types of contracts readily available to outsiders and uninterested parties. These contracts also tend to be drafted very strictly and tightly to ensure that the bank does not lose money on the deal if the beneficiary defaults (as *Shari'ah*-compliance mandates profit/loss sharing).[46]

There are many other examples of similar Islamic *Contractum Trinius* type contracts. In investment financing, for example, to list just a few, there are the *musharaka*,[47] *mudarabah*,[48] Estimated Rate of Return,[49] and *Tawarruq* contracts.[50] *Musharaka* financial transactions

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[46] The profit-loss issue is a delicate one from the perspective of regulatory agencies since a bank takes on the position of entrepreneur, thus not only is there a moral hazard but knowledge of specialized industry or business is essential. The bank may not have that skill-base. Many banks learned their lessons from their 1980s debt-for-equity swap experiences.

[47] *Musharaka* contacts are joint ventures between banks and business firms. Typical ventures call for profits and losses to be split in a pre-arranged manner and generally the bank can withdraw after a set period of time. Khan, *supra* note 1.

[48] *Mudarabha* contracts are ventures in which the bank provides the money and an entrepreneur provides expertise, management, and labor. In this arrangement, profits are shared by both the parties but loses are borne only by the bank. *Id.* For a comparison of *musharaka* and *mudaraba* investments, see Maulana Taqi Usmani *Islamic Finance: Musharakah & Mudarabah*, www.darululoomkhi.edu.pk/fiqh/islamicfinance/mudarabah.html (last visited Sept. 16, 2007).

[49] In Estimated Rate of Return contracts, the "bank determines an estimated rate of return on a specific project. If the project makes more than [the] estimated amount, the client keeps it but [the] bank will take a lower amount if los[s] occurs." Khan, *supra* note 1.

[50] One commentator described t*awarruq* as:

> [T]he mode through which some Islamic Financial Institutions (IFI) are facilitating the supply of cash to their clients. The client— the *mutawarriq*—buys X on deferred payment from the IFI and sells X for a cash amount less than the deferred price to a third party. Also *tawarruq* enables IFI to guarantee a predetermined percentage rate of return to its term-depositor, buying XX from him/her on deferred payment then selling XX for cash, the deferred payment being larger than the cash price.

Mohammad Nejatullah Siddiqi, Economics of *Tawarruq* (February 1, 2007) (position paper presented at the Workshop on Tawarruq: A Methodological Issue in Sharī'a-Compliant Finance), *available at*. http://siddiqi.com/mns/Economics_of_Tawarruq.pdf.

were known and practiced among the Arabs before Islam, were continued during and after the life of the Prophet Mohammed, and thus are considered by many scholars to be the most authentic form of Islamic finance.[51] *Musharaka* is essentially a partnership or joint venture, where both parties are subject to risk and reward.[52] In the *tawarruq* transaction, a person buys some goods from the original owner on a time payment plan. This first buyer then has possession of the goods. The first buyer then sells the goods to a second buyer for cash. With the money that the first buyer gets from the second buyer, he can pay off the full purchase price of the goods. Both the original owner and the first buyer have, thereby, made a profit. As in the *murabaha* transaction, there can be no connection between the time payment purchase contract and the cash sale contract of the goods.[53] Critics have complained that the banks are following the letter of the law instead of the spirit of the law.[54] They argue that combining Islamically permissible contracts to produce interest-bearing loans is the heart of the modern day financial specialization of Islamic banking—and that, they contend, is a violation of *Shari'ah* law.[55] They are quick to point out that "economic and social justice," a key tenant in Islam, recognizes capital as a factor of production, but just not the excessive use of it on a "down-trodden man." As always, there is room for a more in-depth discussion of Islamic finance's intellectual and spiritual honesty; however, it is not explored further in this short paper.

Critics also point to the fact that these Islamic banks are in the business of creating money by agreeing to new loans; thus, requiring that society stay in constant debt in order to make a profit (also prohibited under *Shari'ah* law).[56] The social stigma of perpetuating debt has long been alive. For example, in 1816 Thomas Jefferson wrote, "and I sincerely believe with you, that banking establishments are more

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[51] Hussain G. Rammal, *Financing Through Musharaka: Principles and Application*, www.westga.edu/~bquest/2004/musharaka.htm (last visited Sept. 16, 2007).

[52] SAID ZAFAR & SHAMEELA CHINOY, SUBMISSION ON ISLAMIC FINANCIAL INSTITUTIONS TO THE TASK FORCE ON THE FUTURE OF THE CANADIAN FINANCIAL SERVICES SECTOR, *available at* www.fin.gc.ca/taskforce/pdf/ifi2.pdf.

[53] *See* Siddiqi, *supra* note 50.

[54] *See id.* at 5-6 (discussing harmful effects of *tawarruq*).

[55] Ron Synovitz, *Could Islamic Banks Do More To Help The Poor?* Radio Free Europe, RadioLiberty, March 30, 2007, http://www.rferl.org/featuresarticle/2007/03/73f320d2-d89a-477c-8130-04a3e29c45bb.html (last visited Sept. 16, 2007).

[56] M. Umer Chapra, *Mawlana Mawdūdī's Contribution to Islamic Economics*, 94 THE MUSLIM WORLD 163, 167 (2004).

dangerous than standing armies; and that the principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale."[57] Since the 1990s, this sentiment has renewed itself in the Western world. Supporters of this belief often cite the 2006 United Nations Report on Economic Development and Poverty that implied a connection between debt repayment and children's mortality rates in regions of Africa.[58]

C. EFFORTS TO INTRODUCE MODERN ISLAMIC BANKING

The evolution of modern Islamic banking has been a long and convoluted one. The macro economic concept of *Quranic* law gave birth to the so-called "interest-free" Islamic banking at a micro-economic level. The mid-1940s Malaysia, and the late-1950s Pakistan, "introduced small scale interest-free banking system[s];"[59] however, these two "pre-mature" market systems did not persevere.[60] One can trace the modern (post-World War II) origins of Islamic banking in Egypt, which in 1963, under the leadership of Ahmad El Najjar, began a savings bank "under cover" so as not to give the perception of being Islamic.[61] This was a bold step for the secular Egyptian government which lived in the shadow of fear of Islamic fundamentalism.[62] Eventually, Islamic banking came out from under the cloak of secrecy in Egypt in the form of the Nasir Social Bank (an interest-free commercial bank) in 1971.[63] Even at that point, however, the Egyptian government made no reference to Islam or *Shari'ah* in the charter of the Nasir Social Bank.[64] Additionally, the Philippine government also experimented with Islamic banking with the establishment of The Philippine Amanah Bank ("PAB") in 1973.[65]

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[57] Letter from Thomas Jefferson to John Taylor (May 28, 1916), *as quoted in* El Diwany, *supra* note 38.

[58] HUMAN DEVELOPMENT REPORT 2006, BEYOND SCARCITY: POWER, POVERTY, AND THE GLOBAL WATER CRISIS, *available at* http://hdr.undp.org/hdr2006/pdfs/report /HDR06-complete.pdf.

[59] Khan, *supra* note 1.

[60] *Id.*

[61] Mohamed Ariff, *Islamic Banking*, ASIAN-PAC. ECON. LIT., Sept. 1988, at 46-62.

[62] *Id.*

[63] M. Raquibuz Zaman & Hormoz Movassaghi, *Islamic Banking: A Performance Analysis*, J. GLOBAL BUS., Spring 2001, at 31-38.

[64] Ariff, *supra* note 61, at 46-62.

[65] Zaman & Movassaghi, *supra* note 63, at 32.

They, too, also chose to provide no reference to Islam in the banks charter.[66]

By the mid-1960s, British colonialism had all but receded in the Middle East, forcing the countries of the region to find new national identities. Most choose to closely link themselves to Islam. This was soon followed, at the beginning of the 1970s, with the discovery of oil and the ensuing abundance of petro-dollars, providing the means for these newly inspired Arab nations to create Islamic banks. These and other factors created changes in the political climate during the 1970s in many Muslim countries. They no longer saw any strong need to establish Islamic financial institutions under cover. Regional politics and economic positioning began to change, and with that the attitude towards Islamic institutions. Governments of the Middle East and of other non-oil based Muslim countries began, in the early 1970s, to openly flirt with establishing Islamic banking and financial systems within their economic development plans.[67] These banks were intended to be Islamic, based on Islamic law "in letter and in spirit;" however, conformity to Western global banking standards, i.e., Bank of International Settlement ("BIS") rules, soon diluted the "spirit of the law."[68] Thus, the 1970s brought on an onslaught of Islamic institutions mostly originating in the Middle East. They include the Dubai Islamic Bank (1975), Faisal Islamic Bank of Sudan (1977), Faisal Islamic Bank of Egypt (1977), Bahrain Islamic Bank (1979), and Malaysian Muslim Pilgrims Savings Corporation (1983),[69] among others.[70] Even an intergovernmental (multilateral) Islamic bank called the Islamic Development Bank ("IDB") was created in 1974 by the members of the Organization of Islamic Conference (OIC).[71] The IDB is a Multilateral Development Bank ("MDB"),

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[66] *Id.*

[67] *Id.*

[68] Ariff, *supra* note 61, at 46-62.

[69] This bank was the debut of Islamic banking in Malaysia. Mohamed Ariff, *Islamic Banking – Evolution*, http://www.islamicity.com/finance/IslamicBanking_Evolution.asp.

[70] Ariff, *supra* note 61, at 46-62.

[71] The Organization of the Islamic Conference ("OIC") is an inter-governmental organization grouping fifty-seven States. These States agreed to pool their resources, combine their efforts, and speak with one voice to safeguard the interests, progress, and well-being of their peoples and Muslims the world over. The Organization was established in Rabat, Kingdom of Morocco, on 12 Rajab 1389H (25 September 1969). The OIC is comprised of the following countries: Afghanistan, Albania, Algeria, Azerbaijan, Bahrain, Bangladesh, Benin, Brunei, Burkina-Faso, Cameroon, Chad, Comoros, Cote d'Ivoire, Djibouti, Egypt, Gabon, Gambia, Guinea, Guinea-Bissau, Guyana, Indonesia, Iran, Iraq, Jordan, Kazakhstan, Kuwait, Kyrgyzstan, Lebanon, Libya, Malaysia, Maldives, Mali, Mauritania, Morocco, Mozambique, Niger, Nigeria, Oman, Pakistan,

established to foster the economic development and social progress of its fifty-seven self-declared Islamic member countries and Muslim communities in non-member countries in accordance with the principles of *Shari'ah*.[72]

The Asia-Pacific region was impacted by this changing attitude towards Islamic financial institutions. For example, Malaysia entered the Islamic banking arena in 1983. It is, however, important to note that Malaysia has had a historical tradition with Islamic banking institutions dating back to the early 1960s.[73] For example, the very first Islamic financial institution was the Muslim Pilgrims Savings Corporation created in l963 to assist the population to save so that they would be encouraged and be able to travel for *Hajj* (the once-in-a-lifetime mandatory pilgrimage for every Muslim to the holy cities of Mecca and Medina in Saudi Arabia).[74] This was followed by the establishment of the Philippine Amanah Bank ("PAB") which, although established in l973 by Presidential Decree and fashioned according to Islamic law, also had a charter that made no mention of *Shari'ah* financial law.[75] Some countries even attempted to establish and switch to full Islamic banking systems. For example, Iran switched to Islamic banking in August l983 with a three-year transition period; beginning in 1979, Pakistan opted for a gradual "Islamization" process of its financial system.

This deluge of new Islamic financial institutions even infected Western economic systems. In 1978, the first attempt at Islamic banking was initiated in Luxembourg with the creation of the Islamic Banking System (renamed Islamic Finance House).[76] This was soon followed by others, including the Islamic Bank International (Copenhagen), Islamic Investment Company (Melbourne), and more recently, Citi Islamic Investment Bank (Bahrain).[77] Europe's first Islamic (*Shari'ah*-

Palestine, Qatar, Saudi Arabia, Senegal, Sierra Leone, Somalia, Sudan, Suriname, Syria, Tajikistan, Togo, Tunisia, Turkey, Turkmenistan, Uganda, United Arab Emirates, Uzbekistan, and Yemen. The Organization of the Islamic Conference Home Page, http://www.oic-oci.org (follow "about OIC-In Brief" hyperlink; then follow "Member States" hyperlink; then follow "Member States" hyperlink; then follow "OIC Organs" hyperlink; then follow "The Islamic Development Bank" hyperlink.

72 For an extensive history and description of the Islamic Development Bank, see Islamic Development Bank Home Page, http://www.isdb.orgirj/portal/anonymous (follow "About IDB" hyperlink).

73 Ariff, *supra* note 61, at 46-62.

74 *Id*.

75 *Id.*

76 *Id.*

77 *Id.*

compliant) bond was issued by the German state of Saxony-Anhalt in 2004.[78] To date, there are two large Islamic indexes in the West as well: the Dow Jones Islamic Market Index[79] and the Financial Times Stock Exchange ("FTSE") Global Islamic Index Series.[80]

D. HOW SIGNIFICANT IS ISLAMIC BANKING TODAY?

There is no denying the fact that we have seen a phenomenal growth in Islamic banking: total assets worldwide are estimated to exceed two hundred and fifty billion with a current fifteen percent annual projected growth rate.[81] This should, however, be put into context. Despite its rapid growth, Islamic banking is still relatively insignificant in the scheme of global financial markets as its two hundred and fifty billion dollar assets around the world seem a negligible amount when compared to conventional banks. For example, when compared with only one large private bank, Switzerland based Union Bank of Switzerland ("UBS"), which has total assets (in 2005) worth $1,533 billion, the total global assets of Islamic banking seem insignificant as they only reflect approximately sixteen percent of that of a single private bank.[82] The Islamic financial market is shallow and lacks depth.

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78 Fiona Shaikh, *Government Mulls Issuing Islamic Bonds*, REUTERS U.K., Apr. 23, 2007, *available at* http://uk.reuters.com/article/fundsNews/idUKNOA32299520070423.

79 The Dow Jones Islamic Market Indexes:

> Were introduced in 1999 as the first benchmarks to represent Islamic-compliant portfolios. Today the series encompasses more than 70 indexes and remains the most comprehensive family of Islamic market measures. The indexes are maintained based on a stringent and published methodology. An independent Shari'ah Supervisory Board counsels Dow Jones Indexes on matters related to the compliance of index-eligible companies.

Dow Jones Islamic Market Indexes, http://www.djindexes.com/mdsidx/?event=showIslamic.

80 The FTSE Global Islamic Index Series identifies and tracks:

> [A] global Islamic compatible universe of publicly traded equities in a manner analogous to indices which identify and track the relevant universe of publicly traded equities, that have no restrictions imposed by Islamic Sharia precepts in the selection process. In essence, it is an Islamic stock market indicator. The following indices are calculated: FTSE Global Islamic Index, FTSE Americas Islamic Index, FTSE Europe Islamic Index, FTSE Pacific Basin Islamic Index, and FTSE South Africa Islamic Index.

FTSE, Ground Rules For the Management of the FTSE Global Islamic Index (Ver. 2.3) §§ 1.2-1.3 (Oct. 2001) http://www.ftse.com/Indices/FTSE_Global_Islamic_Index_Series/Index_Rules.jsp (follow "FTSE Global Islamic Index Series Rules" hyperlink).

81 Mohammed El Qorchi, *Islamic Finance Gears Up*, FIN. & DEV, Dec. 2005, at 46.

82 Nimrod Raphaeli, *Islamic Banking–A Fast-Growing Industry*, Free Muslims Coalition, http://www.freemuslims.org/document.php?id-84 (last visited Sept. 10, 2007).

Islamic financial instruments are also enjoying a burst of popularity. For example, in the 1990s, there were approximately ten Islamic mutual funds. In 2005, there are over one hundred and twenty Islamic mutual funds.[83] Additionally, one of the fastest growing sectors of Islamic finance is the Islamic debt market. In Malaysia, for example, Islamic securities accounted for 42 percent of total outstanding private debt securities by end-2004, and Islamic securities accounted for 25 percent of total outstanding bonds.[84]

There are about three hundred Islamic financial institutions in seventy-five countries.[85] Approximately one-quarter of all Islamic financial institutions are operating in nations that have non-Muslim majorities.[86] While some countries have promoted their dual banking system (Western and Islamic banking), a few have taken the step to, at least in name, claim that they only operate under an Islamic financial/banking system (i.e., Iran, Pakistan, and Sudan).[87] Dual banking systems thrive in countries like Bahrain, Malaysia, and the United Arab Emirates ("UAE").[88] The ten largest Muslim states taken together have a combined Gross Domestic Product ("GDP") of $1.2 trillion,[89] 2.7% of the world's GDP valued at approximately $44.6 trillion.[90] Again this is a small portion of the world's GDP for the richest ten Muslim countries. This point is driven home when compared with the United State's approximate GDP of $12.5 trillion, and even Japan's $4.5 trillion, and Germany's $2.8 trillion.[91]

Clearly, despite its small size, the growth in Islamic finance is undeniable and it is spreading globally. There are several reasons cited for this recent growth: (1) strong demand from large immigrant and non-

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83 Said Elfakhani and M. Kabir Hassan, Performance of Islamic Mutual Funds 2 (Dec. 19-21, 2005) (Conference Paper, Economic Research Forum, 12th Annual Conference), *available at* http:www.erf.org.eg/html/ 12_AChtm#Finance (follow "Performance of Islamic Mutual Funds" hyperlink).

84 El Qorchi, *supra* note 81, at 47.

85 *Id.* at 46.

86 Press Release, Ghada Elnajjar, Conference Discusses Prospects For Islamic Banking in the U.S. (Oct. 3, 2002), *available at* http://www.usembassyjakarta.org/press_rel/islamic _banking.html (quoting General Council for Islamic Banks and Financial Institutions).

87 Zaman & Movassaghi, *supra* note 63.

88 El Qorchi, *supra* note 81, at 47. Interestingly Saudi Arabia has only a limited number of Islamic banks: Al-Rajhi; Al Albaraka Investment & Development Company; and the Islamic Development Bank (a multilateral organization).

89 *See* World Bank, *Total GDP 2006*, World Development Indicators Database, July 1, 2007, *available at* http://sitesources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf.

90 *See id.*

91 *See id.*

immigrant Muslims; (2) growth of oil wealth (demand from the Persian Gulf); and (3) competitive products attracting Muslim and non-Muslim investors.[92] Some empirical studies have "suggested that the relative profitability of Islamic banks, especially in the Middle East in recent years, was to a large extent due to the property (real estate) boom."[93]

It is, however, important to note that Islamic financial and banking systems typically cannot be set up nor grown without government involvement. For example, in Malaysia, the government, not the private sector, has systemized Islamic banking into the economy.[94] This should not be confused with the deluge of Islamic financial instruments and banking services currently being offered by Islamic and Western banks alike which does not require state sponsorship. Historically, Islamic banks have been primarily state sponsored, and many have also been fueled by petro-dollars.[95] Conventional banks, on the other hand, are not supported by free money and evolve from natural economic phenomena.[96]

Islamic finance is not supposed to be a product to be offered to a niche market (i.e., only Muslim customers), but is a system that is supposed to sit within an economic structure of a country. It was intended to be promoted and implemented as a system for universal use. In the current market place, this cannot be achieved by the private sector alone because a lead is generally required from the state. It is, therefore, the contention of this paper that it cannot survive as a system but rather will thrive as a product line for a niche market for those who, for religious reasons, demand it—much like specialized savings instruments and other banking services that were designed and advertised to the growing Hispanic community in the United States during the 1980s and 1990s. Most commercial banks also understand that focusing on only the one issue of *riba* (on the interest side of commercial banking) would limit growth, and are, therefore, expanding their Islamic financial services.[97] However, it is important to remember that the market base for Islamic banking is small, and if used as a systemic feature within an

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[92] El Qorchi, *supra* note 81, at 46.

[93] Ariff, *supra* note 61, at 46-62.

[94] *See* Lin See-Yan & Chung Tin Fah, *Money Markets in Malaysia*, *in* ASIAN MONEY MARKETS, 209, 213-15, 234 (David C. Cole et al. eds., 1995).

[95] Timur Kuran, *Islamic Economics and the Islamic Subeconomy*, 9 J.ECON. PERSP., 155, 163 (1995); *but see* Rajesh K. Aggarwal & Tarik Yousef, *Islamic Banks and Investment Financing*, 32 J. MONEY, CREDIT & BANKING 93, 93-94 (2000).

[96] Kuran, *supra* note 95, at 155; *but see* Aggarwal & Yousef, *supra* note 95, at 93-94.

[97] *See* Kuran, *supra* note 95, at 155, 158; *see also* Aggarwal & Yousef, *supra* note 95, at 94.

economy, it tends to operate less efficiently than conventional Western banking, no matter how fast banks are expanding their Islamic financial services.[98]

Many economists who support Islamic banking, however, cite an IMF study by Iqbal and Mirakhor which found Islamic banking to be a viable proposition that can result in efficient resource allocation.[99] Although there has recently been an increasing flow of empirical studies of Islamic banking,[100] the foundations are based on some of the earlier systematic empirical works like, for example, Khan (l983).[101]

> [Khan's observations] covered Islamic banks operating in Sudan, United Arab Emirates, Kuwait, Bahrain, Jordan, and Egypt. Khan's study showed that these banks had little difficulty in devising practices in conformity with *Shari'ah*. He identified two types of investment accounts: a) one where the depositor authorized the banks to invest the money in any project, and b) the other where the depositor had a say in the choice of project to be financed. On the asset side, the banks under investigation had been resorting to *mudaraba*, *musharaka* and *murabaha* modes. Khan's study reported profit rates ranging from 9% to 20% which were competitive with conventional banks in the corresponding areas. The rates of return to depositors varied between 8% and l5%, which were quite comparable with the rates of return offered by conventional banks. Khan's study revealed that Islamic banks had a preference for trade finance and real estate investments. The study also revealed a strong preference for quick returns, which is understandable in view of the fact that these newly established institutions were anxious to report positive results even in the early years of operation.[102]

The study also maintains that Islamic central banking is something that we will not see soon except perhaps in Iran and Pakistan. However, such studies are twenty-plus years old. In our globalizing world, societies, economies, and cross-border financial systems are much more open. Local financial markets are now pressured by global financial markets.

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98 *See* Kuran, *supra* note 95, at 155, 160, 162, 170-71; *see also* Aggarwal & Yousef, *supra* note 95, at 94, 99, 103, 105-06, 118.

99 Int'l Monetary Fund [IMF], *Islamic Banking*, at 3, Occasional Paper No. 49 (March 1987) (prepared by Zubair Iqbal & Abbas Mirakhor).

100 *See, e.g.*, Shahid N. Bhuian, *Exploring Market Orientation in Banks: An Empirical Examination in Saudi Arabia*, 11 J. SERVICES MARKETING 317; Saad A. Metawa & Mohammed Almossawi, *Banking Behavior of Islamic Bank Customers*, 16 INT'L J. BANK MARKETING 299 (1998); IBRAHIM A. WARDE, ISLAMIC FINANCE IN THE GLOBAL ECONOMY (2000).

101 M. Fahim Khan, *Islamic Banking as Practiced Now in the World*, *in* MONEY AND BANKING IN ISLAM, 259 (Ziauddin Ahmad et al. eds., l983).

102 Ariff, *supra* note 61, at 46-62.

Both Iran and Pakistan have attempted to Islamize the entire national banking system on a comprehensive basis. "[Recent] IMF studies expressed considerable uneasiness about the concentration of bank assets on short-term trade credits rather than on long-term financing."[103] It found this "undesirable, not only because it is inconsistent with the intentions of the new system, but also because the heavy concentration on a few assets might increase risks and destabilize the asset portfolios."[104] It is also possible that the tendency to concentrate on short- term (trade) financing reflects the early years of operation: it is easier to administer, less risky, and the returns are quicker. The banks may learn to pay more attention to equity financing as they grow older. "[D]ifficulty in financing budget deficits under a non-interest system underscored the urgent need to devise suitable interest-free instruments."[105] For example, "Iran decreed that government borrowing on the basis of a fixed rate of return from the nationalized banking system would not amount to interest and would hence be permissible. The official rationalization is that, since all banks are nationalized, interest rates and payments among banks will cancel out in the consolidated accounts."[106] This of course appears to be at variance with the traditional aversion to interest in *Shari'ah*, but without the use of the subterfuge of *Contractum Trinius*.

III. U.S. MARKET AND ISLAMIC FINANCE LAW

Given the rapid increase in Islamic financial products and services, there is a definite "Western demand for . . . [this] Eastern product."[107] Although the number of Muslims in the United States is hotly debated, most tend to agree that it is around seven million, or approximately two percent of the U.S. population.[108] Various polls have shown that approximately thirty percent would like to adhere to Islamic principles when dealing with their finances.[109] The demand for Islamic

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[103] *Id.*
[104] *Id.*
[105] *Id.*
[106] *Id.*
[107] Elnajjar, *supra* note 86.
[108] *The Diversity of Muslims in the United States*, USIP SPECIAL REPORT 159 (U. S. Inst. of Peace, Washington, D.C.), Feb. 2006, at 1.
[109] Elnajjar, *supra* note 86.

based finance products is based on wide ranging financial needs from home ownership, savings plans, retirement, loans for schools, and special events. It appears that such desire is mostly a middle-class phenomenon in the United States.[110]

It must be emphasized that Islamic finance/banking in non-Muslim countries exists strictly as a product-based phenomenon and not as a systemic entity. Banks are taking advantage of the "feel good" factor by offering American Muslims a specialized banking service, and in the process making a profit by this new product and service line.[111] While some would say this is a win-win situation, others have criticized this growing financial practice by comparing the current Islamic banking to *Contractum Trinius*, stating that it is not true Islamic banking and is nothing more than legal and accounting tricks.[112] Moreover, critics say that the banks are capitalizing on naïve Muslim consumers who are thirsty for systemic Islamic venues.[113] Although the latter merits a discussion from an intellectual and perhaps even a spiritual point of view, from an economist point of view, however, this is simply a free market phenomenon where commercial enterprises live by *carpe diem* (seize the moment) [114] and the customers, more often than not, live by *caveat emptor* (buyer beware).[115] Many find this arrangement palatable. Many middle-class, educated Muslim consumers understand the fragility of calling these instruments and services Islamic; however, many also purposefully choose not to investigate the matter too closely (to remain "innocent") so that they can make the best of the compromise of living within a Western economic structure and actively practicing Islam.[116]

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110 *Id.*

111 *See, e.g.,* Mahmoud Amin El-Gamal, *A Basic Guide to Contemporary Islamic Banking and Finance*, iii, v (June 2000), *available at* http://www.islamic-finance.ir/Articles/primer.pdf.

112 *See generally id.*; *see also,* THE POLITICS OF ISLAMIC FINANCE (Clement M. Henry & Rodney Wilson, eds. 2004) *and* Zubair Hasan, *Islamic Banking At The Cross Roads: Theory Versus Practice*, *in* ISLAMIC PERSPECTIVES ON WEALTH CREATION 11 (Rodney Wilson & Munawar Iqbal eds., 2005).

113 *See. e.g.,* El-Gamal, *supra* note 111.

114 *See* WORDINFO, http://www.wordinfo.info/words/index/info/view_unit/3681.

115 *Caveat Emptor* ("buyer beware") is a doctrine whereby "the purchaser must examine, judge, and test for himself." BLACK'S LAW DICTIONARY 152 (Abrid. 6th ed. 1991). It is "more applicable to judicial sales, auctions, and the like, than to sales of consumer good where strict liability, warranty, and other consumer protection laws protect the consumer-buyer." *Id.*

116 *See*, *e.g.*, El-Gamal, *supra* note 111.

There are many examples of U.S. Islamic finance initiatives, i.e., the American Finance House LABRIBA,[117] which is one of the oldest *riba*-free and *Shari'ah*-compliant financial companies that is involved in home, auto, business, trade financing, and refinancing.[118] The majority of recent initiatives have been focused on the real estate sector—an arena the critics have cleverly labeled the "great Islamic mortgage caper."[119]

U.S. stock market and hedge fund investing has also become the new bastion for Islamic finance. On the surface, the equity markets, and even bonds, can be easily tailored by creating indexes or funds that do not invest in companies that are engaged in "illicit" businesses according to Islam (e.g., liquor, tobacco, gambling, or companies that have excessive debt-to-asset [are highly-leveraged], excessive income capital [idle capital], or conduct only "ethical" investing). Interestingly enough the Dow Jones Islamic Index[120] outperformed the S&P 500 in 2005, 5.6% versus 3% growth, respectively.[121]

A. THE U.S. FEDERAL RESERVE

The U.S. Federal Reserve ("Fed") takes no stance on *Shari'ah* compliance or interpretation thereof. It has made itself publicly clear that its stance on regulations and new arenas of financial innovation does not depend on any ethnically or religiously defined groups (i.e., Muslims, Hispanics, etc.),[122] it views its role as a watchdog. In this vein, it is

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[117] LABRIBA began operations in 1987. It later entered the housing market with the help of Freddy Mac. Press Release, Freddie Mac, Freddie Mac Investing in Islamic "Mortgages" From American Finance House – LARIBA (Mar. 28, 2001), *available at* http://www.freddiemac.com/news/archives2001/islam.htm.

[118] *See* LARIBA American Finance House, What is Unique about the LARIBA Model, http://www.lariba.com (last visited Sept. 16, 2007).

[119] *See*, *e.g.*, Tarek El Diwany, The Great Islamic Mortgage Caper, ISLAMIC FINANCE, Apr. 2003, http://www.islamic-finance.com/item122_f.htm.

[120] The Dow Jones Islamic Index ("DJGI") family was created in June 2000 for people who wish to invest according to Islamic investment guidelines. The indices track securities approved by the Shariah Supervisory Board of Dow Jones & Co., comprised of scholars from around the world. The indices include stocks from 34 countries and comprise of 10 economic sectors, 18 market sectors, 40 industry groups, and 70 subgroups. The Dow Jones Islamic Market group of indices consists of the broad DJ Islamic Market Index, the DJ Islamic Market Canadian Index, the DJ Islamic Market UK Index, the DJ Islamic Market Europe Index, and the DJ Islamic Market Asia/Pacific Index. *See* Dow Jones Islamic Fund, Dow Jones Islamic Indexes, http://www.investaaa.com (follow Dow Jones Islamic Indexes hyperlink) (last visited Sept. 16, 2007).

[121] For performance data on the Dow Jones Islamic Index and the S&P 500, see *id*.

[122] William L. Rutledge, Executive Vice President, Fed. Reserve Bank of N.Y., Regulation and Supervision of Islamic Banking in the United States, Remarks at 2005 Arab Bankers Association

especially interested in Islamic finance because this market customer base is growing rapidly and because it is likely to receive increasing attention from companies seeking to serve these expanding markets. The Fed believes it must pay attention before a potential problem develops.[123] It is prepared to accommodate Islamic financial products and services, but, as expected, states that it must be within the U.S. structure of banking and securities regulations.[124] The Fed's interest is solely from a point of view of regulatory and supervisory challenges and judgments, and it has made clear that the fact that Islamic banking and finance is based on religious principals is irrelevant to its decisions and oversight.[125] So far, the approach of U.S. regulators "has been fairly ad hoc" in their involvement in Islamic finance law. This is partly due to the fact that, despite the industry's impressive growth in recent years, the U.S. Federal Reserve is of the perspective that Islamic financial products and services involve only a small number of providers and a limited array of services (mostly housing market).[126] Although it has taken a flexible stance in its oversight thus far, at the same time the Fed is fearful that, since the market is so young, it is making up rules as it goes along.[127]

There are two Fed-related noteworthy milestones in the United States. In the late 1990s, "two interpretive letters were issued by the Office of the Comptroller of the Currency" relating to Islamic Retail Banking (Residential Net Lease-to-Own Home Finance Products (1997) and *Murabaha*-based Financing Products (1999)).[128] Special attention was given to home ownership. This was in part due to the fact that Freddie Mac and Fannie Mae had "purchased *Shari'ah*-compliant mortgages from [these] providers"—thereby "supplying [the] crucial liquidity" to Islamic mortgage financing.[129]

There are still several challenges for U.S. regulators with respect to several issues. Most troublesome is the issue of profit-and-loss sharing deposits. As William Rutledge, Executive Vice President of the Bank Supervision Group at the Federal Reserve Bank of New York,

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of North America Conference on Islamic Finance (Apr. 19, 2005), *available at* http://www.ny.frb.org/newsevents/speeches/2005/ rut050422.html.

[123] *Id.*

[124] *Id.*

[125] *Id.*

[126] *Id.*

[127] *See id.*

[128] *Id.*

[129] *Id.*

remarked at the 2005 Arab Banking Association of North America ("ABANA") Conference on Islamic Finance:

> Banking organizations in the U.S. and the U.K. have recently sought approval to offer profit-and-loss sharing deposits; not surprisingly, regulatory complications have arisen. Profit-and-loss sharing deposits are typically structured so that the bank has something akin to a joint investment with the depositor, with returns based on a portion of the profits earned and not on a set rate. Most important, in contrast to a conventional deposit, if the bank loses money, so does the account holder. For this reason, offering a profit-and-loss sharing deposit is a particularly difficult proposition under a Western framework, which takes the certainty of deposit principal as a given.[130]

Thus the Fed has not allowed deposits that are fully structured according to profit-and-loss sharing schemes in the U.S. market. William Rutledge also commented in his 2005 ABANA speech that:

> SHAPE Financial Corporation[131] has publicly described having to modify the deposit product it proposed to offer through University Bank, so that principal is guaranteed, and the deposit-holders share only in bank profits, not losses . . . [even so] customers are advised that their acceptance of full repayment in the case of a loss may not be in compliance with the *Shari'ah*.[132]

There are several other features of U.S. banking law that could potentially hold back Islamic finance market growth. An example given by William Rutledge in his 2005 ABANA speech was as follows:

> [T]he set of restrictions placed on the range of permissible investments that commercial banks may hold. To ensure that banks do not assume unnecessary risk, their investments are generally limited to fixed-income, interest-bearing securities, which are prohibited by the *Shari'ah*. In addition, commercial banks must meet numerous disclosure requirements in order to comply with regulatory policy such as the Truth in Lending Act. These requirements typically mandate advance disclosure of APR and other terms that do not fit the principles on which Islamic finance is structured.[133]

He stated that other complications occur when:

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[130] *Id.*

[131] University Islamic Financial Corporation through University Bank and SHAPE Financial offered the first *Sharia'h* compliant, FDIC-insured, deposit program. University Islamic Financial Corp., Deposit Accounts, http://university–bank.com/islamicbanking/Deposit.html (last visited Sept. 16, 2007).

[132] Rutledge, *supra* note 122.

[133] *Id.*

> [A]n Islamic financial institution that intends to finance the purchase of a home or a car according to "murabaha" or "Ijara" structures may need to consider whether state law requires the institution to qualify as a licensed leasing company or auto lender.[134]

Rutledge also stated that this often presents a

> difficulty for Muslim consumers [when they try to obtain] . . . *Shari'ah*-compliant insurance which presents another hurdle to the accessibility of Islamic finance in Western markets. As mentioned earlier, both Fannie Mae and Freddie Mac have purchased Islamically structured mortgages. Both entities, however, require property insurance and private mortgage insurance to be held on the securitized mortgages they purchase. This requirement forces customers of Islamic financial institutions to purchase traditional insurance for these mortgages that . . . is not compliant with the *Shari'ah.*[135]

This is because a contract of insurance is generally prohibited in *Shari'ah*, inasmuch as it is a contract involving risk and gambling.[136]

IV. GLOBAL STANDARDS FOR ISLAMIC FINANCE LAW

The Islamic financial community is in the process of developing international supervisory standards and practices that reflect the specific needs of *Shari'ah*-compliant financing. This is not only beneficial from a regulatory standpoint, as globalization of legal Islamic financial standards would allow the banking community to be able to create a truly global product line. In his 2005 ABANA speech William Rutledge commented that:

> To this end, institutions like the Accounting and Auditing Organization for Islamic Financial Institutions and the Islamic Financial Services Board [("IFSB")] are serving a critical function . . . the IFSB recently released exposure drafts of capital adequacy and risk management standards for Islamic financial institutions. These standards will help regulators both in countries that already have well-developed Islamic financial systems and in Western countries, to understand and supervise Islamic finance . . .

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134 *Id. See also,* The Institute of Islamic Banking and Insurance, Shariah Rulings on Murabaha, http://www.islamic-banking.com/shariah/sr_murabaha.php (last visited Sept. 15, 2007) (for additional elaboration on murabaha); Islamic Finance, Ijara, http://www.islamic-finance.com/item_f.htm (last visited Sept. 15, 2007) (further defining ijara).

135 Rutledge, *supra* note 122.

136 DAVID M. NEIPERT, LAW OF GLOBAL COMMERCE: A TOUR 30 (2002).

> [the IFSB] is also working to strengthen the corporate governance framework for the Islamic financial services industry, and the Federal Reserve Bank of New York . . . [involvement to date has been its via in the 2007 IFSB-sponsored summit on Islamic finance] . . . of course, corporate governance issues and compliance have become particularly important . . . [to Fed over the past few years] . . . and some of the approaches [the fed] has taken to address this issue already have much in common with the practices of Islamic finance.[137]

V. FUTURE OF ISLAMIC BANKS?

Currently, the future of Islamic finance/banking systems looks grim. The only way Islamic banking can survive as a system is to make a real commitment to transform the banking systems in various Muslim countries. This is hard even in Muslim-majority countries as most of them have already set up Western style financial structures adhering to international banking standards. Furthermore, as the state is a necessary and key component in this process, this system is not exportable to Western countries.

The manner in which Islamic banking is currently being approached in both Muslim and Western economies, is mainly as specialized financial services and products. This will not transform Islamic banking into a true banking system but rather it is more likely to develop and remain as a specialized form of banking services and products only. At best, this paper asserts that the true system of Islamic banking will remain a small segment of global banks (perpetuated by Persian Gulf oil money).

One option to expand would be for existing Islamic banks to branch into and specialize in the "non-interest income" financial business. The trend in the "non-interest" banking business has been upward for the last two decades (see fig. 1 Trends in Net Non-Interest Income as a Percentage of Gross Income of Commercial Banks). If global standards are created, there is significant potential for developing a truly global product line of financial services. It should be noted that the diversity in various countries' banking laws would make it difficult to standardize most financial product lines, especially in the mortgage market for home financing. Islamic banking, however, lends itself to

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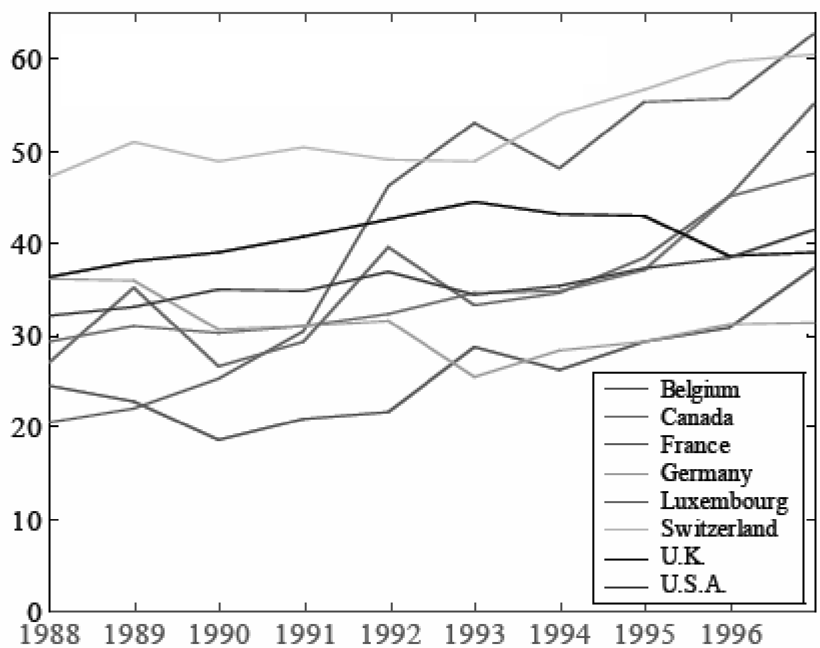
[137] Rutledge, *supra* note 122.

global standards more so than any other type of banking since it is based on one religion and not on varied regional, business, cultural, and social financial norms.

Figure 1 Trends in Net Non-Interest Income as a Percentage of Gross Income of Commercial Banks



Source: Bank Profitability: Financial Statements of Banks, OECD, 1999.

A. CHALLENGES FOR ISLAMIC BANKS

Is the current trend of Western banks becoming involved in Islamic banking instruments and services a benefit for Islamic banking in general? Critics claim that these trends would assist in the disappearance of true Islamic banking systems and that Islamic banks could get diluted within the conventional Western banking system unless Islamic banks do something to establish their distinction as "Islamic."[138] The repeal of the

[138] For further criticisms of Islamic banking, see, e.g., Tariq Al-Rifai, *Islamic Funds Play a Disappearing Act*, *available at* http://www.failaka.com/Library/Articles/Islamic%20Funds%

1933 U.S. Glass-Steagall Act allows conventional banks in the United States to engage in Islamic banking activities and, at the same time, leaves little justification for the establishment of separate Islamic banks.[139] Moreover, big banking corporations may edge out Islamic banks in the United States due to their sheer market size and its accompanying competitive advantage. Given that the Islamic banking lobby is too small in the United States to make any real impact in shaping the future of the American financial system, one possible strategy for Islamic banks might be to join with the conventional banking lobby to persuade regulators to move towards even more financial modernization and innovation.[140]

Islamic banks could also expand their market share and strength by taking advantage of the flexibility in the span of activities for the banks, such as trade (including export/import), lease, and infrastructure banking. They could also take advantage of flexibility in the organizational structure of the banks, including the Bank Holding Company, Bona Fide Subsidiary, and the Universal Banking Models. Current Islamic banking is essentially a hybrid of Universal depository and investment banking. [141] There are, however, other issues that need to be resolved, i.e., the tendency to put "form above substance," resulting in higher, short-term transaction costs (administrative, legal, etc.) of Islamic banks in comparison to their Western counterparts.

The growing criticism, however, of the "bastardization" of Islamic banking and finance systems should not be underestimated.[142] Most of the criticism centers on the fact that these modern day Islamic

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20Disappear%2010-23-2000.pdf; Nasr-Eddine Bernaissa, Michael Weigand, & Stephanie Hauser, *The Challenges That Lie Ahead*, ISLAMIC BANK. & FIN., *available at* http://islamicbankingandfinance.com/summary6.html.

[139] *See* M. Fahim Khan, *Financial Modernization in 21st Century and Challenge for Islamic Banking*, INT'L J. ISLAMIC FIN. SERVICES, *available at* www.iiibf.org/journals/journal3/art3.pdf. The law (actually two laws) was introduced in 1933 as reactions to the problems of the 1929 stock market crash and the federal government's supposed inability to cope. *See* Frontline, *The Long Demise of Glass-Steagall*, PBS.ORG (May 8, 2003), http://www.pbs.org/wgbh/pages/frontline/shows/wallstreet/weill/ demise.html. The Act took the United States off the gold standard and increased the Fed's ability to influence the money supply. *Id.* In 1999, it was repealed by the Gramm-Leach-Bliley Act. *Id.*

[140] Glass-Steagall Act 1933 was repealed due to pressure of the commercial bank lobby. *Id.*

[141] Dr. Shamshad Akhar, Gov. of the State Bank of Pakistan, Islamic Finance—Emerging Challenges of Supervision, Speech at the Fourth Islamic Financial Services Board Summit (May 15, 2007), *available at* http://www.bis.org/review/r070621d.pdf.

[142] *See, e.g.,* Farhad Nomani, *The Problem of Interest and Islamic Banking in a Comparative Perspective: The Case of Egypt, Iran and Pakistan*, 1 REV. MIDDLE EAST ECON. &FIN. 37 (2003).

banks, especially those in non-Muslim countries, are similar in all but name to interest-based conventional banks, and only separated by a fine line of accounting and legal definitions.[143] If the criticism grows more vocal, this could be a potential source of problems for the U.S. Islamic banking community and its growth over the next few decades.

VI. CONCLUDING REMARKS

If Islamic banking and finance is to survive as a systemic entity, it must genuinely adopt an Islamic paradigm, which offers a solution to a world full of Muslim's hungry for alternative banking services and products. If it cannot, it is most likely to enjoy a brief life as a quick get-rich bandwagon scheme and then disappear into the relics of financial history. In all probability, Islamic banking and finance will eventually survive as simply a line of specialty financial services and products offered by banks (both Islamic and non-Islamic) and not as an intricate part of an economic system.

143 *Id.*