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# STATUS OF THE GLOBAL ISLAMIC FINANCE INDUSTRY

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Islamic finance practitioners tend to be primarily concerned with definitions and **1.01**
financial techniques within their area of specialization. Beyond such specifics, their understanding of the bigger picture is often reduced to a few implicit—and faulty—assumptions. One is that there is a fixed, unchanging framework for Islamic finance, applicable everywhere, that has been established once and for all by religious scholars. Another is that Islamic finance has been in existence since the early days of Islam, or that it has appeared fully formed at one point in time.[1]

This chapter intends to bring greater realism to the understanding of Islamic **1.02**
finance. Modern Islamic finance did not come out of nowhere. It appeared as the result of specific historical circumstances in the 1970s, and later evolved through a complex process of trial-and-error. It was also shaped by broader competitive and political-economic factors. Although religion was by definition central to Islamic finance, other variables—political, economic, social, cultural, demographic, etc—also played a significant role. It is important to realize the 'path dependent' nature of this evolution: the appearance and development of the industry were the result of historical accident, but the current shape of Islamic finance determines the range of options for its future development.

[1] These observations are based on my experience of consulting and training with Islamic and conventional banks. This chapter draws heavily from my book *Islamic Finance in the Global Economy* 2nd edn (Edinburgh: Edinburgh University Press, 2010).

**1.03** The growth of Islamic finance shows no signs of abating. Initially scarce, Islamic financial products have multiplied in recent years, attracting a growing number of customers. No longer confined to the outer fringes of global finance, Islamic finance has also gone mainstream. Most major financial institutions are now involved in one way or another in Islamic finance, as are global consulting, accounting, and information companies. Islamic financial institutions now operate in at least 105 countries,[2] and more countries have introduced (or consider introducing) legislation designed to provide a regulatory framework for the industry. Within the Islamic world, Islamic financial institutions have become major economic players.

**1.04** This chapter focuses on the dynamic and diverse nature of Islamic finance. It attempts to bring out nuances and paradoxes that are often obscured by broad-brush assessments of the industry.

## I. The Evolution of Islamic Finance

**1.05** The current state of the Islamic sector can best be understood by tracing its evolution through three distinct phases: the early years (1974–1991); the era of globalization (1991–2001); and the post-September 11 period (after 2001).

**1.06** Islamic finance is a young industry rooted in a very old tradition. Islam developed in a commercial society: the Prophet Muhammed was a merchant, as were his four immediate 'righteous' successors who shaped what came to be regarded as the ideal Islamic society; for centuries, major trade routes were under Islamic control; and merchants played a central role in spreading Islam to various parts of the world. In recent centuries, Islam was characterized by stagnation and decline.

**1.07** Islamic banks came into existence in the mid-1970s as a result of specific historical circumstances. First was the rise of pan-Islamism that marked a new phase of the 'Arab cold war' that had been raging since the 1950s. Its dominant figure, Egypt's President Gamal Abdel Nasser, was then a champion of pan-Arabism and Third World's struggle against Western colonialism. Following the 1958 revolution in Iraq, Saudi Arabia emerged as the main Arab ally of the United States. King Faisal (1963–1975) sought to trump Nasser's pan-Arabism by founding a pan-Islamic movement, the Muslim World League, and used the pilgrimages to Mecca to forge ties with Islamic leaders, both inside and outside the Arab world. He also extended substantial amounts of aid to non-Arab Islamic countries in Asia and Africa.

**1.08** Saudi Arabia's standing grew following the disastrous June 1967 war, after which a humbled Nasser embarked on a more moderate course. The year 1970, which was also the year Nasser died, saw the formal creation of the Organization of the Islamic

[2] Author's database.

Conference (OIC), which brought together 44 countries. It was under the auspices of the OIC that the idea of an Islamic model of finance was put under serious consideration. A related development was the rapprochement between Saudi Arabia and Egypt now led by Anwar Sadat (1970–1981), which created a linkage between the Arab–Israeli conflict, and the price, indeed the availability, of oil. Soon, the price of oil would quadruple.

By the early seventies, the balance of power between oil producers and consumers and between governments and oil companies had shifted. Because of uninterrupted economic growth and the increased reliance on oil—at the expense of other energy sources—worldwide demand was very strong. Oil producers realized that with high inflation and a falling dollar, their oil receipts were steadily dwindling. (In real terms, the price of oil, which had remained stagnant for decades, was going down.) At the same time, oil-producing countries had become more assertive and better equipped to negotiate with oil companies. **1.09**

The October 1973 war between Arabs and Israelis triggered the first round of increases in oil prices along with an oil embargo against countries supporting Israel (including the United States). The sudden change in the financial fortunes of oil-exporting countries, many of them Islamic, was conducive to assertiveness and experimentation. The paradigm of modern Islamic banking was established in those years, through what Monzer Kahf called 'the new alliance of wealth and Shariah scholarship'.[3] Since *riba* was defined as interest, Islamic banking became synonymous with interest-free banking. The prevailing belief was that interest-based banking would be primarily replaced by profit-and-loss sharing (PLS) schemes. **1.10**



Instead of functioning on the basis of interest, Islamic banks would form partnerships based on profit-and-loss sharing with both depositors and would-be borrowers, through the traditional Islamic practice of *mudaraba* (commenda partnership or trusteeship finance). The Islamic financial system was supposed to function according to the 'double *mudaraba*' principle: on the liabilities side of the balance sheet, the depositor would be the financier and the bank the entrepreneur; on the asset side, the bank would be the financier and the person seeking funding the entrepreneur. **1.11**

Another product, the old Islamic sale-based technique of *murabaha*, was, in its updated form, expected to play a subsidiary role. Under the traditional *murabaha*, a buyer would ask a seller to buy a good on his behalf, and resell it to him after adding a pre-determined profit. The updated version added an element of financing to what was originally a spot transaction: the bank would still act as a **1.12**

[3] Monzer Kahf, 'Islamic Banks: The Rise of a New Power Alliance of Wealth and *Shari'a* Scholarship' in Clement M Henry and Rodney Wilson, *The Politics of Islamic Finance* (Edinburgh: Edinburgh University Press, 2004).

merchant, purchasing the required goods directly from a supplier and selling them to the customer, but payment would be deferred. Since it lacked the element of profit-and-loss sharing and sought to mimic conventional finance by replacing the notion of interest with that of profit, the *murabaha* was not enthusiastically endorsed by religious scholars, but was considered an acceptable stopgap that would allow modern Islamic institutions to build experience and resources while they developed a profit-and-loss-based financial system.

**1.13** What were the main tenets of Islamic finance? The realm of finance should be linked directly to the real economy, and governed by the principles of risk sharing and profit-and-loss sharing; interest-based lending (generally considered to be *riba*) should be replaced by Islamic financing contracts based on equity, sale, or leasing; transactions involving speculation or *gharar* (a notion encompassing excessive or avoidable risk, deceptive ambiguity, and risk shifting) should be avoided, as are transactions involving *haram* (religiously forbidden) activities and unethical behaviour; transactions must be clear and transparent and must fulfil social and developmental goals; leverage should be limited; certain conventional practices (such as short-selling) are not allowed; and financial innovations must be monitored by religious scholars. This is, however, the theory or the ideal form of Islamic finance. The reality can best be understood in terms of the evolving context of the industry and its interaction with conventional finance.

**1.14** Islamic finance gathered momentum as certain countries (Pakistan in 1979, Iran and the Sudan in 1983) announced that their banking system would be entirely Islamicized. Another notable development, though one barely noticed at the time, also took place in 1983 when Malaysian introduced an Islamic banking legislation and created Bank Islam Malaysia Berhad (BIMB). Malaysia did not seek to Islamicize its financial sector, but rather to encourage a dual banking structure whereby an Islamic sector would coexist with the conventional one. Unlike Islamic finance in the Gulf, it was primarily driven by the developmental goals of the Malaysian government. The Islamic sector in Malaysia would greatly expand in later years, albeit with little interaction (until the post-September 11 era) with the Gulf-centered Islamic banks.

**1.15** The performance of the first Islamic banks was disappointing: the profit-and-loss sharing model proved to be unworkable; the global recession and the sudden decline in oil prices throughout the 1980s had a devastating effect on the physical assets in which they were heavily invested. Furthermore, the Islamic sector was indirectly affected by financial scandals, such as those of Egypt's Islamic Money Management Companies (IMMCs) and the collapse of Bank of Credit and Commerce International (BCCI).

**1.16** In later years, the international political economy changed beyond recognition, as it entered the age of globalization, the widely used catch-all concept encompassing a wide range of phenomena: the end of the Cold War and the emergence of a unipolar world, deregulation and increased openness of markets, the growing role of finance, the acceleration of technological change, etc. The fall of the Berlin Wall in November 1989 and the disintegration of the Soviet Union in December 1991 marked the end of the Cold War; these were interpreted as the victory in the battle of ideas, of capitalism and the market economy over socialism and central planning. Within the Islamic world, the first Gulf War marked the beginning of a new regional order. The changes leading to a New World Order were accompanied by an ideological shift, which accelerated the transformation of finance. Many of the assumptions, indeed the founding principles, underlying the 1970s *ijtihad* crumbled. In particular, the world of international finance, which had not changed much in the fifties, sixties, and seventies, underwent a veritable revolution in the eighties, one that has accelerated since.

This is when Islamic finance entered its second stage. In a departure from the early ideals, Islamic institutions moved toward more pragmatism and started focusing on ways of replicating conventional finance, albeit through *Shari'a*-compliant contracts and within limits set by *Shari'a* advisers. Largely driven by the oil boom, Islamic finance was also bound to be transformed by the collapse of oil prices in the 1980s. **1.17**

The attempt to create a new, fundamentally different financial order based on profit-and-loss sharing had failed. Islamic banks had instead been achieving the same goals as conventional banks, albeit through Islamic contracts and within the limits imposed by religious advisers. This new phase can be defined by its pragmatism, diversity, multi-polarity, and convergence with conventional finance. **1.18**

Financial deregulation allowed the creation of a wide range of new products. Just as it helped to create products to meet financial, legal, or tax needs, financial engineering helped to devise products that would comply with religious precepts. Deregulation also had the effect of downgrading the role of interest: whereas conventional banks initially relied almost exclusively on 'net interest income' (the difference between the interest charged to borrowers and the interest paid to depositors), they now relied on other sources of profits (from fees, proprietary trading, etc) that were not directly linked to interest. Another factor was the rise of Islamism, which put pressure on governments throughout the Muslim world to allow for religiously-inspired financial products and institutions. **1.19**

A new *ijtihad* gradually developed to deal with the changing position of Islamic finance within the international political economy and the new world of deregulated finance. Islamic finance grew more decentralized, diverse, and pragmatic. New forms of Islamic finance also came into existence outside of the networks created by the first Islamic banks. This growing convergence led to the creation of Islamic units by many conventional banks. Western banks, such as Citibank and HSBC, created Islamic banking subsidiaries, respectively, in Bahrain (Citi Islamic) and in Dubai (HSBC Amanah). The late 1990s also saw the creation of the Dow **1.20**

Jones Islamic Market Index (DJIM), which tracked companies whose products and financial practices did not violate Islamic law.

**1.21** The third phase in the evolution of Islamic finance started after the September 11 attacks. The 'global war on terror' which became the overarching theme of international relations had a significant but paradoxical impact on Islamic finance. The growing integration of Islamic finance in the global economic system was temporarily set back, as Islamic financial institutions found themselves suspected of funding terrorism.[4] But soon afterwards, the Islamic finance industry experienced dramatic growth and major transformations. Criticisms of Islamic banks were no doubt an important factor in the serious effort at rationalizing and streamlining Islamic finance. In parallel, the perception that Islam was under siege resulted in greater religiosity, which in turn drove an increase in demand for Islamic products.

**1.22** Notable developments include countless new commercial and regulatory initiatives as well as the convergence of the Arab and the Malaysian models of Islamic banking. Coming under attack had the effect of greatly concentrating the minds of Islamic bankers and their regulators. As a result, efforts at international coordination and standardization grew more serious and better focused. The year 2002 alone saw the appearance of sovereign *ijara* (leasing) *sukuk* and the creation of coordination and standard-setting mechanisms such as the Islamic Finance Services Board (IFSB), the International Islamic Financial Market (IIFM), the Liquidity Management Center (LMC), and the Islamic International Rating Agency (IIRA). The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), though in existence since 1991 was greatly re-energized in its effort to harmonize accounting and auditing rules and create standard Islamic contracts. In 2005, the International Islamic Centre for Reconciliation and Commercial Arbitration for Islamic Finance Industry was launched in Dubai in order to settle financial and commercial disputes.



**1.23** Another significant development was the growing convergence of the Arab and Malaysian models of Islamic finance (discussed later). The freezing of the assets of prominent Saudis, and the crackdown on Islamic financial institutions and charities led many Muslim investors to take a significant chunk of their assets out of the United States. Home markets could not absorb all those withdrawals (estimated at about $200 billion) and the quest for diversification led more or less naturally to Malaysia, a Muslim country that had achieved an impressive level of economic development and offered a range of investment opportunities. Other forms of political and economic interaction also intensified. Malaysian Prime Minister Mahathir Mohammed's stature grew in the Islamic world as he took a strong stand

[4] Ibrahim Warde, *The Price of Fear: The Truth behind the Financial War on Terror* (London: IB Tauris, 2007).

against those aspects of the global war on terror that he considered as unfairly targeting Muslims. There was also a significant increase in trade and tourism as many Gulf Arabs chose to vacation in Malaysia rather than in the United States or Europe.

As a way of promoting its own viewpoint, Malaysia's central bank announced that it would spend $57 million to invite Islamic scholars from around the world to Kuala Lumpur for a 'Shariah dialogue' programme. Earlier misgivings about diverging interpretations of the *Shari'a* gave way to a quest for common ground. The most dramatic example was the 2002 sovereign Malaysian *sukuk*, which explicitly targeted Gulf investors. (For that issue, Malaysian as well as Arab *Shari'a* scholars gave their endorsement.) 1.24

Those *sukuk* were essentially trust certificates that could be traded on the secondary market because they represented property ownership. The 'coupon' represented the lease paid on the property, which unlike a debt, could be transferred at any price. Hence the institutional innovation of a tradable financial instrument. Insofar as they replicated, from an investor's standpoint, the structure of bonds, they came to be known as Islamic bonds, though they were essentially different.[5] Soon afterwards, those *ijara sukuk* formed the template for a number of *sukuk* issues by corporations and governments in the Arab world and elsewhere. Between 2002 and 2008, the market skyrocketed to $100 billion. 1.25

The new web of institutions linking Arab and Malaysian institutions proved quite effective. Malaysia started working closely with Arab regulators, especially those of Bahrain and the United Arab Emirates on matters of Islamic finance. The Dubai Financial Services Authority (DFSA) entered into a memorandum of understanding with Bank Negara Malaysia, committing both parties to the further development of international Islamic finance markets. Cross-selling initiatives abounded. In sum, Islamic finance was finally moving toward a consistent set of rules and practices, and was well on its way to becoming a coherent, albeit pluralistic, industry. 1.26

## II. Pluralism and Diversity

Any successful belief system, whether religious or secular, has seemingly contradictory characteristics: it is malleable enough to adapt to a variety of geographical settings and survive the test of time, yet it must be able to maintain its specificity, or else it would disappear or become fused with competing belief systems; it is idealistic, sometimes even utopian, yet capable of adjusting to human imperfection and making the kinds of compromises that are endemic to political and economic life. 1.27

[5] Conventional bonds were debt, and at least in the Arab view of Islamic finance, debt could not be sold.

With this in mind we can better understand how a system rooted in the Middle Ages could survive, and thrive, in the global economy.

**1.28** It should be noted at the outset that Islamic commandments are not as unbending as they would superficially appear. There are mechanisms through which Islam adapted to changing circumstances, and came to accommodate itself with modern economics and finance. The general interest (*maslaha*) and overriding necessity (*darura*)—the need to achieve economic welfare and the requirements of a global economy—whether articulated or not, often trump theological or legal concerns.

**1.29** Also, traditional Islamic injunctions are not framed as simple dichotomies, but along a continuum, thus allowing significant flexibility and pragmatism. In the early Islamic community, an action (either for the community as a whole, or for every single member of it) could be regarded as obligatory (*wajib*), meritorious (*mustahabb*), morally neutral (*mubah*), reprehensible (*makruh*), or forbidden (*haram*). Also, most injunctions contain dispensations and exceptions. On the subject of fasting during Ramadan, the sick and the travellers could postpone their fasting, and those for whom it would cause hardship could dispense with it, making up for it instead with a good deed such as feeding a poor person. In finance, this pragmatism has taken the form of 'purification' of improper income through charitable donations.

**1.30** As Islam expanded, it was brought into contact with different cultures and this made it necessary for Islamic jurisprudence to produce legislation on problems for which there were no clear legal precedents to follow. The principles of Islamic jurisprudence (*usul al-fiqh*) provide for a set of elaborate rules to interpret the *Shari'a*. But the existence of such complex rules did not preclude adaptive mechanisms. The principle of *talfiq* ('patching') would for example authorize judges to choose an interpretation from schools of jurisprudence other than their own if it seemed to fit the particular circumstances of the case, see paragraph 2.42.

**1.31** Furthermore, there is a central distinction in Islamic law between *'ibadat* and *mu'amalat*. *'Ibadat* (acts of worship) refer to relations between man and God, such as prayer and fasting, and are immutable, whereas *mu'amalat* (transactions) which refer to relations between man and man, and are open to evolution and change. Thus, in the realm of *mu'amalat*, which is of course that of economic and financial dealings, there is considerable room to develop and change the law, albeit within limits and based on principles discussed in the following pages, to facilitate human interaction and promote justice and prosperity.

**1.32** More generally, three principles allow for departures from existing norms: local custom (*'urf*), the public interest (*maslaha*), and necessity (*darura*). The *Shari'a* can thus be accommodated to societal developments, and allow for innovation, exceptions, and loopholes—provided they are properly justified.

**1.33** Assessments of Islamic banks tend to fall into one of two categories: excessive claims or outright dismissal. It has become nearly impossible to have a nuanced or empirically-grounded understanding of Islamic finance, or capture its evolutionary nature: one set of writings presents Islamic finance as a universal panacea that will produce a world of no inflation, no unemployment, no exploitation, and no poverty; the other dismisses Islamic finance as a failure—at best an inconsequential phenomenon and an exercise in semantics, at worst a fraud or a threat to Western civilization.[6] Such binary approaches cannot capture the diversity and nuances of Islamic finance.

There is a great deal of diversity in Islamic finance. When it comes to the main characteristics of the Islamic sector, no two countries are identical. Despite recent strides in harmonization and streamlining there is still a great deal of diversity and pluralism to the Islamic sector. Perceptions of Islamic finance in the West cannot be separated from general perceptions of Islam as a monolithic, unchanging, and somewhat fossilized belief system. In reality, Islamic finance reflects the diversity of a fourteen-hundred-year-old, 1.4 billion strong religion spread over every continent. Islamic financial institutions come in all shapes and forms: banks and non-banks; large and small; specialized and diversified; traditional and innovative; national and multinational; successful and unsuccessful; prudent and reckless; strictly regulated and freewheeling, etc. Some are virtually identical to their conventional counterparts, while others are markedly different. Some are driven solely by religious considerations; others use religion as a way of sidestepping regulation, as a shield against government interference, as a tool for political change, or simply as a marketing ploy. **1.34**

Despite the growing trend towards harmonization of rules and practices, there is a great deal of diversity within Islamic finance. A quick look at the leading Islamic institutions reveals the heterogeneity of the industry.[7] Large government-owned Iranian banks, that are subject to sanctions and have few interactions with non-Iranian Islamic banks, hold the top spots. Then there are Gulf Cooperation Council (GCC) banks, themselves a heterogeneous group, including some of the earliest Islamic banks such as Kuwait Finance House and Dubai Islamic Bank, and more recent ones, such as Abu Dhabi Islamic Bank and Saudi Arabia's Al-Rajhi. The majority of GCC banks have a domestic focus, though another of the largest banks, Bahrain-based, Saudi-owned Al-Baraka group, had from the beginning a transnational focus. The top ranks of Islamic banks also include Malaysian banks, such as BIMB, which until recently evolved had little contact with GCC banks. The largest Islamic institutions by assets also include Western-based institutions, such as the UK-controlled, but Dubai-based, HSBC Amanah. **1.35**



[6] See Dr Muhammad Saleem, *Islamic Banking: A $300 Billion Deception* (Xlibris Corporation, 2006) and David J Jonsson, *Islamic Economics and the Final Jihad: The Muslim Brotherhood to the Leftist/Marxist-Islamist Alliance* (Xulon Press, 2006).

[7] Brian Caplen and Joseph DiVanna 'Top 500 Islamic Financial Institutions' *The Banker*, 24 November 2010.

**1.36** Examples abound of how deeply embedded Islamic financial institutions are in their institutional and cultural framework. Saudi Arabia was founded as a 'fundamentalist' Islamic state, in the sense that its society and institutions were based on a strict and 'purist' interpretation of Islam. Paradoxically, this has made the issue of Islamic banking and finance politically sensitive. The reason is that by the time Islamic banks came into existence, Saudi Arabia was a wealthy state—to a large extent a rentier economy, living off its oil production and the substantial revenues from its foreign investment and interest income. Its economy was thus heavily dependent, directly and indirectly, on interest. Although Saudi Arabia played a central role in creating and promoting the Islamic finance industry, it did not initially encourage the growth of Islamic institutions at home. It is only in recent years, mostly due to consumer demand, that Islamic finance came to play a growing role in the national economy—making Saudi Arabia one of the latecomers in the Islamic sector.

**1.37** In Egypt, the story of Islamic finance is equally complicated. In the late 1970s the government promoted Islamic banks as part of its new alliance with Saudi Arabia and as a counterweight to left-wing and Nasserite opposition. Yet a disastrous experiment in the (the collapse of Islamic Money Management Companies [IMMCs], companies that were not linked to the emerging Islamic banking sector) suddenly cast suspicions on the entire Islamic sector. Political fears of the Muslim Brotherhood also led the government of Hosni Mubarak to stifle the growth of Islamic banks. In Turkey in the 1980s, a secular but cash-strapped government allowed the creation of Islamic banks though they were not allowed to use the word Islam in their name, or to refer explicitly to their Islamic character. Initially called Special Finance Houses, they are now known as Participation Banks. In Jordan, the policy toward Islamic banks has reflected the accommodative policy toward Islamic groups in general. In Malaysia and Indonesia, Islamic finance has reflected the more syncretic brand of Islam, the developmental nature of government policies, as well as a variety of domestic considerations.



**1.38** The United Kingdom, home to more than 2 million Muslims, has repeatedly announced its intention of becoming a global hub of Islamic finance. The reasons are political (the integration of an often disenfranchised community) and economic (attracting foreign investment to the UK). A number of tax and regulatory changes have been undertaken to fulfil that goal. Especially notable is the introduction of a new *sukuk* regime similar to that for conventional securitizations, adding *sukuk* to the London Stock Exchange, and the announcement that the British government would in the near future be issuing sovereign *sukuk*. Singapore, another country where Muslims are only a small minority (about 14 per cent of the population) has also announced its intention of becoming a hub of Islamic finance. In recent years, countries as diverse as Australia, France, and South Korea have altered their legislation to become more hospitable to Islamic finance, in particular on *sukuk* issuance.

1.39 The first Islamic banks appeared in the Arab world. First was the Dubai Islamic Bank in 1975. The following years saw the creation of Islamic banks in Kuwait, Jordan, Bahrain, Egypt, and the Sudan. Then Islamic banks started appearing all over the world. Significant differences appeared across countries in the importance, status, and characteristics of Islamic financial institutions. Their role in national economies ranges from essential to insignificant. Their 'special character' may or may not be recognized by regulators. In some countries, they are strongly encouraged by the authorities; in others they are barely tolerated. Domestic factors and the diversity of national circumstances (including of course the impact of indigenous forms of Islam) have inevitably added to differences across countries.[8]

1.40 Even those countries that fully Islamicized their financial systems—Pakistan, Iran, the Sudan—did so under different religious, political, economic, and cultural circumstances. In most cases, Islamicization did not occur in a carefully thought out application of Islamic principles and jurisprudence, but in an ad hoc manner and under the pressure of events. As a result, paradoxes abound, and the evolution of Islamic finance often runs counter to common perceptions and stereotypes.

1.41 Two main models can be identified, one associated with the Gulf (I shall refer to it as the Arab model), the other with Malaysia. The Arab *ijtihad* was primarily driven by the surpluses generated by the oil boom of the mid-to-late 1970s whereas the Malaysian effort was driven by the developmental imperative, combined with domestic political factors, principally the promotion of the (Muslim) Malay majority. In other words, the Gulf countries, flush with oil money, were concerned with asset management while Malaysia focused on generating financing for the economy and transforming the country from agricultural backwater to industrializing nation.

1.42 Another fundamental difference between the two systems is that the Arab model had evolved in disorganized fashion while the Malaysian model was based on a directive, top-down, approach. In the first case, the *Shari'a* guidance model was fragmented and decentralized. Banks could do whatever their *Shari'a* Board allowed them to do, and some were even not subject to central bank supervision. Thus the Kuwait Finance House was placed under the authority of the Ministry of Finance. In contrast, Malaysia sought consistency by creating a *Shari'a* Board within its Central Bank, whose decisions would supersede those of individual *Shari'a* Boards.

1.43 The Malaysian model of Islamic finance was more innovative and forward-looking, though religiously controversial. Certain Malaysian practices were not deemed acceptable to *Shari'a* Boards in more conservative Arab states, in particular the widespread use of *bay' al-dayn* (trading of debt). Malaysia's posture could be explained in terms of its broader political economy.

[8] For a general discussion of the recent evolution of economic Islam in different countries, see Vali Nasr, *Forces of Fortune: The Rise of the New Muslim Middle Class and What It Will Mean for Our World* (New York: Free Press, 2009).

1.44 Mahathir Mohammed, Malaysia's long-serving prime minister (1981–2003), sought to harness Islam to his goal of economic growth. His approach to Islamic finance was highly pragmatic. Rather than using what was historically acceptable as a starting point, he challenged the Malaysian *'ulama'* to an *ijtihad* designed to generate new ideas. Religion, rather than being an obstacle to change, was to be an engine of growth and modernization and a tool to promote financial innovation. An Islamic financial system that could offer a growing array of sophisticated financial services was part and parcel of the effort to turn Kuala Lumpur into a leading regional, if not international, financial centre.

1.45 The Malaysian model came into its own in the 1990s. The dual banking logic, as well as other Malaysian innovations such as Islamic insurance (*takaful*), had also taken root. Another singular characteristic of the Malaysian system is that Islamic products were geared to Muslims as well as to non-Muslims. Muslims would have the opportunity to invest according to their religious beliefs, while non-Muslims, especially the Chinese minority which controls most of the country's wealth, would have an extension of choice in money-management. The message of Malaysian leaders was that industrialization and productivity were fully compatible with piety, and that welfare in this world was fully compatible with salvation in the next.

1.46 Scholars in the Arab world considered their Malaysian counterparts too lax in their religious interpretations. As a result, Arab and Malaysian Islamic banks evolved along separate paths, and had minimal interaction until 2001.



## III. Islamic Finance and the Global Financial Meltdown

1.47 By the time of the 2008 financial meltdown, Islamic finance had become part of the mainstream of global finance. The trend was driven primarily by a desire on the part of global financial institutions to tap the wealth of the Islamic world, as opposed to a genuine admiration for the merits of Islamic finance, let alone as part of the quest for an alternative form of finance. Indeed, in the first years of the new millennium, the paradigm of global finance, as epitomized by major Wall Street firms with their focus on financial innovation, commanded near-unanimous support where it mattered, that is among financial regulators, economics and finance professors, the financial community at large, and the media. In those years, Islamic banks were usually on the receiving end of lectures essentially asking them to become more like mainstream finance.

1.48 All this changed with the 2007–08 financial crisis. The crisis could be divided into three phases. In the first one, the decline in US real estate prices drew attention to subprime loans, which, it turned out, had through the miracle of securitization found their way onto the balance sheets of major international financial institutions. In the second phase, losses suffered by such institutions triggered claims for which major Wall Street firms and other companies such as insurer AIG were utterly unprepared. Indeed through highly lucrative and unregulated credit derivatives known as 'credit default swaps', high-flying financial firms had in effect insured countless institutions (and one another) against defaults, and now they had to pay up. As the world's leading global financial institutions discovered the time-bombs on their balance sheets (in the form of toxic assets and unfunded liabilities), they realized that they were essentially insolvent: the ensuing credit freeze caused a global financial meltdown which soon spread to the real economy. The third phase of the financial crisis was thus a global economic recession—which would have turned into a depression were it not for massive government intervention worldwide. It is only then that Islamic banks started to feel the effects of the meltdown.

Why did Islamic institutions escape the first two phases relatively unscathed? Quite simply because many of the practices that caused the financial freeze would not pass muster with *Shari'a* Boards. Indeed, neither the securitization of subprime loans (which is a sale of debt) nor credit default swaps (which are the sale of promises and are rife with *gharar*) are acceptable. **1.49**

Similarly, negative Islamic attitudes toward short-selling were vindicated by the role short-selling played in many episodes of the financial crisis. Indeed, major financial centres subsequently placed limits on short-selling of financial stocks. Some old-fashioned principles such as the distrust of excessive leverage and of open-ended innovation proved well-founded. As for the systematic vetting of new products by *Shari'a* advisers, it played a checks and balances role, and proved a useful corrective to the groupthink that had overtaken conventional finance. **1.50**

When the financial tsunami hit, bringing conventional finance to its knees, just as there was a mood of soul searching within mainstream finance, a sense of self-confidence—indeed triumphalism—overtook Islamic finance. Some did not hesitate to present Islamic finance as a panacea that would solve all the world's economic ills, and as the model that conventional banks should adopt to get out of their predicament.[9] **1.51**

Yet soon afterwards, the extension of the crisis from the financial realm to the real economy exposed the vulnerability of a sector that is mostly asset-backed, though its inherent conservatism mitigated somehow the effects of the economic downturn.[10] This showed that Islamic finance was not after all a panacea, and that a faith-based system is not automatically immune to the vagaries of finance. **1.52**

[9] See for example PK Abdul Ghafour, 'Islamic Finance Panacea for Global Crisis: Chapra' *Arab News*, 23 October 2008 and Robin Brant, 'Is Islamic Finance the Answer?' BBC News, 11 May 2009.

[10] Andrew Wood, 'Islamic Finance Escapes Worst of Crisis', *Financial Times*, 7 June 2009.

**1.53** On balance however, the Islamic sector weathered the financial meltdown better than the conventional sector. If nothing else, there was an acknowledgement within conventional circles that the principles and strictures of Islamic finance were not without merit. This in turn created a renewed sense of self-confidence within the Islamic sector, which also weakened the hand of those who equated progress with uncritical imitation of conventional banks. Perhaps most significantly, the financial meltdown suggested that the quest for an alternative system of finance was not as far-fetched as it first appeared.