

ISLAMIC FINANCE



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## Between Religious Norms and Legal Practice

Wim DECOCK  
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(eds.)



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# INTRODUCTION

Wim DECOCK and Vincent SAGAERT

This volume collects the papers presented at the Leuven Islamic Finance symposium on 7 December 2017. Organized jointly by UMT Law School in Lahore (Pakistan,) and the Faculties of Law and Theology at KU Leuven (Belgium), the conference brought together high-level practitioners and esteemed experts from different academic fields – theology, law, economics – for an inter-cultural and inter-disciplinary dialogue on Islamic finance. The conference was made possible thanks to a generous grant by the Flemish Research Foundation (FWO), the support of Katechetica, the alumni network of the Faculty of Theology, Leuven’s Global Law School and Themis, the post-graduate training and congress centre at the Faculty of Law. Following an invitation by Dean Bernard Tilleman and Dean Mathijs Lamberigts, the general aim of this symposium was to explore the tension existing between the religious and legal principles underlying Islamic finance, on the one hand, and the actual legal practice of Islamic banking, on the other. While Islamic finance must allow the Muslim community to reconcile their economic needs with the principles of religion, there are increasingly signs that the practice of Islamic finance is forced to develop sophisticated legal devices to reconcile the original conception of Islamic finance with the dictates of the modern market. In his standard work on the subject, Ibrahim Warde, professor at the Fletcher School of Law and Diplomacy (Tufts), observes “*a gap between promise and performance*” in this regard.<sup>1</sup> Given the financial importance and development of Islamic finance, it should not surprise that several legal systems try to accommodate Islamic finance within their legal framework. Despite a declining trend in its growth rate, the business of Islamic finance is nevertheless thriving, the sector being worth more than \$ 2,4 trillion at the end of 2017, according to estimates.<sup>2</sup>

The contributions in this volume highlight several aspects of the theory and practice of Islamic finance. The relationship between religion, ethics and finance in both the Islamic tradition and the Christian tradition is explored in *Rodney*

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<sup>1</sup> I. Warde, *Islamic Finance in the Global Economy*, Edinburgh, Edinburgh University Press, 2010<sup>2</sup>, 240.

<sup>2</sup> Global Islamic Finance Report 2018, <https://www.astanafindays.org/storage/media/5b55d014d1e42.pdf>.

Wilson's contribution on Christian and Islamic perspectives on contemporary finance. He confronts the functioning of canon law in the Christian churches with respect to financial management with the *shari'ah* governance of Islamic banking institutions. Different attitudes towards risk-taking and interest are explained, despite a shared commitment to moral values that are supposed to supplement secular laws on banking and finance. The rise of Islamic financial institutions since the 1960s is contrasted with the absence of explicitly Christian financial institutions, except for particular initiatives such as the Kingdom Bank and Ecclesiastical Insurance. Perhaps the most important difference Wilson observes is the lack of centrally administered authorities in the Islamic world, which leads to a wide variety of diverging and often conflicting opinions about legitimate banking activities among Muslims. For example, most Muslim majority countries have not introduced a complete ban on interest-taking, except for the Islamic Republic of Iran, and interpretations of the *riba*-prohibition differ from one country to the other. As a result, Wilson concludes, "*differences within religions may be greater than differences between religions, at least in the realm of finance.*"

This view on the variety of conceptions within Islamic finance is largely confirmed by the second contribution in this volume, in which *Mathias Rohe* assesses the legal aspects of Islamic finance in the contemporary world. He sets out the legal rules by analyzing the variety of interpretations of the prohibitions on interest-taking (*riba*) and high-risk transactions (*gharar*) which underlie Islamic banking activities. The possibilities for applying Islamic legal principles in international contracts, for instance through international private law, are explored. Rohe observes that conflict of law-clauses referring to the law of specific states, e.g. Pakistan, are more likely to be accepted in Europe than general references to Islamic law, at least with state courts. Arbitration mechanisms offer more flexibility. Within European jurisdictions, the notion of suppletive rules as opposed to mandatory substantive law also offers room for the introduction of financial transactions that meet the requirements of Islamic law, such as *ijara*, Islamic lease, *murabaha* and *musharaka*, Islamic partnerships, and *hawala*, a kind of bills of exchange. In conclusion, Rohe sees two main strategies for combining Muslim faith and financial practice. It is possible to try to stick to the traditional texts and invent more or less convincing strategies to reconcile tradition with modernity, for instance by appealing to approved circumvention techniques. Another option is to re-contextualize the old norms, re-interpret them according to the values underlying the *shari'ah* and integrate them with new ethical concerns such as fair trade, ecological impact and labour conditions. Examples are given how these strategies are applied to overcome the tension between the theory and practice of Islamic finance.

The legal and economic technicalities of specific Islamic banking services are analysed in the following two contributions. The legal dimension of the subject

matter is highlighted by *Syed Imad-ud-Din Asad*. He starts with an overview of the religious sources of Islamic law in general, including the *Qur'an*, the *Sunnah*, and their learned interpretation by scholars through individual reasoning by analogy (*Qiyas*) and the common opinion of learned experts (*Ijma*). After a basic introduction to the prohibitions on interest, excessive risk-taking and gambling underlying Islamic finance, a systematic overview of specific financial transactions is provided. Deposit-, equity-, debt- and fee-based products are analyzed in depth. A comparative analysis of the development of Islamic finance in the Muslim world, the UK and Luxembourg gives insight into the interaction between state policies, institutions and the practice of Islamic finance. At the end of his paper, the author notices that one of the great challenges today is to keep the religious inspiration behind the sophisticated legal devices alive, while the practical effects obtained by Islamic finance transactions have developed in such way that they are to resemble those of conventional banking. This tension is compounded by the fact that a major challenge for Islamic banks in non-Muslim-majority jurisdictions is to compete with conventional (non-Muslim) financial institutions.

The urgent problem of obtaining a level playing field with conventional banks is addressed by *Hans Visser* in a paper that concentrates on the regulatory aspects of Islamic finance in non-Muslim-majority countries. As a matter of fact, there are many regulatory hurdles preventing a faster rise of Islamic retail banks in European countries. A major issue concerns the question whether regulators follow what Visser calls an economic or a legal approach, viz. a substantive or formal approach. For tax purposes these approaches lead two very different outcomes. For example, if a strictly legal or formal perspective is applied, then Islamic banks cannot be considered as incurring financing costs (since they do not pay interest in the legal sense of the word, but markups), thus losing the opportunity to deduct those costs when paying taxes. Visser argues for an economic rather than for a legal approach, which would allow the markups to be considered from a substantial point of view as tantamount to interest, thus allowing Islamic banks to deduct them in their tax file. He recognizes, though, that, from a political point of view, there is currently little interest in promoting the substantial perspective. Other pressing issues dealt with by Visser are the differences in accounting standards set by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the International Accounting Standard Board (IASB). He also brings up the question of whether Basel III solvency and liquidity requirements apply to Islamic banks or not. More often than not, Islamic banks face a competitive disadvantage if they are to apply the rules of Basel III, since, for lack of a variety of high-quality liquid assets, they are obliged to meet the rules by holding cash.

Some of the complex legal arrangements that are put in place to make Islamic finance work in non-Muslim-majority jurisdictions are illustrated in

great technical detail by *Martin Bünning* and *Aryana Rezaian*. They discuss the sophisticated legal constructions set up in Germany to allow for the introduction of Shari'ah compliant investment practices that are in line with the German regulatory framework. In this manner, these arrangements can benefit from the existing tax system, especially interest deduction in debt financing. This contribution provides first-hand evidence that, in day to day business, bridging the gap between the theory and practice of Islamic finance is a balancing act that requires sensitivity to cultural diversity as well as specialized knowledge about regulatory regimes.

Diverging views on the history, presence and future of Islamic finance are presented in the last papers of the volume. *Mahmoud El-Gamal* offers a critical account of the rise of Islamic banking since the 1970s from an economist's perspective. Thanks to the explosion of oil revenues in the Middle East, funds could be generated to fuel what El-Gamal calls "a state-sponsored capitalist-Islamism". Unlike earlier forms of socialist-Islamism, it did not threaten the post-colonial political order and allowed aspiring Muslims to affirm their identity while climbing the rungs of society. El-Gamal's thought-provoking analysis of the historical factors that contributed to the rise of Islamic finance leads to a pessimistic forecast. Decreasing revenues from petro-dollars mean that many of the states that took the lead in promoting Islamic finance are at risk of economic decline, which would inevitably compromise the future of Islamic finance, or, at least, make it evolve in different ways. El-Gamal observes a shift in paradigm from capitalist-Islamism to terrorist-Islamism, which needs to be carefully monitored by regulators. Neither aggressive anti-terror nor aggressive modernization policies should be pursued. The social and financial capital of Muslim populations struggling to reconcile tradition and modernity should not be lost, for instance by stimulating home grown models such as mutual housing cooperatives or credit unions that borrow the Islamic finance brand name. In an ideal world, El-Gamal thinks, Muslims should be taught "that there is nothing intrinsically un-Islamic about modern financial practices." A compromise view on the historical development and future perspectives for Islamic finance is nevertheless offered by *Amel Makhlouf*. She takes a longer view on the development of Islamic trade and finance, arguing that these faith-based forms of commerce and banking will continue to be successful, as they once did in the medieval period, long before the age of the petro-dollars.

In conclusion, this volume offers contributions by outstanding scholars and practitioners in the field that reveal the complexities involved in applying religious principles and legal theory to the daily practice of business and finance. A fruitful dialogue has been created between lawyers, theologians, and economists from academia and practice who hold diverging views about the present state and the future of Islamic finance. Many papers clearly show that there is still growth potential for Islamic finance in the Western world,

not only among Muslim clients but also among non-Muslims looking for alternative investment instruments. As several speakers and attendants have indicated during the conference, Islamic finance has an important role to play in stimulating environmental and social impact investing.<sup>3</sup> From a European perspective, though, the “hype” about economic finance nevertheless appears to belong to the past. In the wake of the 2008 financial crisis, several political leaders in the UK, France and Luxemburg made big public statements about their desire to turn their financial centres into the European capital of Islamic finance. Islamic finance was at some point even thought to be crisis-proof, despite later evidence to the contrary.<sup>4</sup> A decade on, the political climate has shifted considerably, even if Western European countries such as Belgium continue to explore ways to integrate Islamic banking into the conventional financial system.<sup>5</sup> Prospects for Islamic finance in countries such as Malaysia, Iran, Saudi Arabia, Kuwait, United Arab Emirates, Indonesia, Pakistan and Egypt remain of a wholly different order, though, than in Europe or the United States. While the latest Global Islamic Finance Report indicates slowing growth rates for the sector even in those countries, the Islamic finance sector continues to flourish in large parts of Southern Asia, the Middle East and Northern Africa. Perhaps, then, there is not only a growing gap between promise and performance in the Islamic finance industry, as Ibrahim Warde noticed, but also between geopolitical areas in the world economy.

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<sup>3</sup> In this regard, see R. Jaufeerally, “Islamic Banking and Responsible Investment: Is a Fusion Possible?” in W. Vandekerckhove et al. (eds.), *Responsible Investment in Times of Turmoil*, Dordrecht, Springer, 2011, 151–164; and S. Farook and R.U. Shikoh, “Integration of Social Responsibility in Financial Communities”, in K. Hassan and M. Mahlknecht (eds.), *Islamic Capital Markets: Products and Strategies*, Chichester, Wiley, 2011, 69–89.

<sup>4</sup> S. Ongena, S. Zaheer and F. di Mauro (ed.), *Islamic Finance in Europe*, (European Central Bank Occasional Paper Series, 146), June 2013, 41–47.

<sup>5</sup> See the presentations at the symposium “Islamic Banking: An Opportunity for Belgium” (Brussels, 5 December 2013), [www.financialforum.be/sites/financialforum.be/files/media/1340.pdf](http://www.financialforum.be/sites/financialforum.be/files/media/1340.pdf).