What went wrong? Credit crisis and Islamic finance

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'The Islamic finance industry is not immune from the global downturn that occurred in conventional banking. It has its own successes and failures.'

THE ISLAMIC FINANCE AND BANKING industry has experienced tremendous development in the past three decades. The innovation of various new products and instruments has been a symbol of creativity and interaction between banking consumers, Muslim scholars, bankers, and accounting and legal practitioners. What began as a pioneering idea has now become a well-known industry that has accelerated the growth of developing countries in South-East Asia, Pakistan and the Middle East. It has evolved from being a faith-based solution to a sophisticated financing technique that is increasingly popular.

GROWTH AND DECLINE

One of the motivations of the Islamic finance and banking industry is to move away from the mould of conventional banking and develop its own market, system and philosophy. A few countries, such as Bahrain, Qatar, Malaysia, Saudi Arabia, Kuwait and the UAE, have leapt forward in developing a special legal regime and market for Islamic finance at a domestic level. Rules, policies and *fatwa* have been improved to keep the techniques and application of Islamic finance products as close as possible to its scholastic theories. The Islamic finance industry has grown by 20% annually over the past few years and estimates of its current assets range from $700bn to $1 trillion. Growth of the *sukuk* market alone was at 49% in 2005, 153% in 2006 and 79% in 2007. Judging by its steep growth and innovation, some industry observers claimed that Islamic finance has successfully separated itself from the traditional banking industry.

However, by the fourth quarter of 2008 the Islamic finance industry worldwide saw a dramatic decline when compared to its phenomenal rise. The decrease continued in the first half of 2009, at 22% less than 2008. It was then followed by two *sukuk* defaults in the Middle East region and more *sukuk* defaults worldwide, despite *sukuk* being trumpeted for years as having not known a single default. These statistics show that the Islamic finance industry is not immune to the global downturn that occurred in conventional banking and that it is changing into a more accessible system of financing, with its own successes and failures.

What went wrong? How can Islamic finance products suffer turmoil in a conventional banking crisis? Does the Islamic finance method not emphasise mitigating risk, real asset trading, actual ownership and sound business venture (which should avoid speculative and uncertain business ventures and risky financial techniques, such as short selling and derivatives)?

It might be argued that the exaggerated reliance of Islamic financial products on assets, especially real estate assets when such assets were in a decline worldwide, prompted defaults and a lack of interest. A perfect example is the Nakheel *sukuk*, which had underlying real estate assets in Dubai. When the value of these assets went sour, the company could not afford to pay back its *sukuk* by the redemption date.

Therefore, Islamic financial practitioners must be creative to attract investors back to Islamic finance. Creativity should, of course, not be in opposition with the spirit of *Sharia*, and practitioners should be allowed to interpret and be creative within this context.

An example of bold innovation is Malaysia's secondary *sukuk* market, which is based on the principle of *bay al-dayn* (sale of debt). Across the Middle East regions a sale of debt by a creditor to a third party in consideration of monetary value is not allowed unless it is made instantly and at par, hindering the establishment and development of a secondary *sukuk* market in the Middle East. However, the *Sharia* Advisory Council of the Securities Commission Malaysia took a different position based on two points. First, as *sukuk* is a securitised debt it, is also a form of asset (*mal*) or a financial right (*haq mali*) that is able to be sold and bought at any agreed price between the parties. Secondly, the securitised debt is analogous to an asset-backed financial right, such as shares, copyright and patent right, and is no longer similar to money. As such, sale of *sukuk* is not governed by the rules of money exchange. Based on these two considering the sale of debt is permitted in Malaysia and, as a result, Malaysia has, so far, the single largest *sukuk* secondary market in the world, which encourages issuance of its domestic *sukuk* that now stands at 62% of the world's outstanding *sukuk*.

With this in mind, one of the most controversial statements on the current conditions of Islamic financing was that made by prominent *Sharia* judge and scholar Sheikh Taqi Usmani in 2007, who highlighted that almost 85% of the equity-based *sukuk* in the market is not *Sharia*-compliant due to the use of purchase undertaking to secure a capital guarantee. Although later sources reported that he was misquoted. Whether such a restrictive statement assists the growth of Islamic finance industry or whether it hinders it must be evaluated, especially when the Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI) subsequently stated that redemption undertaking is allowed. However, it should be in accordance with the Islamic nature of a transaction related to risk and reward. In particular, the purchase can be based on the net value of the assets, their market value, fair value or a price to be agreed at the time of their actual purchase.

Another area that needs improvement is the over-reliance on debt-based financing structures. Surveys in the past five years indicate that the majority of financing techniques used by Islamic banking were on debt-based contracts. Although these techniques are *Sharia*-compliant, the creation of more debt by consumers has an adverse effect on society at macro level, especially where it involves long-term project financing or businesses related to new technology, research and development. This is due to the burden of serving a series of fixed payments to the banks, irrespective of the situation of the consumers' businesses and projects.

Scholars of Islamic finance have long argued that Islamic banks should move from debt to equity financing, which provides more opportunities for businesses to grow and survive and which, in turn, enhances the likelihood of a successful outcome for the banks. It will be interesting to see if Islamic banks are willing to take such a bold step to structure a product by moving away from their traditional regime as creditors. (It should not be considered that buying a company share is, in essence, buying a call option, because equity is a call option on the value of the firm. Therefore, this is a different view of derivatives, and an open and new horizon for Islamic derivatives.)

FURTHER READING

What went wrong? Western Impact and Middle Eastern Response, Bernard Lewis (Oxford University Press, 2002).

'The final authority in interpreting and deciding any legal issues under Islamic finance contracts is still in the hands of local judges who may not have a full understanding of* Sharia *principles.'

LACK OF HARMONISATION

The world is increasingly integrated and globalised due to the advancement of communication and transportation technologies. Financial and banking markets can no longer work in isolated jurisdictions shielded from the rest of the world. Looking at the growth of the Islamic finance industry in its frontier regions, such as the US and in European countries, it is obvious that there should be an authority, not only that sets the standards on *Sharia* principles and financing techniques, but that is also empowered to regulate the legal and *Sharia* issues pertaining to Islamic finance worldwide.

At present, Islamic finance principles are governed by the rulings of individual *Sharia* scholars, domestic banking and securities authorities, and local courts. International bodies, such as Islamic Finance Service Board (IFSB) and AAOIFI, have been actively organising seminars and publishing standards for market practitioners. However, not many countries accept the standards issued by AAOIFI as being mandatory. As a result, a difference of opinion on acceptable Islamic finance principles still exists between countries. It is also interesting to note that the final authority in interpreting and deciding any legal issues under Islamic finance contracts is still in the hands of local judges who may not have a full understanding of *Sharia* principles.

As the world is unified by the impact of the financial crisis, countries with an Islamic finance industry should work together in accepting and implementing standards and regulations from one regulator. Perhaps a mechanism, such as a legal requirement for a court to seek an expert opinion from an international Islamic finance regulator, can be incorporated into the countries' justice system.

Another aspect that requires innovation is harmonisation by way of standard contracts and general conditions. As Islamic finance practice evolves alongside various legal systems in the world, there is a greater need for the terms and conditions of *Sharia*-compliant documents and products to have universally accepted general terms and conditions for particular financing techniques. For example, the general terms and conditions of a *wakala* contract, which are legally enforceable and recognised in Dubai as *Sharia*-compliant, should enjoy the same position if they are used in New York.

Indeed, the need for a high-quality standard of documentation cannot come too soon, considering a growing trend in legal defence by consumers of Islamic finance products to avoid payment obligations by arguing that the financing contracts that they have signed are not *Sharia*-compliant, mainly due to loopholes or the style of wording in the terms and conditions of the contracts, as well as the financing techniques used. Such arguments have been used in English courts, for example, *Beximco Pharmaceuticals Ltd & ors v Shamil Bank of Bahrain EC* [2004] and *The Investment Dar Company KSCC v Blom Developments Bank SAL* [2009]. In *Beximco* the defendants argued that the *Murabaha* agreement and the exchange in satisfaction and users agreements (ESUAs) were unlawful, invalid and unenforceable under the principles of *Sharia* because they were loans disguised with interest. Similarly, in *Investment Dar* the defendant's contention was that the *wakala* agreement was not in compliance

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with *Sharia* because Investment Dar was taking the deposit with the interest. The defendants' lawyers in both *Beximco* and *Investment Dar* constructed their arguments around the interpretation of certain clauses in the contracts.

Although the judges in *Beximco* chose not to discuss the *Sharia* principles in dispute, the fact remains that the defendants' lawyers challenged certain clauses used in the *Murabaha* agreement and the ESUAs. However, in *Investment Dar* the defendant's lawyers succeeded in convincing the judges to overturn a summary judgment on a lesser point that the *wakala* agreement was not in compliance with *Sharia*. The final outcome of *Investment Dar* is yet to be seen. The conclusion may mark another bad turn that could have been avoided by having a set of high-quality standards for general terms and conditions.

Could *Sharia* risks in *Beximco* and *Investment Dar* have been mitigated by having standard clauses and closing procedures that are recognised worldwide, similar to the International Commercial Terms (Incoterms) as published by the International Chamber of Commerce?

It may be considered, however, that to allow these Islamic financial institutions and their lawyers to submit such arguments in a court of law for whatever reasons they might have is scandalous and might cause irreparable harm to the Islamic finance industry.

MORE LESSONS

The recent *sukuk* defaults in Kuwait, the US, Malaysia and the Middle East serve as a reminder for Islamic finance practitioners and investors that existing products, techniques and systems require improvement and further innovation. It is evident that Islamic finance is not immune from financial crisis and business risks. One of the issues that needs to be addressed, pursuant to the defaults, is how various legal systems interpret and handle the recovery mechanism for *sukuk* investors on the assets and businesses underlying the *sukuk*. The Chapter 11 (of the US Bankruptcy Code) reorganisation of East Cameron Partners will be a valuable case study on the treatment of *musharaka*-type *sukuk* ($165.67m *sukuk* issued in 2006 by East Cameron Partners) under US insolvency law. It is also interesting to see, especially in the Gulf Cooperation Council (GCC), how English law deals with legal issues claimed under *sukuk* default litigation, since majority of GCC *sukuk* is governed by English law. What will be the conflict between the rulings of the English courts and its enforcement in one of the GCC jurisdictions where the assets and businesses are located? These countries might have jurisdictional restrictions, as for example in the UAE, where its courts are empowered to reject a foreign judgment if it considers that the UAE court has the competency to decide on the subject matter of the foreign judgment, especially in the event of real estate assets.

Now is a good time to reflect on the various aspects of Islamic finance that could go wrong and to co-operate for better solutions in the future.

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Beximco Pharmaceuticals Ltd & ors v Shamil Bank of Bahrain EC [2004] EWCA Civ 19

The Investment Dar Company KSCC v Blom Developments Bank SAL [2009] EWHC 3545 (Ch)