

Recent Developments

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

I. INTRODUCTION

Three decades ago, many saw Islamic finance as something of an oxymoron. Religious prohibitions on the collection of interest (*riba*) and speculative investment (*gharar*) seemed to stand in clear tension with modern economic practices, limiting Muslim consumers' ability to engage in worldwide financial markets.¹ But subsequent years of innovation have yielded financial instruments and services that are able to reproduce many of the benefits of conventional finance without violating the tenets of Islamic law, or *shari'ah*.² Increasingly popular among Muslim and non-Muslim issuers alike, these Islamic financial products are estimated to be worth as much as \$822 billion worldwide, making them a significant part of the global financial system.³ This rapid growth has not come without controversy. Critics have charged that ostensibly *shari'ah*-compliant products often mimic conventional financial products too closely, compromising the ethical principles served by *riba* and *gharar* restrictions. These disputes over *shari'ah* compliance have at times deterred Muslim consumers from purchasing disputed products and limited how broadly the products can be effectively marketed across the Islamic world.

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

1. For a more complete description of these restrictions, see FRANK E. VOGEL & SAMUEL L. HAYES, III, *ISLAMIC LAW AND FINANCE: RELIGION, RISK, AND RETURN* 71-93 (1998). Other Islamic principles encourage trade by mutual consent, promote commercial probity, emphasize the freedom of contract, and prohibit participation in immoral activities such as the production of alcohol or pornography. *See id.* at 53-69.

2. The term *shari'ah* technically refers to God's infallible divine law, while the rules that imperfect individuals develop in attempting to divine and interpret *shari'ah* are referred to as *fiqh*. While most Islamic finance rules should properly be defined as *fiqh*, *see id.* at 23-24, this piece refers to them collectively as *shari'ah*.

3. *Islamic Banking Assets Continue Double-Digit Growth: Survey*, PENINSULA (Doha), Nov. 6, 2009, <http://www.thepeninsulaqatar.com> (search for "Islamic banking assets growth").

the AAOIFI should retain its historical commitment to gradual change and consensus-building as it approaches its new responsibilities.

II. DEBATING *SHARI'AH* COMPLIANCE

Understanding the significance of the AAOIFI's recent actions requires some basic background on the interpretive debates surrounding *shari'ah* compliance. At its core, modern Islamic finance is built upon several "nominate contracts," including cost-plus sales (*murabaha*), leases (*ijara*), advance purchases (*salam*), silent partnerships (*mudaraba*), and full partnerships (*musharaka*).⁴ Each of these types of contract is accepted as legitimate under Sunni Islamic doctrine, either because it appears in the religion's holy texts or because it has been clearly approved of by prior generations of Islamic scholars.⁵ Contemporary scholars often justify these contracts on the more pragmatic grounds that they link investors' returns to tangible assets, encourage risk-sharing, and otherwise discourage *riba* and *gharar* in a manner consistent with *shari'ah*.⁶

Modern financiers have found ways of using these nominate contracts that simulate many of the characteristics of conventional financial products, allowing them to capture Muslim consumers in what some cynically call "*shari'ah* arbitrage."⁷ For example, through a *murabaha* contract, a consumer may ask a bank to make a purchase on his behalf on the condition that he later repay the cost plus an additional fee. If this fee is benchmarked to prevailing interest rates, then the transaction has the same economic effect as a conventional interest-bearing loan. While the bank retains ownership and its associated risks until repayment, use of the item purchased can be provided through an accompanying *ijara* lease or other arrangement.⁸ Complex products, such as so-called "Islamic bonds," or *sukuk*, often use several layers of nominate contracts, alongside special purpose corporate entities and other measures. In the case of *sukuk*, these help simulate the fixed payments and reliable returns on principal provided by conventional debt instruments.⁹

Defenders of *shari'ah* arbitrage typically rely on a classical formalist approach to Sunni Islamic jurisprudence, which gives great precedential weight to previously approved legal structures and practices.¹⁰ Because each

4. See VOGEL & HAYES, *supra* note 1, at 138-50, 181-200. While Shi'a Islam has its own interpretive approach to Islamic finance issues, this analysis limits itself to the more prevalent branch of Sunni Islam. For a brief comparison of Sunni and Shi'a approaches, see MAHMOUD A. EL-GAMAL, *ISLAMIC FINANCE: LAW, ECONOMICS AND PRACTICE* 19-20 (2006).

5. See EL-GAMAL, *supra* note 4, at 17-19.

6. See, e.g., MUHAMMAD TAQI USMANI, *AN INTRODUCTION TO ISLAMIC FINANCE*, at xiv-xvii (2002).

7. EL-GAMAL, *supra* note 4, at 75.

8. See VOGEL & HAYES, *supra* note 1, at 140-45. For additional examples along these lines, see EL-GAMAL, *supra* note 4, at 3-7.

9. See Michael J.T. McMillen, *Asset Securitization Sukuk and Islamic Capital Markets: Structural Issues in These Formative Years*, 25 WIS. INT'L L.J. 703, 749-58 (2008) (describing the structures of several complex *sukuk* arrangements).

10. See VOGEL & HAYES, *supra* note 1, at 42-44 (describing the "casuistic style" of classical Sunni legal reasoning). *But see* Haider Ala Hamoudi, *The Muezzin's Call and the Dow Jones Bell: On the Necessity of Realism in the Study of Islamic Law*, 56 AM. J. COMP. L. 423 (2008) (arguing that the formalist emphasis on classical doctrine serves a largely rhetorical function).

nominate contract has been accepted as *shari'ah*-compliant in the past, these individuals argue that even complex arrangements of them must be compliant as well, so long as they conform with the previously approved forms.¹¹ Many critics, however, maintain that *shari'ah* compliance should be judged by a product's functional impact on society as compared to *shari'ah* principles of social justice and risk sharing.¹²

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

III. MANAGING *SHARI'AH* COMPLIANCE RISK

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

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

11. See Ayman A. Abdel-Khaleq & Christopher F. Richardson, *New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings*, 7 CHI. J. INT'L L. 409, 411-13 (2007); Shaykh Yusuf Talal DeLorenzo, *Shari'ah Compliance Risk*, 7 CHI. J. INT'L L. 397, 405-07 (2007).

12. See Haider Ala Hamoudi, *Jurisprudential Schizophrenia: On Form and Function in Islamic Finance*, 7 CHI. J. INT'L L. 605, 619-21 (2007).

13. Several prominent pan-Islamic organizations, such as the Organization of the Islamic Conference, address contentious subjects in Islamic law through treatises and collective rulings. While their opinions are widely respected, they are also rare and not necessarily authoritative. See MOHAMMAD HASHIM KAMALI, *SHARI'AH LAW: AN INTRODUCTION* 255-57 (2008).

14. See VOGEL & HAYES, *supra* note 1, at 34-41.

15. See *id.* at 36-38 (describing concerns over patching, or *talfiq*).

16. See KAMALI, *supra* note 13, at 162-66. *But see* Robert R. Bianchi, *The Revolution in Islamic Finance*, 7 CHI. J. INT'L L. 569, 577-80 (2007) (describing how the "democratization of religious thought" happens as lay Muslim consumers' purchasing power gives their perspectives greater significance).

17. See DeLorenzo, *supra* note 11, at 397.

accept the board's position, most try to include scholars with widely recognized religious qualifications from a diverse array of jurisprudential perspectives.¹⁸ That said, the rapid growth of the Islamic finance industry has created a shortage of qualified Islamic scholars in recent years, stretching scholars' availability and forcing some institutions to rely increasingly upon lay experts.¹⁹

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

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

18. See *id.* at 399-402.

19. See Alexia Garamfalvi, *Islamic Scholars Play Role in High Finance*, LEGAL TIMES (Wash., D.C.), Apr. 30, 2007, at 13.

20. See *Who Regulates the Islamic Finance Sector?*, REUTERS, Apr. 13, 2009, <http://www.reuters.com/article/idINKLR44252720090413>. For additional information on the history of the AAOIFI and IFSB, their recent activities, and examples of their standards, visit their websites. Accounting and Auditing Organization for Islamic Financial Institutions, <http://www.aaofi.com> (last visited Nov. 28, 2009); Islamic Financial Services Board, <http://www.ifsb.org> (last visited Nov. 28, 2009).

21. See Tarek S. Zaher & M. Kabir Hassan, *A Comparative Literature Survey of Islamic Finance and Banking*, FIN. MARKETS, INSTITUTIONS & INSTRUMENTS, Nov. 2001, at 155, 185-187 (surveying regulatory approaches to Islamic finance).

22. See DeLorenzo, *supra* note 11, at 401.

23. See Bianchi, *supra* note 16, at 575-76.

24. See EL-GAMAL, *supra* note 4, at 86-89 (describing the two regions' different approaches to *salam*, or futures). But see Liau Y-Sing & Tom Freke, *As Scholars Quibble, Sharia Banks Eye Convergence*, REUTERS, Apr. 17, 2009, <http://www.reuters.com/article/idUSTRE53G14X20090417> ("Malaysia shows signs of tempering its market-driven approach to please cash-rich but conservative Middle East investors.").

IV. THE AAOIFI'S PROPOSED NEW REGULATORY ROLE

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

This interpretation is informed by the AAOIFI's actions during a recent controversy surrounding the *shari'ah* compliance of certain types of *sukuk*. In an influential 2007 paper, the Chairman of the AAOIFI's *Shari'ah* Board, Sheikh Muhammad Taqi Usmani, argued that *sukuk* that guaranteed purchasers interest-free loans and repurchase agreements in cases of missed payments or default were not *shari'ah*-compliant, as they effectively tied an investor's returns to the creditworthiness of the issuer instead of the value of the underlying assets in violation of *gharar* restrictions.²⁹ Later that year, Usmani made public statements that as much as eighty-five percent of the world's *sukuk* could be *shari'ah*-noncompliant due to these and other measures, triggering an intense controversy.³⁰ After several months of debate, the AAOIFI confirmed much of Usmani's analysis and issued new *sukuk* guidelines prohibiting these practices.³¹ Tellingly, these guidelines also admonished the *shari'ah* supervisory boards that had permitted such activities, reasserting their duty to "make sure that the operation complies, at every

25. *AAOIFI To Monitor Shariah Products*, REUTERS, Oct. 10, 2009, http://www.business24-7.ae/Articles/2009/8/Pages/09082009/08102009_af046d1da5cd49bb9d0cab506b826ef4.aspx (quoting a statement by Mohamed Nedal Alchaar, Secretary-General of the AAOIFI).

26. *Id.*

27. *Id.*

28. *See Islamic Finance Growth Seen 10-20 Pct in 3yrs—Study*, REUTERS, Oct. 15, 2009, <http://www.reuters.com/article/idUSLF70613620091015>.

29. *See* Muhammad Taqi Usmani, *Sukuk and Their Contemporary Applications* 7-13 (2007) (unpublished manuscript), available at http://www.failaka.com/downloads/Usmani_Sukuk_Applications.pdf; *see also* Farmida Bi, *AAOIFI Statement on Sukuk and Its Implications* (Sept. 2008), <http://www.nortonrose.com/knowledge/publications/2008/pub16852.aspx>.

30. *See Islamic Bond Rules May Be Reviewed*, GULF DAILY NEWS (Bahr.), Nov. 22, 2007, <http://www.gulf-daily-news.com/NewsDetails.aspx?storyid=200624>.

31. *See* Accounting & Auditing Org. for Islamic Fin. Inst. (AAOIFI), *Clarification of the AAOIFI Standards Concerning Sukuk* (Feb. 2008), http://www.aoifi.com/aoifi_sb_sukuk_Feb2008_Eng.pdf.

stage, with [*shari'ah*] guidelines and requirements.”³² As Alchaar later described, these actions effectively “wrecked the market”³³ for *sukuk*, leading to a decrease in overall issuances and a dramatic shift toward less controversial *ijara*-based *sukuk* structures. As institutions feared that consumers would react negatively to the AAOIFI’s public censure, they rallied market forces that effectively curbed the offending practices and triggered a more widespread reevaluation of *sukuk* standards by issuers.³⁴

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

V. IMPLICATIONS FOR THE ISLAMIC FINANCE INDUSTRY

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

Yet there are signs that some influential figures within the AAOIFI feel that such a strong stand is necessary. Most notable among them is Sheikh Usmani. In his 2007 paper on *sukuk*, Usmani noted that Islamic scholars’

32. *Id.* at 4.

33. Jason Benham, *Islamic Bond Market ‘Wrecked’ by Critical Remarks*, ARABIANBUSINESS.COM, Oct. 29, 2008, <http://www.arabianbusiness.com/536401-islamic-bond-market-wrecked-by-critical-remarks> (quoting a statement by Mohamed Nedal Alchaar, Secretary-General of the AAOIFI).

34. See Daliah Merzaban, *Scholar Critique Spurs Ijara Islamic Bond*, REUTERS, Apr. 15, 2009, <http://www.reuters.com/article/idUSTRE53C0ZX20090415>.

35. See, e.g., Lahem al Nasser, *Imitating Traditional Banking Will Destroy Islamic Banking*, ASHARQ ALAWSAT (London), Nov. 28, 2009, <http://aawsat.com/english/news.asp?section=6&id=18957>.

36. *Lack of Sharia Standard Limiting Islamic Funds—BNP*, FORBES.COM, Sept. 13, 2009, <http://www.forbes.com/feeds/afx/2009/09/13/afx6879191.html> (quoting a statement by Jacques Tripon, Global Head of Islamic Banking, BNP Paribas).

37. For a survey of industry perspectives on convergence, see Karen Remo-Listana, *Islamic Finance Standardisation Needs To Be Tackled Carefully*, EMIRATES BUSINESS 24/7, Oct. 25, 2009, <http://www.business24-7.ae> (search for “Islamic finance standardisation”).

leniency on many matters of *shari'ah* compliance had been intended to permit the industry to innovate and grow in its difficult early years, when it had to compete directly with conventional finance. But now that the industry has come into its own, Usmani argues, Islamic institutions should “cooperate among themselves for the purpose of developing authentic products that . . . serve the higher purposes of Islamic law” more than economic interests.³⁸ Usmani saw his position on *sukuk* as a reflection of this need to push the industry toward higher standards, a need that has been echoed in postfinancial crisis rhetoric.³⁹

The AAOIFI's new regulatory authority could be a potent tool for those wishing to push Islamic finance out of its infancy and toward more rigorous standards. But employing it too aggressively will deter innovation and thus make Islamic financial products increasingly inefficient compared to conventional products. As this efficiency gap increases, marginal Muslim consumers willing to purchase conventional ones if they offer significantly better terms may effectively get priced out of the Islamic market. Not only would this weaken the impact of the AAOIFI's censure, but some institutions might also find it more profitable to buck the AAOIFI and adopt less demanding standards that capture these marginal consumers. Ironically, this could result in the very outcome that the AAOIFI is intended to counteract: fragmentation along interpretive and regional lines.⁴⁰

VI. CONCLUSION

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

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

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

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