

# The Moralisation of Contracts: An Islamic Perspective

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In the wake of the 2008 Global Financial Crisis (GFC), perhaps the greatest downturn of the global economy since 1929, many Islamic financial professionals were ready to claim that history had proved the divine footprint of Islamic Finance principles and *Shari'ah* at large. Not a single Islamic Financial Institution (IFI) was impacted by the collapse of subprime mortgage bonds and the cascading effects it generated at a systemic level among the network of banks which were exposed to highly leveraged markets blighted with toxic assets, derivatives and all sorts of complex financial devices which were structured in Western countries and which shifted the object of their investments too far from the real economy.

Today Islamic Finance assets are worth \$2.2 trillion dollars

worldwide and are forecast to reach nearly \$4 trillion by 2022 (The Business Debate, May 2018). Targeting a market of approximately 1.6 billion Muslims around the world and offering their services to non-believers as well, Islamic Finance firms have reached Western countries, with major European hubs in France, Germany and the UK. They are currently competing, albeit quietly and not always holistically, with conventional financial institutions (The Economist, October 2018).

This paper will focus on the analysis of Islamic Finance theory and practice as opposed to conventional finance. If we are to investigate the financial service's industry's ethical drivers, or debate their shortcomings, then it is worth confronting them with a model that

Au lendemain de la crise financière mondiale (CFM) de 2008, peut-être le plus grave ralentissement de l'économie mondiale depuis 1929, de nombreux professionnels de la finance islamique étaient prêts à affirmer que l'histoire avait prouvé l'empreinte divine des principes de la finance islamique et de la Charia en général. Pas une seule institution financière islamique (IFI) n'a été touchée par l'effondrement des « subprimes » ni par les effets en cascade qu'il a générés au niveau systémique via les banques fortement exposées aux actifs toxiques, aux produits dérivés et à toutes sortes de mécanismes financiers complexes. Ces derniers ont tous été structurés dans les pays occidentaux lesquels ont déplacé l'objet de leurs investissements beaucoup trop loin de l'économie réelle.

proudly declares itself an alternative to Western secular finance by being founded on the moral principles of the Islamic faith and *Shari'ah*.

As Islamic Finance has gained momentum since 2008, questions have arisen about whether *Shari'ah*-compliant financial services firms provide for greater ethical awareness and outcomes in their business practices. Could the GFC have been avoided if the financial services industry observed *Shari'ah* principles? How will IFIs react when the risk of default materialises?

To answer these questions I will first explain the pillars on which Islamic financial regulation is based. I will then move on to showcasing how Islamic financial practitioners and jurists have worked towards the creation of *Shari'ah*-compliant financial products. In this regard, *Shari'ah* scholars play a crucial role in that each Islamic financial services firm must appoint a board of *Shari'ah* experts who will ultimately judge the permissibility of the products and services offered by the industry. As I will show, the ethicality of the Islamic Finance industry is located in the structuring phase of a deal, what I like to call the Moralisation of Contracts. In that sense I maintain that the Islamic model of capital financing is inherently formalistic; it cannot ensure that the morality of agents will follow from the morality of contracts. In the last sections the case of Dana Gas default procedure will be presented to support the

arguments discussed in this paper and to outline the ethical issues that may face Islamic Finance when exposed to a specific type of risk that does not affect conventional financial firms: namely *Shari'ah* non-compliance risk.

## Islamic Finance Pillars

The complexities of Islamic normative and ethical frameworks are mainly the outcome of what has been referred to by sociologists and philosophers as legal pluralism, a phenomenon reflecting the coexistence of multiple legal or normative authorities and sources of law within a given region or state. Malaysia is a good example of a plural legal system where the federal constitution provides for a dual legal framework of *Shariah* laws applying to Muslim citizens and secular criminal and civil laws applying to non-Muslims.

The definition of *Shari'ah* is itself problematic due to the constant tension between its interpretive and literary nature. As will be shown, this tension is the fulcrum of current debates among traditionalists and reformists in Muslim countries.

There are four main sources of *Shari'ah* commonly reported in Islamic law texts: the *Qur'an*, the *Sunnah* (practice) of the Prophet, *Ijma'* (Scholarly Consensus) and *Ijtihad* (Independent Juristic Reasoning). While the *Qur'an* provides basic principles regarding how life on earth is to be lived, the *Sunnah* demonstrates through

Alors que la finance islamique gagne du terrain depuis 2008, des questions se posent quant à savoir si les sociétés de services financiers conformes à la Charia accordent une plus grande considération à l'éthique dans leurs pratiques commerciales. La CFM aurait-elle été évitée si le secteur des services financiers avait suivi les principes de la Charia ? Comment les IFI vont-elles réagir lorsque le risque de défaillance se matérialisera ?

the Prophet's practice how these principles are to be implemented. As reported by Abdur Rashid Siddiqui, *Ijma* and *Ijtihad* are often grouped together to represent a legal term which refers to the use of reason and judgement to determine *Shari'ah* rulings (Siddiqui 2018). These come into operation when both the *Qur'an* and the *Sunnah* are silent on a particular issue. Nowadays small groups of scholars and jurists may reach a consensus over a specific topic; however this consensus will only be accepted globally when an assembly of world-renowned jurists and scholars endorses it.

Islamic law with regard to Islamic Finance is mostly defined as *fiqh*, or Islamic jurisprudence. This definition has its origins in the colonial era when *fiqh* was institutionalised as the authoritative approach to Islamic law by European scholars and became the dominant form of applied religious knowledge in contemporary Islamic finance (Rudnycky 2019). *Fiqh* is often described as the human understanding of the *Shari'ah*. Whereas *Shari'ah* is considered immutable and infallible by Muslims, *fiqh* is considered fallible and changeable. As will be shown, changes in the interpretation of a specific aspect of *Shari'ah* will not come without ethical concerns regarding the general practice of the Islamic Finance industry.

## Justice in Exchange: Islamic and Christian Views on Trade

In order to understand how Islamic finance is structured, consideration must be given to a number of principles defining the philosophy that underlies transactions and exchanges in Muslim countries.

In a lecture at the University of South Australia (2013), Professor Mervyn Lewis traces back the philosophy of transactions to the anthropological aspects of Muslim and Christian societies and explains how these aspects led to an earlier development and definition of justice in exchange in the former.

Christianity developed in feudal societies, where most transactions were in kind and the Church was a major land owner which accounted for 50% of production. By contrast, Islam was born in the merchant towns of Arabia; exchange and market transactions were therefore an everyday part of life. In this regard, one of the most popular passages from the Bible is emblematic, describing Jesus's reaction towards the merchants in the Temple: "The crowds replied, 'This is Jesus, the prophet from Nazareth in Galilee.'" Then Jesus went into the temple courts and drove out all who were buying and selling there. He overturned the tables of the money changers and the seats of those selling doves. And He declared to them, 'It is written:

La définition de la charia est problématique en raison de la tension constante entre sa nature interprétative et littérale. Cette tension est le pivot des débats actuels entre traditionalistes et réformistes dans les pays musulmans. La loi islamique en ce qui concerne la finance islamique est principalement définie comme fiqh, ou jurisprudence islamique. Le fiqh est souvent décrit comme la compréhension humaine de la charia. Alors que la charia est considérée comme immuable et infaillible par les musulmans, le fiqh est considéré comme faillible et changeant.

‘My house will be called a house of prayer.’ But you are making it ‘a den of robbers.’” (Gospel of Matthew 21:12).

Conversely, a market economy existed in Muslim countries; therefore, Islam had to come to terms with the market and so the principle of justice in exchange was defined: “trading was extolled, the forms of unjust exchange elucidated and a system of just exchange was mandated” (Lewis 2013). Licence to trade culminates with the verses in *Surah AL-Baqaran*, the second and longest chapter of the *Qur’an*: “Those who devour usury (*riba*) shall not rise again [on the Day of Resurrection] except as he rises, whom Satan of the touch prostrates; that is because they say, ‘Trade is like usury (*riba*).’ But Allah has permitted trade, and forbidden usury (*riba*).” (*Qur’an* 2:275).

In the first place, Islam does not recognise the time value of money. A dollar is worth the same today as it will be worth in three months’ time, should one decide to lend it to a borrower. Money is not to be seen as a commodity either; when purchasing and selling products, money does not change hands until the item being purchased is delivered.

Closely linked to this principle is the *Qur’an*’s strict prohibition against the collection of interest or *riba*, which is sometimes also translated as usury or exploitation. This prohibition originates from the belief that money and profits

are earned. To charge interest is considered an unrighteous gain since the financial institution is only profiting from its ability to lend money.

The third main principle is the avoidance of *gharar*, often referred to as uncertainty or hazard and any activity linked to gambling and speculation. When entering an Islamic contract, the price, quantity, and time of payment must be known in advance by the parties. It is therefore no wonder that many of the products and practices currently accepted in Western countries, such as futures, derivatives, short-selling, interest-bearing products and even money market devices are not tolerated in Muslim countries.

Last but not least, pious Muslims cannot invest in products that are considered *non halal* like alcohol, drugs, tobacco and certain foodstuffs.

### No Risk No Gain: Unconditional Rewards and other Dangerous Aspects of Debt-Based Economies

Islamic Finance professionals seem to locate the root cause of detachment from the real economy in the practice of lending at interest.

The main objection against *riba* is that it represents a gain that is fixed and certain in exchange for what is uncertain, such as the success of a venture. A financier will still be entitled to claim returns even if the venture fails. As will

be shown, this sets the ground for a major *moral hazard*. There are at least 12 verses in the Qur'an dealing with *riba*, with the very first one claiming: "And what you give in usury (*riba*), that it may increase upon the people's wealth, increases not with God". (*Qur'an* 30:39).

This verse suggests that an economy based on interest will only make the wealthy wealthier and the poorer, poorer. It basically keeps on strengthening the position of stakeholders who are already favoured in contractual terms.

Islamic Finance professionals provide additional reasons why lending at interest is considered morally unjust and dangerous. As they argue, conventional lending institutions can be defined by the practice of *risk transfer*. Despite benefitting from several years of low tax regimes, Western banks have always sought ways to minimise their risk exposure to the detriment of customers, requiring collateral in exchange for credit, as well as to the detriment of tax payers if they need a government bail-out. In a landscape where profits are certain and losses are almost always compensated by collateral or public funds, it is no wonder that secular financial institutions have crossed so many lines. This is the moral hazard that follows in an economy heavily reliant on interest-linked products.

Instead, a more balanced exposure to risk will result in greater moral consideration and outcomes as outlined in the legal maxim *Al-*

*ghurm bil ghunm*, or "There is no reward without risk."

Interestingly the assumption of risk plays the role of a moralising agent in Islamic Finance. As will be shown in the next section, every contract, to be considered *Shari'ah*-compliant, must elucidate the elements of risk undertaken by the signatories.

### Shari'ah-Compliant Debt: A question of *Maquillage*?

To circumvent the limitations imposed by *Shari'ah* on interest, models of financing based on debt have been structured in the form of a sales contract that allows lending institutions to make a profit rather than collecting a fixed income.

There are three major ways Islamic Finance can structure a loan that is compliant with *Shari'ah* rulings: *Murabaha*, a sales contract where a bank will purchase an asset on behalf of its clients and sell it back at a mark-up price on a deferred payment basis; *Ijarah*, generally defined as an operational lease, where ownership of the tangible asset remains with the lessor, usually a bank that purchases a good, its usufruct being transferred to the lessee for specified rental payments incorporating profits; and *Sukuks* or Islamic Bonds, which are financial certificates defined by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) as securities of equal denomination representing individual ownership interests in

La stricte interdiction faite par le Coran concernant l'intérêt ou *riba* – traduits aussi parfois comme usure ou exploitation – découle de la conviction que l'argent et les profits sont gagnés.

a portfolio of eligible existing or future assets. The *Fiqh* academy of the OIC (Organisation of Islamic Cooperation) legitimised the use of *Sukuk* in February 1988 (Wikipedia). The risks assumed in these types of contract are the ones associated with the sale of a commodity for money in the case of a *Murabaha* structure or the termination of a lease and duty of repair which the lessor is committed to in an *Ijarah* deal.

The most popular *Sukuks* are those structured in *al-ijarah* contracts where the Originator holds assets that are the basis of return, the assets are then sold to a Special Purpose Vehicle (SPV) and leased back. SPVs sell *Sukuk* certificates to investors. Each certificate represents a share in ownership of the assets. Periodic distributions are paid to investors from rental revenues. This type of instrument is also transferrable at a mutually negotiated price, thereby allowing secondary market trading. These products can nowadays provide returns that are fixed like any interest-based instrument.

It comes as no surprise that, insofar as Islamic financial devices have been developed to replicate the performance of conventional finance products, many academics and *Shari'ah* scholars have fiercely criticised the massive use of debt-based products and the formalist approach of Islamic financial practitioners that define as permissible any action or object not explicitly forbidden by the scriptures. Criticism comes in different

wordings, from the more politically correct “*Shari'ah-Compliant*” as opposed to *Shari'ah-Based*, to “*Creative Shari'ah Compliance*”, which appeared in a recent publication by Ahmad Alkhamees (2017), to the more explicit attack of Rumees Ahmed in his publication “*Shari'ah compliant: a user's guide to hacking Islamic law*“(2018).

### Authenticity: A Debate on Substance for the Islamic Finance Industry

Supporters of a reformist approach have sought ways to reach beyond form to substance, lamenting the fastidious attention paid towards formal aspects of *Shari'ah* in the Islamic Finance industry, which has practically turned into the *halal* equivalent of its Western counterpart without showing significant differences in the way capital is being financed. As they claim, in order to tackle substantive aspects of Islamic Finance, the industry should be grounded in the wisdom revealed by *Shari'ah* and its objectives, a concept known as *Maqasid al Shari'ah*.

The best definition of the objectives of *Shariah* was provided by a prominent XII century theologian, philosopher and jurist of Islam: “The very objective of the *Shari'ah* is to promote the well-being of the people, which lies in safeguarding their faith (*deen*), their lives (*nafs*), their intellect (*naql*), their posterity (*nasl*) and their wealth (*mal*).

Les établissements de crédit conventionnels peuvent être définis par le transfert de risque qu'elles réalisent. Bien que bénéficiant depuis plusieurs années de régimes fiscaux avantageux, les banques occidentales ont toujours cherché des moyens de minimiser leur exposition au risque au détriment de la clientèle, en exigeant une garantie en échange d'un crédit, ainsi qu'au détriment des contribuables en cas de nécessité d'un renflouement gouvernemental. Dans un paysage où les profits sont certains et les pertes presque toujours compensées par des garanties ou des fonds publics, il n'est pas étonnant que les institutions financières laïques aient franchi tant de limites.

Whatever ensures the safeguarding of these five serves the public interest and is desirable, and whatever hurts them is against the public interest and its removal is desirable.“ (Abu Hamid al-Ghazali d.1111 CE) Models of financing based on participatory exposure to risk in the Profit and Loss Sharing (PLS) model, via means of equity-based instruments, have been endorsed as truest to the principles of Islamic faith, drawing from the renewed interest in *Maqasid al Shari'ah* and linking it to the fundamental principle of 'no risk, no gain' underlying Islamic transactions.

The most commonly used contracts in the form of Profit and Loss Sharing are:

1. *Mudaraba*: an investment partnership whereby the *Rab ul Mal* (investor) provides capital to the *Mudarib* (entrepreneur) in order to undertake a business activity. While profits are shared on a pre-agreed ratio, loss of investment is borne by the investor only and the *Mudarib* loses its share of the expected income and the time/ work invested in the commercial project.
2. *Musharaka*: a joint enterprise or partnership structure in which partners share in both the profit and losses of an enterprise. This contract allows for the financier to achieve a return in the form of a portion of the actual profits earned according to a pre-determined ratio.

*Mudaraba* and *Musharaka* are seen as structures that are truly compliant with the Islamic principle of risk sharing, in that only the ratio for profit is guaranteed. However, revenues mainly depend on the performance of the business which cannot be known in advance. These models should represent the major source of capital financing according to Muslim reformists. Nonetheless, studies have shown how PLS has gradually declined in use to 6.34% of total financing, down from 17.34% in 1994-6 (Khan M. Mansoor & M. Ishaq Bhatti).

There are obvious reasons why PLS contracts have proved hard to implement compared with debt products. Firstly, in order to allow a wide distribution and usage of these modes, Islamic banks have to turn into venture capital platforms and apply specialised accounting and reporting skills that are typical of private equity firms. Such processes are notably costlier and time-consuming compared with debt-based instruments.

Secondly, PLS structures cannot effectively meet industry demands for project financing, home financing, liquidity management and consumer credit. Last but not least, due to information asymmetry between the financier and the entrepreneur, the moral hazard shifts onto the latter, who may report less profit to the bank than they have actually earned in order to keep a greater revenue stream for themselves.

## When Things Go Bad: Testing the Ethical Resilience of Islamic Finance

A detailed analysis of the arguments provided by both Islamic traditionalists, who support the issuance of debt-based instruments, and by Islamic reformists, who endorse models of financing based on the participatory exposure to risk via means of equity-based products, leads to the conclusion that the ethicality of the industry is located in the structuring phase of a deal: what I call the Moralisation of Contracts. In that sense, I maintain that both approaches are inherently formalistic and do not provide sufficient grounds for the elucidation of moral action.

Just as the financial resilience of banks is scrutinised by stress-tests, an effective way to prove the ethical resilience of this model would be to test it against distressed circumstances. If *Shari'ah*-based financial institutions were able to provide a better response in critical circumstances than their conventional counterparts, then a case could be built that Islamic Finance principles and practice are more solid than secular ones.

### Dana Gas: A Case Study on *Shari'ah* Risk and the Moral Uncertainty of Default Procedures in Islamic Finance

The case of Dana Gas, a natural gas company in the Middle East with a public listing on the Abu

Dhabi Securities Exchange (ADX), is emblematic of the debate about morality and trust in Islamic Finance. The company issued a convertible *sukuk* in the form of a *Mudarabah* contract in 2007 for a total of \$1 billion, with maturity in 2012 offering a profit rate of 7.5%. When approaching maturity, following a period of distressed circumstances, the company defaulted in October 2012 and in November 2012 announced it had reached a restructuring agreement with *sukuk* holders. Despite the restructuring agreement, the company faced a number of other critical challenges after 2012 that prevented it from fully overcoming its financial problems. Fearing that it might not be able to fulfil its payment obligations, Dana started discussions with holders about a possible second restructuring of the *sukuk* in May 2017. The terms of a second restructuring seemed less favourable for the *sukuk* holders who were less willing to let it pass without further negotiations. However, after preliminary discussions among parties and their legal representatives in the second week of June 2017, Dana Gas announced that the *sukuk* was no longer *Shari'ah*-compliant in the UAE due to changes in the interpretation of *Shari'ah*. In consequence, it would not distribute upcoming payments due to the unlawful nature of the *sukuk*.

This led to a conflict of jurisdiction in that the *Mudarabah* agreement underlying the *sukuk* structure was regulated by UAE law,

La finance islamique joue le rôle d'un agent de moralisation dans la prise en charge du risque. Une exposition au risque plus équilibrée se traduira par une plus grande considération morale et de meilleurs résultats, comme indiqué dans la maxime juridique *Al-ghurm bil ghum*, ou «Il n'y a pas de récompense sans risque.»

De la même manière que la résilience financière des banques est examinée au moyen de tests de résistance, un moyen efficace de prouver la résilience éthique de la finance islamique serait de la tester lors de circonstances difficiles. S'il était avéré que les institutions financières basées sur la Charia sont en mesure de fournir une meilleure résistance aux circonstances critiques que leurs homologues conventionnelles, on pourrait alors affirmer que les principes et les pratiques de la finance islamique sont plus solides que les principes laïques.

whereas the Purchase Undertaking, the part of the *sukuk* contract, was governed by English law (Zada & Muhammad, 2018). Regardless of which law will eventually prevail, this case elucidates the meaning of *Shar'iah* Risk and sets a precedent with no shortage of moral concerns:

1. On the one hand, there are no clear guidelines defining retroactivity in *Shari'ah*. Fairness of retroactivity in law is perhaps one of the most controversial matters in all jurisdictions and has been formally addressed by Western cultures in the legal maxim *Nullum crimen, nulla poena sine lege* (there is neither crime nor penalty without a law). If a new interpretation of *Shari'ah* enters into force, should this affect the previously agreed terms and conditions of a deal? In order for Islamic Finance to be trusted by a larger spectrum of potential investors and its own community, the question of retroactivity should be tackled by both governmental and religious authorities.
2. The sudden change of behaviour by Dana Gas Management, which switched from negotiating with *sukuk* holders to claiming nullification of its payment obligation by virtue of *Shari'ah* non-compliance, raises concerns about whether the decision was made out of zealous observation of the law rather than convenience.

Islamic faith does not encourage judgement about human intentions; to safeguard the unity of the Islamic community, it is desirable not to ruminate on suspicious thoughts about other believers, as elucidated in a passage of the *Qur'an*: "Oh you who have faith! Avoid much suspicion. Indeed some suspicions are sins" (Surah Hujurat 49:12).

Other passages in the *Qur'an* openly suggest that ultimately, the judgement of human intentions is mandated to Allah. Now, if we allow questionable behaviour to go morally unchecked, inasmuch as they are governed by a legal and religious framework, we incur the formalistic risk of equating legality with justice, which eventually leads to moral self-licensing. This represents a dangerous slippery slope for moral consciousness and a very tangible one, as witnessed during the Holocaust. When confronted with war crimes allegations in Israel, Otto Adolf Eichmann, the Nazi operative responsible for organising the transportation of millions of Jews to concentration camps, based the legitimacy of his deeds on the grounds of an authoritarian system made of hierarchies and commands to which he was subordinated and therefore unable to take any moral stance on the genocide he was helping to perpetrate. His position was analysed in *Eichmann in Jerusalem: A Report on the Banality of Evil* (Arendt, 1963).

*Shari'ah* non-compliance risk presents a unique problem for the Islamic Finance industry as it cannot be measured by statistical modelling in the same way that one can calculate market or credit risk. The unpredictability of *Shari'ah* rulings may have consequences at a systemic level.

In 2008 the *Shari'ah* board of AAOIFI ruled that 85% of the *sukuk* under issue around the world were not compliant with *Shari'ah* (Maurer, 2010). The main reason behind that statement was that most *sukuk* were asset-based rather than asset-backed, meaning there was no legal transfer of ownership of the underlying assets to holders who would not have recourse to liquidate them in the event of a default. As in the case of Dana Gas, it is not hard to imagine what would happen if 85% of *sukuk* issuers were to nullify their payment obligations at the same moment, due to *Shari'ah* non-compliance rulings. This would have consequences as dramatic as the GFC for financial stability in Islamic Finance countries.

### Innovation and other Challenges for Islamic Finance Institutions

In his recent publication “Beyond Debt: Islamic Experiments In Global Finance”, Professor Daromir Rudnycky (2018) eloquently unfolds the experimental ethos of Islamic Finance practitioners and scholars who join forces to create authentic financial devices that meet the religious requirement imposed by *Shari'ah*.

One key aspect of innovation for Islamic Finance is the implementation of standards to allow the use of derivatives for hedging. Use of derivatives would improve its overall credit-worthiness, as it is most actively used in real estate and energy markets.

On the other hand, a 2015 study by the IMF detected a number of regulatory issues which raised concerns about the soundness of the Islamic Finance industry. To name a few:

1. An important challenge is to ensure that profit-sharing investment accounts (PSIA) at Islamic banks are treated in a manner that is consistent with financial stability. Many regulators treat them as deposits, which undermines their loss and liquidity absorbency features.
2. Islamic banks appear well-capitalised, but there are challenges with the implementation of the Basel III Accord, due to the scarcity of *Shari'ah*-compliant high-quality liquid assets.
3. Islamic Finance raises a number of taxation issues. These include tax incentives for debt over equity, the tax treatment of sales, and additional layers of transactions in some instruments. Moreover, differences in the treatment of Islamic and conventional finance, if unchecked, can create cross-border spill-overs and encourage international tax arbitrage.

Le risque de non-conformité à la Charia constitue un problème fondamental pour la finance islamique, car il ne peut être modélisé statistiquement comme on le fait pour calculer le risque de marché ou de crédit. Le caractère imprévisible du verdict de la Charia peut avoir des conséquences au niveau systémique. En 2008, le comité Charia de AAOIFI a statué que 85% des sukuk concernés dans le monde n'étaient pas conformes à la Charia (Maurer 2010). La principale raison qui a conduit à cette affirmation est que la plupart des sukuk étaient basés sur des actifs plutôt que garantis par des actifs, ce qui signifie qu'il n'existait aucun transfert légal de propriété des actifs sous-jacents à des détenteurs qui donc n'auraient aucun moyen pour les liquider en cas de défaillance.

More generally, the IMF study pointed out the need for greater regulatory harmonisation in Islamic Finance, especially for cross-border operations. Some even argued that standardisation of *Shari'ah* interpretation is desirable. The author disagrees. By its nature, a textual interpretation is in the intellectual domain and should be kept free from restrictions. Besides, it would prove hard to implement, due to the many schools of thought regarding *Shari'ah* and *fiqh*.

Instead, a global agreement on how to manage the effects of *Shari'ah* non-compliance must be reached that minimises the risk of financial loss for investors. In this regard, the AAOIFI should play a major role in strengthening its powers, encouraging greater adoption of its standards by member countries.

At present, out of 45 AAOIFI member countries, only 12 have adopted its standards as mandatory regulatory requirements. Regardless of such adoption, the AAOIFI does not have the financial sanctioning powers of a regulatory agency due to its status as a standard-setting organisation. The same applies to the Islamic Financial Services Board (IFSB).

The author believes that the establishment of a Supranational Authority with sanctioning powers over the conduct of IFIs is desirable and would confer greater accountability and trust on the industry. Although this change will not come overnight, it should

be addressed and endorsed by the Organisation of Islamic Cooperation in its OIC-2025 action plan.

## Conclusions

The Islamic model for capital financing cannot alone ensure that the morality of agents will follow from the morality of contracts, in the same way that the rules of a sport cannot prevent the occurrence of a foul. This is despite taking into account the debate among practitioners and *Shari'ah* scholars whose unprecedented input and recognised status in financial services represents an additional layer of prudential oversight for the industry, alongside regulators; one that is very positive, in light of ethical reflections on the authenticity of Islamic Finance.

Claims that Islamic Finance principles would have prevented the Global Financial Crisis of 2008 are only justified in terms of correlation. Yet correlation does not prove a direct causality and, even if it could, it has been shown that a systemic failure of this model could be triggered by the very nature of *Shari'ah* risk.

However impressive the figures on Islamic Finance assets may seem at first sight, with an estimated \$2.2 trillion managed worldwide, this total does not even surpass the total assets under management (AUM) of one major global bank alone such as HSBC, which had an estimated \$2.5 trillion in AUM in 2018.

The Islamic Finance industry is still relatively small compared with its Western counterpart and has

yet to prove it can represent a real alternative to mainstream finance, rather than a niche market. To do so, its business model needs to reach scales of at least 25% of global AUM, which are estimated to hit \$100 trillion by 2020, according to a PWC report (PWC). Due to the practical limitations imposed by *Shari'ah*, it is hard to imagine Islamic Finance will reach such levels without compromising the integrity of its business model.

If a connection can be established that links the limited market share,

size and growth of an industry or a country with greater levels of integrity in business conduct, then this paper can conclude with an open question which sounds more like a moral dilemma: should we, as Western societies, aim at lowering our growth figures to the level of Islamic Finance in order to account for better integrity, thereby giving up both the benefits and systemic risks such wealth creates? Regardless of the choice, the author believes that an answer to this question can only be reached by political means. •

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