Islamic finance, Sharia non-compliance and the standardisation of Sharia governance

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ISLAMIC FINANCE, SHARIA NON-COMPLIANCE AND THE STANDARDISATION OF SHARIA GOVERNANCE

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Abstract

The research presented in this thesis examines the questions of (i) why the prevailing form of Islamic finance has tended to only *textually* comply with Sharia law while breaching principles underlying; and (ii) how *Sharia* governance could be standardised in order to ensure that Islamic finance reliably provides a genuinely Islamic alternative to conventional finance so as to engender market trust in the Islamic finance industry.

The primary methodologies applied in this thesis are a text-based analysis and a qualitative interview study. A thorough text-based analysis of the religious and academic thinking around Islamic finance serves as a useful starting point for the design of the qualitative semi-structured interviews of a sample of 20 academics with experience of Islamic finance in practice across three culturally distinct jurisdictions (namely, the UK, the Kingdom fo Saudi Arabia, and Malaysia).

This paper finds that the existing models of Sharia governance across and within jurisdictions allow for a variety of interpretations, leading, in turn, to the inconsistent issuance of *fatwas*, thereby undermining the credibility of Islamic finance as genuinely compliant with Sharia principles. A lack of standardisation permits the coexistence of *Sharia* boards operating at different levels of *Sharia* supervision. This provides banks with the opportunity to seek to obtain a competitive financial advantage by utilising a less rigorous standard of *Sharia* governance. In order to counter the logics of neoliberal capitalism which result in banks 'shopping around' for favourable interpretations, this thesis concludes that *Sharia* governance should be part of an integrated and standardised system of Islamic corporate governance.

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Abbreviations

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ABCP	Asset backed commercial paper
ABS	Asset backed securities
ASAS	Association of *Sharia* Advisors in Islamic Finance
BNM	Central bank of Negara Malaysia
CDO	Collateralised debt obligations
CED	Committee for Economic Development
EVM	Enlightened value maximisation
FMI	Financial market infrastructure
FSB	Financial Stability Board
GSE	Government sponsored enterprise
IDB	Islamic Development Bank
IFA	Islamic *Fiqh* Academy
IFSB	Islamic Financial Services Board
IGOs	Intergovernmental organisations
IMF	International Monetary Fund
ISRA	International Shari'ah Research Academy for Islamic Finance
KSA	Kingdom of Saudi Arabia
LIBOR	London Interbank Offered Rate
M&A	Mergers and acquisitions
MMF	Money market funds
OECD	Organisation for Economic Cooperation and Development
OIC	Organisation of the Islamic Conference
PLS	Profit and loss sharing
SAC	*Sharia* Advisory Committee
SAMA	Saudi Arabian Monetary Agency
SC	*Sharia* Committee
SLR	*Sharia* Law Reports
SSB	*Sharia* Supervisory Board
SPV	Special purpose vehicle

TCE	Transaction costs economics
UAE	United Arab Emirates
UK	United Kingdom
US	United States
US$	United States dollars

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Author's declaration

I declare that all the material contained in this thesis is my own work

Chapter One: Research Overview and Introduction

1.1 Statement of the problem to be addressed

The justification for Islamic finance is that it provides a genuinely Islamic alternative to conventional finance. As will be explained below and in chapter three, Islamic finance has been criticised for inconsistent *Sharia* rulings, or *fatwas*. It has also been criticised for focusing on technical compliance rather than embracing the spirit of *Sharia*, resulting in products that have a tendency to resemble those offered by conventional financial institutions. As a consequence, Islamic finance is open to the criticism that it is not a reliable alternative to conventional finance. That criticism may adversely affect confidence in Islamic finance, which may slow its growth or even precipitate a crisis. While these criticisms have been identified and widely discussed in the literature, the problems of inconsistent *Sharia* rulings and dubious Islamic financial products remain, highlighting the need for a coherent, comprehensive and practical solution. This need for a solution to the problems in Islamic finance provides the rationale for this thesis, which aims to critically examine the problems of inconsistent and technical *Sharia* rulings, and to suggest how those problems may best be addressed to ensure that Islamic finance provides a reliable and genuinely Islamic alternative to conventional financial products and services.

1.2 The research question

One potential solution to the problem of inconsistent *Sharia* rulings is to standardise governance, but this simply begs the questions of what standardisation means and how best to organise and implement this standardisation in order to achieve the desired impact on Islamic finance. In particular, the solution should not simply focus on standardisation, but must also address the question of how to ensure that Islamic finance is truly Islamic in spirit and not simply in form. The research question, which reflects both of those issues, is, therefore, as follows: how should *Sharia* governance be standardised in order to ensure that Islamic finance reliably provides a genuinely Islamic alternative to conventional finance?

The research question can be divided into a number of component questions, all of which will be covered as part of this thesis. These questions are:

1. What are the problems with *Sharia* governance in practice and what are the sources of these problems?
2. What are the possible solutions to the problems encountered in the current models of sharia governance?
3. What is the best course of actions to take to improve the current models of sharia governance?

1.3 Scope

The research presented in this thesis analyses Islamic finance and the current approach to *Sharia* governance. It examines the relevance of institutional influences to the development of the current approach and the problems of: (i) inconsistent *fatwas*; and (ii) *fatwas* that deem products acceptable on the basis of formal or technical *Sharia* compliance only. Data was obtained from reliable published sources and from a qualitative interview study carried out by the researcher. Much of the analysis was focused on Islamic finance in general, but the KSA, the UK and Malaysia were used as concrete, specific examples of Islamic finance and *Sharia* governance in practice. The main reasons for choosing these countries are: all three have significant Islamic finance sectors; they reflect a range of cultural and religious contexts with the KSA representing Islamic countries, Malaysia representing non-Islamic states that have a Muslim majority population, and the UK representing countries with a minority Muslim population;[1] and the KSA is the researcher's home country, while the host institution is based in the UK. Other potential choices for fieldwork in future research include majority-Mulsim and Shariah law-governed jurisdictions such as Iran or Sudan.

1.4 Originality

The problem of inconsistent *Sharia* rulings is not a new issue and has been identified and discussed by other commentators.[2] Despite consideration and some suggestions for a standardised approach,[3] there has been a paucity of empirical work and the solutions have not been considered in sufficient depth. As such, the issue has yet to be satisfactorily resolved by the proposal of a detailed and workable solution. This deficiency forms the motivation for this thesis as well as providing the opportunity for making an original contribution to the debate. This original contribution will be realised through a deep engagement with the problem of *Sharia* non-compliance and the possible ways by which an acceptable level of standardisation of *Sharia* governance might be achieved.

That deep engagement will be achieved by applying the perspective of new institutional theory to provide insights into both the causes of the problems addressed

[1] See the discussion in section 1.5.2.
[2] Hakimah Yaacob, Marjan Muhammad, Edib Smolo, 'International Convention for Islamic Finance: Towards Standardisation' (2011) International Shari'ah Research Academy for Islamic Finance Research Paper No 29/2011; Hakimah Yaacob & Apnizan Abdullah, 'Standards Issuance for Islamic Finance in International Trade: Current Issues and Challenges Ahead' (2012) 65 *Procedia - Social and Behavioral Sciences* 492.
[3] Hakimah Yaacob, Marjan Muhammad, Edib Smolo, 'International Convention for Islamic Finance: Towards Standardisation' (2011) International Shari'ah Research Academy for Islamic Finance Research Paper No 29/2011, 39. Hakimah Yaacob & Apnizan Abdullah, 'Standards Issuance for Islamic Finance in International Trade: Current Issues and Challenges Ahead' (2012) 65 *Procedia - Social and Behavioral Sciences* 492, 496.

by this thesis and their possible solutions. As will be discussed in the section on methodology, new institutional theory is a well established methodological approach. It has been used in the context of conventional finance,[4] and to develop regulatory theory.[5] It has not, however, been used to examine Islamic finance and *Sharia* governance. As such, in providing a novel perspective on *Sharia* governance and the risk of *Sharia* non-compliance, the use of new institutional theory further adds to the originality of the thesis.

Finally, the research providing the foundations for the argument presented in this thesis includes a qualitative interview-based study. This will generate new information regarding the attitudes of Islamic finance professionals and academics towards the provision of Islamic finance in practice. When considered from an interpretative, institutional perspective, the insights gained from the interview responses will further enhance the originality of the text-based research.

Thus, the primary novel contributions of this thesis are:

- the application of new institutional theory to examine the different weaknesses observed in the current sharia governance models.
- The adoption of a cross-cultural interview-based analysis encapsulating (i) views on Shariah doctrines on money; and (ii) the varied application of such doctrines in the UK, KSA, and Malaysia.

1.5 Islamic finance: a background review

1.5.1 A brief history of Islamic finance

In its widest sense, the term "Islamic finance" can be used to refer to any transaction governed by *Sharia* principles, which of course could be traced back to the origins of

[4] Suhaib Riaz, 'The global financial crisis: an institutional theory analysis' (2009) 5 *Critical Perspectives on International Business* 26.
[5] Robert Baldwin, Julia Black, 'Really Responsive Regulation' (2008) 71 *Modern Law Review* 59.

Islam. As Lewis and Algaoud note, the Prophet Muhammad (pbuh), when acting as his wife's agent or *mudarib*, himself employed the profit-sharing approach of *mudaraba*.[6] Modern interest in Islamic finance, however, began in 1941, with the publication of *The economic problem of man and its Islamic solution*. This was followed by 'early experiments with Islamic banking ... in Malaya in the mid 1940s',[7] the establishment in 1953 of the National Commercial Bank in the Kingdom of Saudi Arabia (KSA), which was wholly governed by *Sharia* law, and by farmer credit unions established in Pakistan in the 1950s.[8] Many commentators, however, give credit for the Mit Ghamr savings project established in Egypt in 1963 to the Islamic economist Ahmed al-Najjar. This was the first practical example of what is currently referred to as Islamic Finance.[9]

The Mit Ghamr savings project was ended by the Egyptian Government in 1968, but in 1971 it was effectively incorporated in the Nasser Social Bank.[10] At around the same time as the Mit Ghamr project began, in 1963, the Muslim Pilgrim Savings Corporation was established in Malaysia. In 1969, this became the Pilgrims Management and Fund Board, more commonly known as the Tabung Haji, which did not have the status of a bank, but nevertheless acted as an investment company governed by *Sharia* principles. Although limited in its role, this bank's success 'provided the main impetus for establishing Bank Islam Malaysia Berhard ... a fully-

[6] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 4.
[7] *Ibid*, 5.
[8] Rodney Wilson, 'Islamic Banking and its Impact on the International Financial Scene', in Muazzam Ali (ed) *European Perceptions of Islamic Banking* (Institute of Islamic Banking and Insurance, 1996) 99, 101,105. See also the National Commercial bank's website, available at: <http://www.alahli.com/en-us/about-us/Pages/default.aspx>, accessed, 14 September 2016.
[9] Hussam Sultan, 'Islamic microfinance: between commercial viability and the higher objectives of shari'a', in S Nazim Ali (ed), *Shari'a Compliant Microfinance* (Routledge 2012) 46, 48. See also Ann Elizabeth Mayer, 'Islamic Banking and Credit Policies in the Sadat Era: The Social Origins of Islamic Banking in Egypt' (1985) 1(1) *Arab Law Quarterly* 32.
[10] Natalie Schoon, 'Islamic finance - a history' (August 2008) *Financial Services Review* 10, 11.

fledged Islamic commercial bank'.[11] The Tabung Haji remains the controlling shareholder of the Bank, which began to function as Malaysia's first Islamic Bank in 1983 following the introduction of the Islamic Banking Act 1983.[12]

In 1970, the 2nd Islamic Foreign Ministers Conference in Karachi recommended a detailed investigation into the project that would result in the establishment of the Islamic Development Bank (IDB). The project was then endorsed by a Declaration of Intent issued by the First Conference of Finance Ministers of Islamic Countries in 1973. Subsequently, in 1975, the IDB was established in the Saudi Arabian city of Jeddah.[13] Throughout the latter half of the 1970s, triggered by the growth of 'Arab oil wealth in the wake of the 1973-74 energy price rises' and given momentum by the IDB, [14] there was a 'major expansion in Islamic banking'.[15] 1975 saw the establishment of the Dubai Islamic Bank in the United Arab Emirates (UAE). Then, in 1977 the Faisal Islamic Banks were set up in Egypt and the Sudan. The Kuwait Finance House was established during the same year, followed by the Jordan Islamic Bank in 1978 and the Bahrain Islamic Bank in 1979.[16]

Subsequent to these small beginnings, other exclusively Islamic organisations were established, and conventional Western banks began to offer Islamic financial

[11] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 6.
[12] RAM Rating Services Berhad, *Bank Islam Malaysia Berhard: Financial Institution Ratings* (2010), 2-3.
[13] See the Islamic Development Bank's website, available at: <http://www.isdb.org>, accessed 14 September 2016.
[14] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 7, 11.
[15] Rodney Wilson, 'Islamic Banking and its Impact on the International Financial Scene', in Muazzam Ali (ed) *European Perceptions of Islamic Banking* (Institute of Islamic Banking and Insurance 1996) 99, 106.
[16] *Ibid*.

products.[17] By 1996 there were, 'well over 100 Islamic financial institutions ... operating around the world and ... managing an estimated 80 billion dollars'.[18] This figure is likely to be an underestimate as Lewis and Algaoud note that the combined assets of reporting Islamic banks, which excludes institutions such as the IDB, amounted to US$148 billion in 1997.[19]

The emergence of Islamic finance has been attributed to the 'decolonisation and the creation of new states with a majority Muslim population' that occurred in the second half of the 20th century.[20] It was seen as an alternative to liberal capitalism, forming part of a way of life consistent with *Sharia* principles, therebyalso meeting the religious needs of the devout Muslims.[21] Wilson notes, that during this latter half of the twentieth century:

> There was considerable dissatisfaction with conventional commercial banking in most Islamic countries, both on the part of Muslim scholars and intellectuals, and amongst the general public, who were aware of the Quranic position on interest.[22]

This led to an increasing desire for a genuine *Sharia* compliant alternative based on risk and profit sharing participation.[23] This approach involves “participation” in a transaction that is supported by real assets and uses the financing provided on the

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[17] Natalie Schoon, 'Islamic Finance - an overview' (2008) 9 *European Business Organization Law Review* 621, 626.
[18] Muazzam Ali, 'Introduction', in Muazzam Ali (ed) *European Perceptions of Islamic Banking* (Institute of Islamic Banking and Insurance 1996) 5.
[19] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 7.
[20] Filippo di Mauro, Pierluigi Caristi, Stephane Couderc, Angela Di Maria, Lauren Ho, Balijeet Kaur Grewal, Sergio Masciantonio, Steven Ongena, Sajjad Saher, *Islamic Finance in Europe*, Occasional Paper No 146, (European Central Bank 2013), 12.
[21] *Ibid*.
[22] Rodney Wilson, 'Islamic Banking and its Impact on the International Financial Scene', in Muazzam Ali (ed) European Perceptions of Islamic Banking (Institute of Islamic Banking and Insurance 1996) 99, 103.
[23] *Ibid*, 104.

basis that the profit (or loss) resulting from the investment subsequently made would be shared between the parties investing in that particular project through Islamic financing arrangements.

As a relative latecomer into the global financial services market, Islamic Financial organisations are small compared to their non-Islamic counterparts. As Schoon notes, in 2008 the combined assets of 280 of the top 500 Islamic financial institutions amounted to US$540 billion dollars. This contrasts with the assets of HSBC, which were 'well in excess of $2 trillion'.[24] Nevertheless, this once niche market is now a significant minority provider of financial services because of the growing use of *Sharia* compliant financial products by Muslims across the globe. The demand from the Muslim community, however, is only part of the picture as interest from the non-Muslim communities has grown in recent years. Even before interest in Islamic finance was boosted by the 2007 global financial crisis,[25] a 2005 editorial in Company Lawyer described the interest in *Sharia* governed commercial activity as 'high fashion'.[26] Between 2006-2010, the industry doubled in size and the industry was then valued at US$895 billion, a rise of 8.9% on the previous year.[27] By the end of 2012, the industry was estimated to be worth US$1.6 trillion.[28] In 2014 this had risen to an estimated US$1.81 trillion.[29] Given the interest of non-Muslims and the

[24] Natalie Schoon, 'Islamic Finance - an overview' (2008) 9 *European Business Organization Law Review* 621, 626.
[25] Although often dated as 2008, the crisis began in 2007. See further, section 2.2.2.
[26] Editorial, 'Banking on Islam' (2005) 26 *Company Lawyer* 193.
[27] David Oakley, 'Growth survives the storms' *The Future of Islamic Finance, Financial Times Special Report* (December 14, 2010) 1.
[28] Filippo di Mauro et al, *Islamic Finance in Europe*, Occasional Paper No 146, (European Central Bank 2013), 9.
[29] Haroon Latif (auth), Hammaad Chaudry (ed), *State of the Global Islamic Economy Report 2015/2016* (Thomson Reuters 2015), 39 <http://islamic-finance.zawya.com/ifg-publications/Global_Islamic_Economy_2015-230915060918U/> accessed 02 September 2016.

scope for increased use within the Muslim community,[30] Islamic Finance is likely to continue to expand. Indeed, if the projected potential growth of Islamic finance is fulfilled, the industry will be worth US$3.2 trillion by 2020.[31]

The demand for *Sharia* compliant financial services is being embraced, both by Islamic countries and those secular countries with a significant Muslim community. Officials from both the United States Federal Reserve and the United Kingdom's (UK) Financial Conduct Authority have acknowledged the need to facilitate the provision of Islamic Finance out of respect for the religious beliefs of the Muslims living within their respective countries.[32] In recognition of the interest in and demand for Islamic finance, many countries have made specific arrangements to facilitate the establishment of Islamic financial services. For example, some countries, including the United Kingdom, Ireland, France and Malaysia, have implemented specific tax arrangements.[33] These efforts are motivated not just by the demand from the Muslim community, but also by the recognition that Islamic finance is now an 'integral part of [the global financial system]', and is no longer only an insular service restricted to the devout Muslim.[34]

1.5.2 The structural and motivational contexts of Islamic finance

According to Lewis and Algaoud, the continuing development of Islamic finance has generally followed one of two forms. In some Muslim countries, such as Iran, Sudan,

[30] In 2010 it was estimated that Islamic finance was used by only 12% of the 1.6 billion Muslims globally: David Oakley, 'Growth survives the storms' December 14, 2010, *The Future of Islamic Finance, Financial Times Special Report*, 1, 2.
[31] Haroon Latif (auth), Hammaad Chaudry (ed), *State of the Global Islamic Economy Report 2015/2016* (Thomson Reuters 2015), 40.
[32] Editorial, 'Banking on Islam' (2005) 26 *Company Lawyer* 193.
[33] Filippo di Mauro et al, *Islamic Finance in Europe*, Occasional Paper No 146, (European Central Bank 2013), 25-29; Kevin Brown, 'Malaysia seeks end to slide in issuance' *The Future of Islamic Finance, Financial Times Special Report* (December 14, 2010) 4.
[34] Filippo di Mauro et al, *Islamic Finance in Europe*, Occasional Paper No 146, (European Central Bank 2013), 13.

and Pakistan, the approach taken 'involves the restructuring of the whole financial system to accord with Islamic precepts'.[35] In other countries, the approach has been to establish Islamic finance to operate alongside conventional banking. It is also worth noting that Islamic finance may be provided by wholly Islamic organisations on a national or international basis, or by conventional organisations with an Islamic finance 'window'.[36] One might further distinguish three different religious and cultural contexts that provide the backdrop to the development of Islamic finance: Muslim countries (e.g. KSA); non-Muslim countries with a majority Muslim population (e.g. Malaysia);[37] and non-Muslim countries with a minority Muslim population (e.g. England). Acknowledging these different forms and contexts will be important when considering the primary research question of how standardisation of *Sharia* governance might be implemented to benefit Islamic finance.

As well as accounting for the structural context of the research, it is important to appreciate the motivational context. Understanding the reasons why Islamic finance has generated such interest, and continued to grow into a significant, if minority, force in national and global financial services will necessarily inform the approach to governance since regulation should reflect the interests of the major stakeholders. The motivations behind the rise in Islamic Finance will, therefore, be briefly explicated.

The first, and main motivation, is the desire for *Sharia* compliant Islamic finance for religious or faith-based reasons. Visser comments that: 'The movement for ... an

[35] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 14.
[36] *Ibid*.
[37] 61.3% of Malaysians are Muslim, see: Department of Statistics, Malaysia, *Population Distribution and Basic Demographic Characteristic Report* (2010), available at:
<http://www.statistics.gov.my/portal/>, last accessed 12 September 2016.

Islamic financial system ... is rooted in the experience of Muslims in what they, or at least some of them, felt in the past was an unfriendly non-Muslim environment'.[38] Within this broad faith-based motivation, Visser distinguishes between two different approaches: a radical, insular Islamisation growing out of the politics espoused by Maududi and Sayyid Qutb; and a more moderate approach of an Islamic financial system co-existing with conventional financial institutions in a more integrated way.[39] However, as Visser comments, 'generally the world of Islamic finance itself gives the impression that the interest in earning money in a *Sharia*-compliant way is more prevalent than any hatred of critics'.[40] Nevertheless, the more radical views could influence both *Sharia*-compliance *fatwas* and academic commentary on Islamic finance.

The latter of the two faith-based approaches, championed by the Islamic economist Mohammad Siddiqi, sees Islamic finance as a much needed and more equitable alternative to that offered by conventional financial services.[41] As such it overlaps and feeds into the second motivation, which lies in the interest and potential demand for ethical financial services. The initial motivation for this was prompted by:

> …the failure of economic development in the post-independent states of Asia and Africa in 1960s and 1970s [and] was attributed to flawed capitalist economic development strategies, which ignored the importance and centrality of human beings and their well-being.[42]

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[38] Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar 2009), 1.
[39] *Ibid*, 2-7.
[40] *Ibid*, 8.
[41] *Ibid*, 6-7.
[42] Mehmet Asutay, 'A Political Economy Approach to Islamic Economics: Systematic Understanding for an Alternative Economic System' (2007) 1-2 *Kyoto Bulletin of Islamic Area Studies* 3, 5.

Beyond its early political origins, the ethical motivation developed further with the growth of a more domestic interest in the private sector.[43]

Based on the prohibition of *riba* (interest) and gambling, Siddiqi argues that Islamic finance offers an ethical approach that 'downsiz[es] individualism'[44] and supports 'the cooperative nature of man's life requiring fairness and care for others'.[45] For Siddiqi, Islamic banking and finance, a sub-culture of Islamic economics, has been a quest for infusing justice and morality into the "ordinary business of life"'.[46] This ethical approach will be of interest to Muslim investors, particularly those who are devout. However, although 'concerned with a very different set of ethical criteria from Western "green" or ethical investors',[47] the interest and demand for ethical Islamic finance is not restricted to Muslims, and there appears to be a secular market for it.[48]

The third and final motivation came from the 2007 financial crisis.[49] Wiebier and Salah note that:

> When the credit crisis struck, some in the Arab world were quick to suggest that Islamic finance methods were more resistant to the impact of the credit crisis than more conventional finance schemes.

[43] Mohammad N Siddiqi, 'Towards a Grass-Roots Based Islamic Finance for All' Keynote Address at the 8th Annual International Conference Lariba Islamic Banking (Los Angeles, 16 June 2001).
[44] Mohammad N Siddiqi, 'Islamic Finance & Beyond: Premises and Promises of Islamic Economics', presented at the Harvard University Forum on Islamic Finance "Islamic Finance: Challenges and Global Opportunities" (Cambridge (Mass), October 1& 2 1999), available at: http://www.islamic-economics.com/, accessed 18 June 2014.
[45] Mohammad N Siddiqi, 'Evolution of Islamic Banking and Insurance as Systems Rooted in Ethics', presented at the Takaful Forum (New York, April 26 2000), available at: http://www.islamic-economics.com/, accessed 18 June 2014.
[46] Mohammad N Siddiqi, 'Islamic Finance & Beyond: Premises and Promises of Islamic Economics', presented at the Harvard University Forum on Islamic Finance "Islamic Finance: Challenges and Global Opportunities" (Cambridge (Mass), October 1& 2 1999).
[47] Rodney Wilson, 'Islamic finance and ethical investment' (1997) 24 *International Journal of Social Economics* 1325.
[48] Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar 2009), 9.
[49] Fredj Jawadi, Abdoulkarim Idi Cheffou, Nabila Jawadi, 'Do Islamic and Conventional Banks Really Differ? A Panel Data Statistical Analysis' (2016) 27 *Open Economics Review* 293.

> This perhaps overly optimistic view was belied by the Dubai Debt Crisis of late 2009 ... Yet it is a fact that Islamic countries have (so far) weathered the credit crisis quite well.[50]

This resistance is at least in part due to the specific characteristics of Islamic finance derived from *Sharia* principles and including: (i) a requirement for risk sharing; (ii) the requirement that financial transactions must be directly connected to real or tangible assets; (iii) the prohibition of trading debt for profit; and (iv) the prohibition of speculative and excessive risk taking that can be characterised as gambling.[51] This is not to suggest that Islamic finance is without risk - the risks associated with Islamic finance will be considered in subsequent chapters - but, that compliance with *Sharia* principles means that it is generally more risk-averse than conventional finance. Such 'socially responsible' financial services are likely to be of interest, not just to Muslims, but to anyone disenchanted by the more self-serving, greed motivated conventional financial sector.[52]

1.5.3 *Sharia* governance and the call for standardisation

As will be discussed in chapter three, the defining characteristic of Islamic finance is its compliance with the *Sharia*.[53] The need for Islamic financial products to be

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[50] Reinout Wibier, Omar Salah, 'The credit crunch and Islamic finance: *Sharia*-compliant finance against the backdrop of the credit crisis' (2011) 26 *Journal of International Banking Law and Regulation* 509.

[51] Reinout Wibier, Omar Salah, 'The credit crunch and Islamic finance: *Sharia*-compliant finance against the backdrop of the credit crisis' (2011) 26 *Journal of International Banking Law and Regulation* 509, 515. Ayman Zerban, Eslam H Elkady, Rafik F Omar, 'Islamic Finance and Global Financial Crises: How to keep Finance on Track' (2012) 14 *Topics in Middle Eastern and African Economies* 190, 207-209. Adel Ahmed, 'Global financial crisis: an Islamic finance perspective' (2010) 3 *International Journal of Islamic and Middle Eastern Finance and Management* 306, 307.

[52] Adel Ahmed, 'Global financial crisis: an Islamic finance perspective' (2010) 3 *International Journal of Islamic and Middle Eastern Finance and Management* 306, 308. Aamir A Rehman, 'The Relevance of Islamic Finance Principles to the Global Financial Crisis' Discussion Paper presented at the *Panel Discussion on the Evolution of the Global Financial Crisis form the Current Crisis*, (Harvard Law School, March 16 2009).

[53] Beebee Salma Sairally, 'Integrating Environmental, Social and Governance (ESG) Factors in Islamic Finance: Towards the Realisation of Maqasid Al-Shariah' (2015) 7 *ISRA International Journal of Islamic Finance* 145, 148.

Sharia compliant creates the risk of *Sharia* non-compliance, which is managed by *Sharia* governance.[54] The problem is that there are essentially two broad approaches to assessing Sharia compliance. First, compliance may be assessed on the basis of technical requirements, such as the formal prohibition of *riba* (interest). Second, compliance may be assessed by reference to the spirit of *Sharia*, which emphasises the philosophy of Islam, reflected in the *Maqasid al-Sharia*, which values money as an instrumental means to an end rather than as something of intrinsic value and prioritises social justice over profit.

This division in the approach to *Sharia* compliance may result in inconsistent *Sharia* rulings and the release of products that are technically compliant, but which are constructed to resemble conventional financial products.[55] Where technical compliance provides the yardstick, form is prioritised over substance, allowing contracts that circumvent the demands of *Sharia*.[56] This may allow payments that are linked to interest rates and,[57] while they may be characterised as the payments of profit, or as payments for services or for shouldering risk, behave like interest and highlight a divergence between Islamic finance in substantive theory and Islamic finance in formal practice.[58] The danger of this focus on technical compliance, when coupled with inconsistent *Sharia* rulings, is that it creates the opportunity for *fatwa*

[54] Ahcene Lahsasna, *Shari'ah Non-Compliance, Risk Management and Legal Documentation in Islamic Finance* (Wiley 2014), 12.
[55] Feisal Khan, 'How 'Islamic' is Islamic Banking?' (2010) 76 *Journal of Economic Behavior & Organization* 805, 817; Saad Azmat, Michael Skully, Kym Brown, 'Can Islamic banking ever become more Islamic? (2015) 34 *Pacific-Basin Finance Journal* 253.
[56] Muhammad Ayub, Camille Paldi, 'Dichotomy between Shari'ah Compliance and the Economic Goals of Islamic Finance Institutions' (2015) 5 *Journal of Islamic Business and Management* 69, 92-93.
[57] Beng Soon Chong, Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based?' (2009) 17 *Pacific-Basin Finance Journal* 125.
[58] Khairul Anuar, Shamsher Mohamad, Mohamed Eskander Shah, 'Are Deposit and Investment Accounts in Islamic Banks in Malaysia Interest Free?' (2014) 27 *JKAU: Islamic Economics* 27, 46.

shopping.[59] This allows financial institutions to shop around for a favourable ruling on a new financial product, thereby avoiding the constraints of more restrictive *Sharia* rulings that measure compliance against the spirit of *Sharia*.

The coexistence of inconsistent approaches to *Sharia* governance, which facilitates inconsistent *Sharia* rulings and *fatwa* shopping, creates a reputational risk for Islamic finance and erodes consumer confidence in the credibility of Islamic finance as a reliable Islamic alternative to conventional finance.[60] This danger has prompted the call for *Sharia* governance to be standardised,[61] perhaps by establishing an international *Sharia* board.[62] The problem of inconsistent *Sharia* rulings and the need for standardisation creates the context and justification for the research question addressed in this thesis.

1.6 Methodology and methods

1.6.1 The theoretical framework for the thesis

Whether formal or informal, acknowledged or unacknowledged, all research is shaped by its theoretical framework, which provides the methodology and

[59] Umar A Oseni, M Kabir Hassan, Abu Umar Faruq, 'The Legal Implications of "Fatwa Shopping" in the Islamic Finance Industry: Problems, Perceptions and Prospects (2016) 30 *Arab Law Quarterly* 107.
[60] Khairul Anuar, Shamsher Mohamad, Mohamed Eskander Shah, 'Are Deposit and Investment Accounts in Islamic Banks in Malaysia Interest Free?' (2014) 27 *JKAU: Islamic Economics* 27, 33.
[61] M Fahim Khan, 'Setting Standards for *Shariah* Application in the Islamic Financial Industry' (2007) 49 *Thunderbird International Business Review* 285; Rahmat Hakim, 'Harmonization of Sharia Rulings in Islamic Finance: An Analysis' (2013) 7 *Ijtihad* 267; Jamal Abbas Zaidi, 'Shari'a Harmonization, Regulation and Supervision' (2008) Paper presented at the AAOIFI-World Bank Islamic Banking and Finance Conference, Manama, Bahrain, 10-11 November 2008; Rahail Ali, Mustafa Kamal, 'Standardising Islamic Financing: Possibility or Pipe Dream?' (2009) 10 *Business Law International* 19; Frederick V Perry, 'The Corporate Governance of Islamic Banks: A Better Way of Doing Business?' (2011) 19 *Michigan State Journal of International Law* 251, 270-277; Hakimah Yaacob , Marjan Muhammed, Edib Smolo, 'International Convention for Islamic Finance: Towards Standardisation' (2011) International Shari'ah Research Academy for Islamic Finance Research Paper No 29/ 2011.
[62] Abdulazeem Abozaid, 'The internal challenges facing the Islamic finance industry' (2016) 9 *International Journal of Islamic and Middle Eastern Finance and Management* 222, 227.

epistemology of that research.[63] The theoretical framework identifies the philosophy behind the inquiry, and the arguments formed in response to the research question connects theory to practice and defines the assumptions and biases that inform all such projects. Thus, by providing a particular 'lens' through which to view the issue at hand,[64] the theoretical framework 'has implications for every decision made in the research process'.[65]

The theoretical framework for this thesis is mixed. The primary frame is provided by new institutional theory, but this will be supplemented by theories of governance, regulation and the management of risk. In this section, the basics of these theoretical methods will be explained to allow a better understanding of the arguments that follow when considering the substantive issue of standardising *Sharia* governance of Islamic finance. Working definitions of certain concepts that will be relevant to the substantive analysis will also be provided.

1.6.1.1 New institutional theory

The decision to utilise new institutional theory is motivated by two factors. First, it provides a well established methodology for understanding 'organizational and political change', producing a more complete picture than 'rational-actor or functionalist accounts'.[66] This should enable an understanding of the social and ideological tensions affecting the delivery and governance of Islamic finance. Second, conventional and Islamic financial institutions share many similar features

[63] Michael Crotty, *The Foundations of Social Research and the Research Process* (Sage 1998), 2-9.
[64] Scott Reeves, Mathieu Albert, Ayelet Kuper, Brian David Hodges, 'Why use theories in qualitative research' (2008) 337 *British Medical Journal* 631.
[65] Donna M Mertens, *Research Methods In Education and Psychology: Integrating diversity with Quantitative and Qualitative Approaches* (Sage 2005), 7.
[66] Paul J DiMaggio, Walter W Powell, 'Introduction', in Powell WW, DiMaggio PJ (eds) *The New Institutionalism in Organizational Analysis* (University of Chicago Press 1991) 1, 3.

amenable to the analytical method of new institutional theory, for example the structural arrangement of financial services within a broad framework of both informal and formal institutions.[67] While this theoretical methodology has been used to evaluate the non-Islamic or conventional financial industry,[68] it has not so far been utilised for an analysis of the Islamic financial industry. Applying this methodology, therefore, will provide a fresh perspective that may reveal new insights.

The essence of new institutional theory is that agents, including organisations, 'are embedded in broader environments and created and changed by environmental change', particularly in terms of legitimacy and culture.[69] The process of change derives from Weber's concept of bureaucratisation, which has the effect of creating an 'iron cage' of homogenisation.[70] Through this process of institutional isomorphism, organisations become 'imprisoned' within an institutional framework.[71] Moving on from Weber's argument that the competitive marketplace was the most important driving force of bureaucratisation, Dimaggio and Powell argue that:

> Bureaucratization and other forms of homogenisation emerge ... out of the structuration of organizational fields ... [which] in turn is effected largely by the state and the professions.[72]

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[67] S F Shah, MW Raza & MR Khurshid, ´Islamic banking controversies and challenges´ (2012) 3 *Interdisciplinary Journal of Contemporary Research in Business* 1018, 1019.
[68] See, eg Suhaib Riaz, 'The global financial crisis: an onstitutional theory analysis' (2009) 5 *Critical Perspectives on International Business* 26.
[69] John W Meyer, 'Rationalized Environments', in Scott WR, Meyer JW (eds), *Institutional Environments and Organizations* (Sage Publications 1994), 28.
[70] Paul J DiMaggio, Walter W Powell, ´The iron cage revisited: institutional isomorphism and collective rationality in organisational fields´ (1983) 48 *American Sociological Review* 147.
[71] Royston Greenwood, Roy Suddaby, 'Institutional Entrepreneurship in Mature Fields: The Big Five Accounting Firms' (2006) 49 *Academy of Management Journal* 27, 28.
[72] Paul J DiMaggio, Walter W Powell, ´The iron cage revisited: institutional isomorphism and collective rationality in organisational fields´ (1983) 48 *American Sociological Review* 147.

The context of these 'highly structured organizational fields' interacts with the responses to 'uncertainty and constraint' of the individuals that work within them resulting in the process of isomorphism.[73]

Dimaggio and Powell define their 'unit of analysis', which they label the 'organizational field', as: 'those organizations that, in aggregate, constitute a recognized area of institutional life'.[74] This is determined empirically by reference to four elements:

1. The level or extent of interaction between the organisations;
2. The existence of 'sharply defined interorganizational structures of domination and patterns of coalition';
3. The 'informational load' that the organisations handle; and
4. A sense of 'common enterprise'.[75]

In other words, '[o]rganizational fields are clusters of organizations and occupations whose boundaries, identities and interactions are defined and stabilized by shared institutional logics'.[76] These institutional logics are securely established rules that define the nature, limits and membership of the organizational field.[77]

The decisions of the professionals working within these fields tend to create an environment that then acts as a constraint against future change and shifts from the early motivation of efficiency to one of legitimacy.[78] This creates an iterative process

[73] *Ibid*.
[74] *Ibid*, 148.
[75] *Ibid*, 148.
[76] Royston Greenwood, Roy Suddaby, 'Institutional Entrepreneurship in Mature Fields: The Big Five Accounting Firms' (2006) 49 *Academy of Management Journal* 27, 28.
[77] Ibid.
[78] Paul J DiMaggio, Walter W Powell, ´The iron cage revisited: institutional isomorphism and collective rationality in organisational fields´ (1983) 48 *American Sociological Review* 147, 148.

by which organisations within the field respond to each other in an isomorphic feedback loop.

Isomorphism may be defined 'as a constraining process that forces one unit in a population to resemble other units that face the same set of environmental conditions'.[79] In the context of the institution, the environment centres on interactions between organisations that 'compete not just for resources and customers, but for political power and institutional legitimacy, for social as well as economic fitness'.[80] These interactions, which provide the driving force for institutional isomorphism, may be characterised as:

1. *'coercive* isomorphism that stems from political influence and the problem of legitimacy': whenever organisations exist in a dependent relationship with other organisations they may be subject to coercive pressures to conform to the norms of those organisations on which they depend;
2. *'mimetic* isomorphism resulting from standard responses to uncertainty': organisations facing uncertainty tend to model their response on other organisations that appear to have managed the uncertainty successfully; this may occur intentionally or through the migration of key employees or the shared use of consulting or advisory services; and
3. *'normative* isomorphism, associated with professionalism': this derives from the need within a profession to create an identity based on norms and is

[79] *Ibid*, 149. They follow the description in: Amos Hawley, 'Human ecology', in Sill DL (ed), *International Encyclopedia of the Social Sciences* (Macmillan 1968), 328-337.
[80] Paul J DiMaggio, Walter W Powell, ´The iron cage revisited: institutional isomorphism and collective rationality in organisational fields´ (1983) 48 *American Sociological Review* 147, 150.

heavily influenced by formal university education, professional networks and professional bodies that register and train members.[81]

In addition to the driving force of institutional isomorphism, organisations may also be subject to competitive isomorphism, which tends to be most relevant during the earlier stages of an emerging field and works through the economic natural selection of 'market competition, niche change, and fitness measures'.[82] As the field matures, competitive isomorphism is largely, although not completely, supplanted by institutional isomorphism.

The essence of isomorphism is that internal and external factors work within an organisational field to shape organisations in such a way that they tend to resemble each other in attitude, behaviour and norms. These factors primarily arise from dominance, legitimacy, prestige and success, whether real or perceived. They operate through authority or coercion, copying or mimicking behaviour, inducement,[83] a shared educational and socio-cultural background, or the effects of socialisation.[84] The tendency towards similarity, then, arises because organisations are 'deeply and essentially embedded in wider institutional environments' that are caused by and reflect that wider institutional context.[85] They are not discretely bounded wholly independent entities, autonomous in an individualistic sense. Rather they are

81 *Ibid*.
82 *Ibid*.
83 W Richard Scott, 'Unpacking Institutional Arguments', in Powell WW, DiMaggio PJ (eds), *The New Institutionalism in Organizational Analysis* (University of Chicago Press 1991) 164, 176-177.
84 Paul J DiMaggio, Walter W Powell, ´The iron cage revisited: institutional isomorphism and collective rationality in organisational fields´ (1983) 48 *American Sociological Review* 147, 153.
85 W. Richard Scott, John W Meyer, 'Developments in Institutional Theory', in Scott WR, Meyer JW (eds), *Institutional Environments and Organizations* (Sage Publications 1994) 1, 1-2.

autonomous in the relational sense of being both constrained and dependent on, but enabled by, a network of relationships.[86]

Any analysis from an institutional perspective must take into account that the existence and activity of organisations, and other relevant actors, are essentially shaped by institutional influences, both locally and more widely at the societal and global level. As Meyer et al comment, 'Actors and action are illuminated by universalistic lights'.[87] They suggest that:

> An institutional analysis rests on two central themes. First, the rationalization of social activity stands in a reciprocal relation to the social construction of the actor's given ontological status in society. Second, the institutional rules undergoing rationalization and social ontology operate at a very general (now often worldwide) level, not simply at the level of local negotiation.[88]

The implications of these two themes are: first, that a social activity can be shaped either by influencing the activity directly or indirectly through the social construction of the actors; second, that any change in the activity will affect the actor, which will, in turn, affect the activity in an ever decreasing feedback cycle that tends towards standardisation; third, that effective local changes, through common concerns and diffusion,[89] can have a wider influence than might be initially anticipated; and fourth,

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[86] John W Meyer, John Boli and George M Thomas, 'Ontology and Rationalizaton in the Western Cultural Account', in Scott WR, Meyer JW (eds), *Institutional Environments and Organizations* (Sage Publications 1994) 9, 9-16.
[87] *Ibid*, 19.
[88] *Ibid*, 20-21.
[89] John W Meyer, 'Rationalized Environments', in Scott WR, Meyer JW (eds), *Institutional Environments and Organizations* (Sage Publications 1994) 28, 30.

that organisations must be analysed within the global context of worldwide isomorphic pressures.[90]

With those two themes in mind, a general model of the institution and institutionalisation may be defined, comprising of following four elements.[91]

1. The organisation: These have 'identities, structures and activity patterns', all of which depend on and are shaped by the isomorphic influences of the wider environment. Each of these three aspects of the organisation are subject to both external influences and internal influences from the other aspects.[92]
2. The causal mechanisms that connect the existence and nature of organisations to the rationalised wider environment.
3. The rationalised wider environment: This operates through, for example, public rules and regulations, ideologies, religions and cultural values. The environment may be stratified into layers of influences and entities, such as the supranational or global society, the nation state, the regulators (regulators, legislators, judges) the experts (science and professions), the organisation. The organisation stratum, will be more influential in the 'absence of strong central regulation' and where organisations have similar identities and common form.[93] The entities of the global society, such as the UN or World Bank system, are not agents in the sense of having self-interested goals. Rather they are 'loose ... communities with little sovereignty' with a 'disinterested' advisory or regulatory 'posture ... managing ... [and] constructing]. the agreements and long-run interests of ... human beings,

[90] *Ibid*, 31.
[91] *Ibid*, 33-36.
[92] *Ibid*, 34.
[93] *Ibid*, 37.

national states, and organizations in light of more general natural and moral laws'.[94]

4. The 'macrosociological processes' that operate within the wider environment to organise that environment into a rationalised unit that can then exert isomorphic pressure on the organisations.

Having considered the isomorphic pressure of institutions on organisations, it should be noted that the influence is not a one-way street and institutions may also be subjected to functional, political and social pressure to change.[95] As DiMaggio and Powell note:

> institutions are not only constraints on human agency; they are first and foremost products of human actions. Indeed, rules are typically constructed by a process of conflict and contestation.[96]

Thus, institutions are established and shaped by human agents (elite institutional entrepreneurs) with the collective interest, resources and power to effect the required change in social structure. Thus, although the process has received less attention, it is nevertheless apparent that organisations, particularly those with significant resources,[97] are capable of exerting influence on institutions just as institutions exert pressure on organisations.[98] As Riaz comments, '[o]rganizations represent powerful

[94] *Ibid*, 47.
[95] M Tina Dacin, Jerry Goodstein, W Richard Scott, 'Institutional Theory and Institutional Change: Introduction to the Special Research Forum' (2002) 45 *Academy of Management Journal* 45, 46.
[96] Paul J DiMaggio, Walter W Powell, 'Introduction', in Powell WW, DiMaggio PJ (eds), *The New Institutionalism in Organizational Analysis* (University of Chicago Press 1991) 1, 28.
[97] Royston Greenwood, Roy Suddaby, 'Institutional Entrepreneurship in Mature Fields: The Big Five Accounting Firms' (2006) 49 *Academy of Management Journal*, 27, 39.
[98] Walter W Powell, 'Expanding the Scope of Institutional Analysis', in Powell WW, DiMaggio PJ (eds), *The New Institutionalism in Organizational Analysis* (University of Chicago Press 1991) 183, 190-191.

interests ... that have a bearing on the survival of the institutional framework in the domain of the organization's operation and influence'.[99]

The tendency for organisations to influence institutional change is more likely where, because they are multi-disciplinary, 'they bridge organizational fields' and so 'come into contact with contradictory logics'.[100] Similarly, 'less embedded organizations' that exist at the periphery of an organisational field are more likely to produce or facilitate change through 'institutional entrepreneurship'.[101] Furthermore, a misalignment between the boundaries of influence of institutions and the activity of the organizational field provides an additional source of pressure for institutional change.[102]

The interaction between the institution and the organisation does not stop here. The institutional changes caused by pressure from organisations may, in turn, exert a new influence on the organisational field that can affect the values and principles that constitute the nature and integrity of those organisations.[103] In other words, the relationship between institutions and organisations, while not equal is nevertheless an iterative one, with influence and change working in both directions, within a stratified range of environments from local to global.

1.6.1.2 The institution

[99] Suhaib Riaz, 'The global financial crisis: an institutional theory analysis' (2009) 5 *Critical Perspectives on International Business* 26, 28.
[100] Royston Greenwood, Roy Suddaby, 'Institutional Entrepreneurship in Mature Fields: The Big Five Accounting Firms' (2006) 49 *Academy of Management Journal* 27.
[101] Royston Greenwood, Roy Suddaby, 'Institutional Entrepreneurship in Mature Fields: The Big Five Accounting Firms' (2006) 49 *Academy of Management Journal* 27, 29.
[102] *Ibid*, 38.
[103] M Tina Dacin, Jerry Goodstein, W Richard Scott, 'Institutional Theory and Institutional Change: Introduction to the Special Research Forum' (2002) 45 *Academy of Management Journal* 45, 52-53.

Before examining risk, regulation and governance, the second theoretical axis of this analysis, it is first necessary to provide a working definition of the institution. This is important because, as Jepperson notes, the use of the term "institution" has been used with '[striking] variety and vagueness'.[104] However, a number of features or attributes can be identified. First, an institution must be ordered or organised. Second, it should be so well established within the relevant societal context that it is essentially taken for granted.[105] Third, an institution is a socially constructed representation of an entity that has an observable effect within the relevant social context,[106] or as DiMaggio and Powell put it, institutions are cognitive 'macrolevel abstractions'.[107] Fourth, whether something is characterised as an institution depends on context, and the relevant level of analysis. Fifth, institutions arise and persist through relatively unreflective, recurrent behaviour shaped by the rules, scripts and identities that form their constituents and allow them to provide a social order and normative framework.[108] Sixth, an institution is 'culturally' persistent and relatively resistant to change.[109]

Jepperson defines an institution as: 'a social order or pattern' and a 'socially constructed, routine reproduced ... program or rule systems, [operating] as relative fixtures of constraining environments and accompanied by taken for granted

[104] Ronald L Jepperson, 'Institutions, Institutional Effects, and Institutionalism', in Powell WW, DiMaggio PJ (eds), *The New Institutionalism in Organizational Analysis* (University of Chicago Press 1991) 143.
[105] *Ibid*, 149.
[106] *Ibid*.
[107] Paul J Di Maggio, Walter W Powell, 'Introduction', in Powell WW, DiMaggio PJ (eds), *The New Institutionalism in Organizational Analysis* (University of Chicago Press 1991) 1, 15.
[108] Walter W Powell, 'Expanding the Scope of Institutional Analysis', in Powell WW, DiMaggio PJ (eds), *The New Institutionalism in Organizational Analysis* (University of Chicago Press 1991) 183, 192.
[109] See, Lynne G Zucker, 'The Role of Institutionalization in Cultural Persistence' (1977) 42 *American Sociological Review* 726.

accounts'.[110] By creating 'identities and activity scripts', they can both constrain and empower organisations and other agents.[111] For Meyer et al, an institution is a set of 'cultural rules giving collective meaning and value to entities and activities, integrating them into the larger schemes'.[112] For DiMaggio and Powell: 'Not norms and values but taken-for-granted scripts, rules, and classifications are the stuff of which institutions are made'.[113] For the purposes of this thesis then, an institution will be defined as:

> *a socially constructed, context dependent, essentially taken for granted and relatively resistant system of cultural rules and behavioural scripts that establishes a social order and normative framework that both constrains and empowers societal agents.*

1.6.1.3 Risk, regulation and governance

Another axis for analysis lies in an understanding of risk and the governance and regulation of that risk. Before considering governance and regulation, it is first necessary to set out an approach to risk and its relevance. Risk is not, in itself, a harm, but may be defined as the likelihood or probability of a particular harm, where harm may be characterised, following Feinberg, as a setback to interests.[114] Thus, risk comprises two elements: the type or nature of the harm and the likelihood or probability that the harm will materialise. In other words, risk involves 'exposure and

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[110] Ronald L Jepperson, 'Institutions, Institutional Effects, and Institutionalism', in Powell WW, DiMaggio PJ (eds), *The New Institutionalism in Organizational Analysis* (University of Chicago Press 1991) 143, 144, 149.
[111] *Ibid*, 146.
[112] John W Meyer, John Boli and George M Thomas, 'Ontology and Rationalizaton in the Western Cultural Account', in Scott WR, Meyer JW (eds), *Institutional Environments and Organizations* (Sage Publications 1994) 9, 10.
[113] Paul J Di Maggio, Walter W Powell, 'Introduction', in Powell, WW, DiMaggio PJ (eds) *The New Institutionalism in Organizational Analysis* (University of Chicago Press 1991), 1, 15.
[114] Joel Feinberg, *Harm to Self* (Oxford University Press 1986), 10.

uncertainty'.[115] Both of these elements offer scope for risk management, with the aim of either reducing the likelihood that the harm will materialise or, if that fails, limiting the impact of the harm that ensues. In Islamic finance, risk (*Mukhatarah*) is perceived as as 'the situation that involves the probability of deviation from the path that leads to the expected or usual result'.[116] Alternatively, it has been defined as 'the likelihood of loss.'[117]

It is the appreciation of risk and our ability to 'manage' it that 'defines the boundary between modern times and the past'.[118] However, it is not just an appreciation of risk that characterises modern society: it is also the paradoxical explosion of risk that has accompanied human progress.[119] '[R]isk is a modern concept',[120] that 'inherently contains the concept of control'.[121] But, while risk can be managed, the uncertainty and lack of knowledge that are also inherent to risk, also means that it cannot be completely controlled. This is particularly so for those risks that result directly from human activity, which includes the risk of financial crisis.[122] However, recognising that risk cannot be completely controlled or eliminated does not reduce the value of effectively managing the risk. Indeed, it is the effective management, distribution and pricing of risk that gives rise to successful banking institutions. Whilst conventional banks primarily role is to accept and distribute risks, banks abiding by

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115 Glyn A Holton, 'Defining Risk' (2004) 60 *Financial Analysts Journal*, 19, 22.
116 Vaughan, Emmet J. and Therese Vaughan (1999), *Fundamentals of Risk and Insurance* (John Wiley & Sons) p.7.
117 Megginson, William L. (1997), *Corporate Finance* Theory, (Addison-Wesley), p.95.
118 Peter L Bernstein, *Against the Gods: The Remarkable Story of Risk* (John Wiley & Sons 1996), 1-2.
119 Darryl SL Jarvis, 'Risk, Globalisation and the State: A Critical Appraisal of Ulrich Beck and the World Risk Society Thesis' (2007) 21 *Global Society* 23, 23-24.
120 Ulrich Beck, 'The Silence of Worlds and Political Dynamics in the World Risk Society' (2002) 1(4) *Logos* 1, 3.
121 Ulrich Beck, 'The Terrorist Threat: World Risk Society Revisited' (2002) 19 *Theory, Culture & Society* 39, 40.
122 *Ibid*, 41.

Shariah principles are prohibited by the principles of *qimar*, *maysir*, and *gharar* from assuming excessive risks or engaging in speculation. It is instructive to consider this distinction when assessing the market practices of Islamic banks.

Today, we live in a global risk society in which individuals and organisations both face and give rise to greater or lesser degrees of risk and specific groups that represent particular risks '[become] defined by this "risk"'.[123] Risk is 'ubiquitous and thus grounds a politics of fear and a politics of prevention'[124] with the relationship between the risk-taker and the risk-facers grounding both an individual and a social responsibility. These risks may be global in nature, transcending national and geographical boundaries, establishing dispersed and diverse '[cosmopolitan] risk communities', and requiring a reflectively selective appreciation of the lives and views of the less familiar 'other'.[125] The impact of global risk is to transform these 'others' into global neighbours that demand consideration when making 'risk decisions',[126] and this necessarily impacts on the governance and regulation of risky activity, 'undermining the operative logic of the institutions of the nation-state and of industrial society'.[127] Global issues require global solutions and even risks that are relatively localised, in an immediate sense, may have "knock-on" effects mediated, for example, by the contagions of illegitimacy, which are the inverse of the contagions of legitimacy phenomenon discussed earlier.

However, this begs the question of whether risks can be effectively regulated and whether they should be regulated in the first place?

[123] Ulrich Beck, 'Critical Theory of World Risk Society: A Cosmopolitan Vision' (2009) 16 *Constellations* 3.
[124] *Ibid*.
[125] *Ibid*, 3-5.
[126] *Ibid*, 6.
[127] *Ibid*, 11.

As to the normative question of whether risks should be regulated Beck proposes that untramelled risk and risk management allows the creation of structural social inequality between those who create the risks, and possess the power to divert that risk, and those who have the risk imposed upon them.[128] This insight raises questions of responsibility, justice, trust, credibility, and legitimacy that must be addressed, alongside any attempt to manage risk, by regulatory or governance regimes. A failure to effectively manage global risks threatens the 'failure of institutions that derive their legitimacy from a declared mastery of danger'.[129] As Mythen notes, 'transboundary risks are capable of producing aftershocks that do not fall neatly within the dominion of nation states'.[130] This undermines the effectiveness of national regulation, increases the public perception of uncertainty and insecurity, and challenges the legitimacy of local responses to global risks. The desire for this legitimacy provides a strong motivation for the regulation of risk.

The need for global regulation and governance to achieve legitimacy through security requires transnational cooperation. This can occur through a retreat into a 'fortress state' with cooperation offered through 'surveillance' and the external provision of power. The alternative, and preferable solution, is an 'open world state' that takes a relational approach to national self-determination and recognises a responsibility towards foreign 'others' regardless of national borders.[131] It is this latter solution that is likely to offer a more complete, persisting and resilient solution

[128] *Ibid*, 9.
[129] Ulrich Beck, 'The Silence of Worlds and Political Dynamics in the World Risk Society' (2002) 1(4) *Logos* 1, 4.
[130] Gabe Mythen, 'From "Goods" to "Bads"? Revisiting the Political Economy of Risk' (2005) 10(3) *Sociological Research Online*, [1.1], available at:
<http://www.socresonline.org.uk/10/3/mythen.html>, accessed 1 July 2014.
[131] Ulrich Beck, 'The Silence of Worlds and Political Dynamics in the World Risk Society' (2002) 1(4) *Logos* 1, 16.

because, through dialogue and the acceptance of cultural and religious difference, it allows the construction of a more genuine global neighbourhood and reflects the risk relationship that unites us.[132]

As to the positive aspect of the effectiveness of risk regulation at establishing its stated objectives, it bears emphasising that both the identification and characterisation of risks are normative and ideological as well as empirical acts.[133] Risks involve both objective and subjective elements and it is the subjective elements of risk perception and the impact or consequences of risk that are perhaps most open to competing moral accounts. In addressing risk and risk-management, it is important to bear this subjectivity in mind in order to ensure the trust, credibility, justice and legitimacy necessary to sustain an effective regulatory system. Furthermore, it should also be noted that the global nature of risk should not be misunderstood as a universal risk. A global risk is simply one that transcends national borders and not necessarily one that affects everyone, or at least affects everyone equally or significantly.[134] It does, however, mean that the methodological perspective must engage with a cosmopolitan or transnational analysis that does not restrict the unit of analysis to the nation state, but includes de-nationalised spaces.[135] The empirical questions must be addressed with a methodology that is conscious of the ‘global’ nature of risk. Accepting the need for a cosmopolitan analysis is not to diminish the persisting relevance of the nation state,[136] but is to emphasise the need for a stratified

[132] Ulrich Beck, 'Living in the world risk society' (2006) 35 *Economy and Society* 329, 331.
[133] *Ibid*, 333.
[134] See, Ulrich Beck, 'The Terrorist Threat: World Risk Society Revisited' (2002) 19 *Theory, Culture & Society* 39, 42.
[135] Ulrich Beck, 'The Terrorist Threat: World Risk Society Revisited' (2002) 19 *Theory, Culture & Society* 39, 53.
[136] Darryl SL Jarvis, 'Risk, Globalisation and the State: A Critical Appraisal of Ulrich Beck and the World Risk Society Thesis' (2007) 21 *Global Society* 23, 39.

analysis engaging with the organisations and institutions at sub-national, national, regional and global levels.

This thesis is concerned with risk created by human activity, in particular, financial risk, and not with the likelihood of natural hazards. This is important because it provides an additional opportunity for governance and regulation by addressing the behaviour that creates the risk. This approach can be used in conjunction with strategies that aim to reduce the likelihood that the risk will materialise and the impact of the harm that results should those strategies fail. One such class of risk, which came to the fore with the 2007 financial crisis, is systemic risk.

Systemic risk is the likelihood that a 'trigger event, such as economic shock or institutional failure ... [will cause] a chain of bad economic consequences - sometimes referred to as a domino effect'.[137] This domino effect, or contagion,[138] results in the failure of a sufficient number of organisations (banks or other financial services companies) that it goes beyond the failure of individual entities and becomes a failure of the system itself.[139] These systemic risks must be distinguished from the systematic risks of the normal swings inherent to the workings of the market.[140] Systemic risk should also be distinguished from global risk. A systemic financial risk may be a global risk, but may also be more localised to regions or even nations, depending on the financial architecture involved.

[137] Steven L. Schwarz, 'Systemic Risk' (2008) 97 *Georgetown Law Journal* 193, 198. The use of the term 'institutional' is in the business sense and not in the sense of the sociological institutional theory.
[138] Franklin Allen, Douglas Gale, 'Financial Contagion' (2000) 108 *Journal of Political Economy* 1.
[139] Viral V Acharya, 'A Theory of systemic risk and design of prudential bank regulation' (2009) 5 *Journal of Financial Stability* 224.
[140] Steven L. Schwarz, 'Systemic Risk' (2008) 97 *Georgetown Law Journal* 193, 204.

A final distinction is between systemic and individual risk, where individual risks are those restricted to a single entity, or limited number of individual entities, and do not threaten the system as whole. Depending on the nature of the harm, there can be a regulatory tension between systemic and individual risk. In the context of banks, for example, an individual organisation can lower the risk to its own security by diversifying risks, but if all banks take the same approach then this can lead to the risk of multiple failure, i.e. similar individual risk diversification strategy may increase the risk of systemic failure. As Beale et al note, this creates a regulatory dilemma between allowing individual banks to maximise their own stability and constraining that freedom in order to protect the system.[141] This example illustrates a general truism, that, just as there is often a tension between the individual and society, so there is a often a tension between the individual and any collective, including specific systems.

The danger posed by systemic risk, and a powerful motivation for regulation, is that the market participants tend to protect themselves, but not others or the system as a whole, against such a threat. Furthermore, because such risks are comparatively rare, they may be effectively sidelined and ignored by individual organisations.[142] The other key regulatory issue is that systemic risks can be distinguished from other kinds of financial risk as being a threat to the very financial system itself,[143] and indeed to the institutionalised rules and norms that support the system. This threat arguably justifies a normative concern that goes beyond economic efficiency and justifies

[141] Nicholas Beale, David G Rand, Heather Battey, Karen Croxson, Robert M May, Martin A Nowak, 'Individual versus systemic risk and the Regulator's dilemma' (2011) 108 *Proceedings of the National Academy of Sciences* 12647.
[142] Steven L. Schwarz, 'Systemic Risk' (2008) 97 *Georgetown Law Journal* 193, 206.
[143] *Ibid*, 207.

regulation on the basis of a wider public interest.[144] Such regulation must focus on not just the individual organisation but on the organisation as part of the system and on the system itself.[145] The extent of that regulation, then, should reflect the extent of the system and may require layers of regulation and governance engaging with the organisation, the nation, the region and the world.

The relevance of risk to the theoretical framework of this thesis is that it provides both the motivation for the establishment of regulation as well as a pervasive discourse that may itself be seen as an institution but also threatens the existence and persistence of other institutions. For example, Rothstein et al distinguish societal risk from institutional risk, the latter representing those risks to the regulatory bodies themselves and to the 'legitimacy of their associated rules and methods'.[146] In other words, the narrative of risk intersects with institutions and an institutional analysis, connecting the analytical entities and providing a lens through which to view the relationships and interactions between those entities.

Levi-Faur suggests that: 'Like many other political concepts, regulation is hard to define, not least because it means different things to different people'.[147] As a start towards a definition, Levi-Faur notes that it is 'a distinct type of policy' with 'opaque' costs, the most significant of which are the compliance costs faced by the regulated

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[144] *Ibid*, 207.
[145] Viral V Acharya, 'A Theory of sytemic risk and design of prudential bank regulation' (2009) 5 *Journal of Financial Stability* 224, 225.
[146] Henry Rothstein, Michael Huber, George Gaskell, 'A Theory of Risk Colonisation: The spiralling regulatory logics of societal and institutional risk' (2006) LSE Research Online 1, 2, available at: <http://eprints.lse.ac.uk/2675>, accessed 3 July 2014, originally published in: (2006) 35 *Economy and Society* 91-112.
[147] David Levi-Faur, 'Regulation and regulatory governance', in Levi-Faur, D (ed) *Handbook on the Politics of Regulation* (Edward Elgar 2011) 3.

parties.[148] It is concerned with standard setting,[149] rule making and possibly rule monitoring and enforcement, and is focused on risk management.[150] Traditionally, regulation has been centred on the state and involves 'some form of "command and control"'.[151] As a policy of rules designed to manage risk by controlling behaviour,[152] regulation is essentially normative and value laden. Its goals include, the correction of market failure, risk management and distribution, social justice and the prevention of the self destruction of the regulated systems.[153]

Levi-Faur goes on to suggest that it might be better to accept a plurality of meanings rather than try to force a definition.[154] This is fine for a discussion of regulation in general, but distinct contexts may require a more monistic approach. As such, the approach will be to build on the already identified features of regulation and consider some of the differing views before providing a definition for the specific purpose of this thesis.

One regularly relied on definition of regulation defines the term as the'sustained and focused control exercised by a public agency over activities that are valued by the community'.[155] This view of regulation focuses on the functioning of the administrative bodies tasked with implementing the regulatory rules and overseeing

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[148] *Ibid*, 4.
[149] Jason M Solomon, 'New Governance, Preemptive Self-Regulation and the Blurring of Boundaries in Regulatory Theory and Practice' (2010) *Wisconsin Law Review* 591, 596.
[150] David Levi-Faur, 'Regulation and regulatory governance', in Levi-Faur, D (ed) *Handbook on the Politics of Regulation* (Edward Elgar 2011) 3, 4.
[151] Julia Black, *Critical Reflections on Regulation* (Centre for Analysis of Risk and Regulation, London School of Economics 2002), 2.
[152] See, Christopher Hood, Henry Rothstein, Robert Baldwin, *The Government of Risk: Understanding Risk Regulation Regimes* (Oxford University Press 2000), 1.
[153] Julia Black, *Critical Reflections on Regulation* (Centre for Analysis of Risk and Regulation, London School of Economics 2002), 7.
[154] David Levi-Faur, 'Regulation and regulatory governance', in Levi-Faur, D (ed) *Handbook on the Politics of Regulation* (Edward Elgar 2011) 3, 5.
[155] P. Selznick 'Focusing Organizational Research on Regulation', in Noll, R. (ed) *Regulatory Policy and the Social Sciences* (University of California Press 1985) 363.

those parties subject to regulation. It emphasises that regulation is both persistent and specific or targeted. It is, however, as Levi-Faur notes, a restrictive definition that excludes private, civil and self- regulation, as well as the regulation of activities not valued by the community.[156]

Although accepting the pluralism of the conception of regulation, Levi-Faur defines it preferentially as:

> the *ex ante* bureaucratic legalization of prescriptive rules and the monitoring of and enforcement of these rules by social, business, and political actors on other social, business and political actors.[157]

This very particular approach restricts regulation to the bureaucratic, so excluding any legal mechanism (legislature and judiciary). Scott, on the other hand, provides a much wider definition of regulation as:

> any process or set of processes by which norms are established, the behavior of those subject to the norms monitored or fed back into the regime, and for which there are mechanisms for holding the behavior of regulated actors within the acceptable limits of the regime.[158]

Black notes that regulation is increasingly being conceived of as separate from the state, which opens the door for a 'wide range of different configurations of state,

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[156] David Levi-Faur, 'Regulation and regulatory governance', in Levi-Faur, D (ed) ***Handbook on the Politics of Regulation*** (Edward Elgar 2011) 3, 6.
[157] ***Ibid***, 6.
[158] C. Scott, 'Analyzing regulatory space: fragmented resources and institutional design' (2001) Summer, *Public Law* 329, 331.

market, community, associations and networks to deliver public policy goals'.[159] But, although this 'decentred' regulation is consistent with the trend towards globalisation, it does, as she acknowledges, raise the question of the nature of regulation. This decentred approach relies on a five key arguments: (i) the complexity that arises from the variety of factors that interact to create the problems that require regulation; (ii) the fragmentation of knowledge and power that is dispersed amongst a number of different actors and not located solely with the state; (iii) that actors and systems change autonomously and are, at least to some extent, self-regulating, which can result in sometimes unpredictable consequences from attempts at external regulation; (iv) that there is a complex set of 'interactions and interdependencies' between the various actors involved in the process of regulation; and (v) the 'collapse of the public/private distinction'.[160]

The consequence of this changing approach to regulation is the plurality of definitions noted earlier. To rationalise this, Black identifies three senses in which regulation may be defined: (i) functional, or what regulation does; (ii) essentialist, representing regulation through the identification of core attributes; and (iii) conventionalist or how the term is used with the relevant community. Opting for a functional approach she defines decentred regulation as:

> the sustained and focused attempt to alter the behaviour of others according to defined standards or purposes with the intention of producing a broadly identified outcome or outcomes, which may

[159] Julia Black, *Critical Reflections on Regulation* (Centre for Analysis of Risk and Regulation, London School of Economics 2002), 1.
[160] *Ibid*, 3-6.

> involve mechanisms of standard-setting, information gathering and behaviour modification.[161]

For present purposes, the aim is to provide a useful definition of regulation that may be distinguished from the concept of governance so that both terms may be helpfully employed in the analytical and prescriptive discussion of Islamic finance and *Sharia* compliance. Before settling on the definition of regulation, then, it is first necessary to consider the meaning of governance and the more specific notion of corporate governance. A reasonable starting point is Wood's comparison of the two concepts, which is relevantly in the context of the financial sector.[162]

For Wood, who seeks to argue that governance provides a more sustainable and effective approach:

> Regulation tells people what to do, while governance involves setting up structures, inside or outside organisations, so as to make it desirable for the organisations *in the best service of their own interests* to do what is thought also to be in the public interest ... governance is a particular type of regulation, one which focuses on structures rather than on either processes or outcomes.[163]

There is a sense here that Wood is setting regulation up as a straw man in order to establish the supremacy of governance, but the final sentence of the quote provides a useful insight, which distinguishes governance as being specifically concerned with structures. Wood's definition of governance also provides a useful truism, that it is

[161] *Ibid*, 20.
[162] Geoffrey Wood, 'Governance or regulation? Efficiency, stability and integrity in the financial sector' (2006) 7 *Journal of Banking Regulation* 2.
[163] *Ibid*, 3.

likely to be more effective to incentivise agents than to simply instruct them. Creating structures that identify the organisation's interests with the public interest may be a better approach than a command and control approach to regulation.

Dealing specifically with corporate governance, Chiu, on the one hand, frames regulation as public, external and concerned with risks and the social good. On the other hand, corporate governance under the agency model, which focuses on aligning managerial and shareholder interests, is 'inward-looking and serves private transactional interests'.[164] In her brief editorial, Chiu expresses the view that, since the 2007 financial crisis, regulation has extended its influence into the corporate governance arena, suggesting perhaps a fluid interface in the relationship between the two approaches to managing behaviour.

Solomon notes that: 'the term "new governance" [is used in much of the literature] to refer to a specific kind of regulatory approach, generally one with particular attributes such as benchmarking, transparency and democratic participation'. Solomon himself prefers to use the term to refer to a 'regulatory state of mind' akin to responsive regulation.[165] This new approach is characterised by a blurring of traditional regulatory boundaries, including 'the roles of regulatory actors', the stages and modes of regulation, the structure, and function of regulatory processes.[166] This does not alter the basic meaning and purpose of regulation, but does affect the structure and the process of regulation, creating more interactional, more

[164] Iris, H-Y Chiu, 'The interface between financial regulation and corporate governance' (2012) 33 *Company Lawyer* 65.
[165] Jason M Solomon, 'New Governance, Preemptive Self-Regulation and the Blurring of Boundaries in Regulatory Theory and Practice' (2010) *Wisconsin Law Review* 591, 592-593.
[166] *Ibid*, 593-594.

interdependent, and more iterative mechanics. The strict divisions between regulator and regulated, public and private, policy setting and implementation, become 'blurred' under the 'new governance' method.

The sense of the relationship between governance and regulation so far has been that governance is a particular type of, or approach towards, regulation. Braithwaite et al, however, see regulation as being a type of governance. Governance is concerned not just with regulation but also with provision and distribution, while regulation is 'about steering the flow of events and behavior'.[167] Certainly, governance, as etymologically related to government, is often used as a wider concept than regulation, involving all the roles of government. However, it is also used either as a synonym or a hyponym of regulation.

For the sake of clarity, this terminological confusion will be resolved as follows. Because this thesis is not concerned with all of the broad roles of government, governance, as a bare term, will not be used. Instead, *regulation* will be used as the hierarchically top level or parent term. This parent term needs to be all-encompassing and, for the purposes of this thesis, Black's definition of regulation (see above) will be relied on. The term *state regulation* will be used to refer to the more traditional 'command and control' or directive regulation established and run solely by the state. For the types of regulation that are more democratically interactive, relational, reflective and discursive, involve both public and private agents, and blur traditional boundaries, the term *new governance* will be used.

[167] John Braithwaite, Cary Coglianese, David Levi-Faur, 'Can regulation and governance make a difference? (2007) 1 *Regulation and Governance* 1, 3.

Before concluding this section, the concept of corporate governance needs explication. As Masdoor notes, there is a plethora of corporate governance theories, including the agency theory, stewardship theory, stakeholder theory, resource dependency and transaction cost theories, and a variety of ethical theories.[168] For present purposes, however, beyond acknowledging that there are a range of views regarding the nature and purpose of corporate governance, there is no need to explore these different theories. The aim here is to provide a more general explanation of corporate governance, which may then be further refined when considering the more substantive issue of *Sharia* compliance and governance in subsequent chapters.

For Masdoor, corporate governance is a 'set of processes and structures for controlling and directing an organization. It constitutes a set of rules, which governs the relationship between management, shareholders and stakeholders'.[169] For Blair, corporate governance is:

> the whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated.[170]

Both of these definitions can be narrowly construed to be concerned solely with the firm as an isolated entity, distinct from its social context. Thus, Shleifer and Vishny explain that: '[c]orporate governance deals with the ways in which suppliers of

[168] Khalid Abu Masdoor, 'Ethical Theories of Corporate Governance' (2011) 1 *International Journal of Governance* 1.
[169] *Ibid*.
[170] MM, Blair, *Ownership and Control: Re-Thinking Corporate Governance for the Twenty-First Century* (Brookings Institution, 1995), 3.

finance to corporations assure themselves of getting a return on their investment'.[171] Alternatively, corporate governance can be conceived more broadly as involving not just the relationship between the firm and its investors, but also between the firm, its investors, its employees, and the wider community.

While corporate governance in its narrowest sense may be seen as a matter for the firm and its investors alone, a more expansive view admits of other interests and allows state involvement in the regulation of corporate governance arrangements. Bearing this in mind, Lashgari's view that '[c]orporate governance is concerned with managing the relationship among various corporate stakeholders',[172] crucially depends on who counts as a stakeholder. The more central stakeholders are the shareholders, creditors, and employees. A wider net would include customers and an even wider net would catch any person affected by the firm's activities, including the community as a whole.

In his foreword to the World Bank Group's Report on Corporate Governance, Sir Adrian Cadbury explained that:

> Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.

[171] Andrei Shleifer, Robert W Vishny, 'A Survey of Corporate Governance' (1997) 53 *Journal of Finance* 737.
[172] Malek Lashgari, 'Corporate Governance: Theory and Practice' (2004) September, *The Journal of American Academy of Business* 46.

> The incentive to corporations and to those who own and manage to adopt internationally accepted governance standards will help them to achieve their corporate aims and to attract investment. the incentive for their adoption by states is that these standards will strengthen the economy and discourage fraud and mismanagement.[173]

Corporate governance requires the coordinated management of the company to ensure compliance with both the law and the ethical standards set down in the relevant corporate governance framework. This will include rules reflecting the principles of: transparency; accountability; fairness and responsibility.[174]

This ethical approach to corporate governance, that takes a relational, rather than individualistic, view of the firm, is reflected in the concept of corporate social responsibility.[175] Corporate social responsibility extends beyond, but is grounded in, good corporate governance.[176] It obliges companies to consider the interests of all those who might be affected by their activities, to behave in a way that does not unreasonably and unjustly prejudice those other interests, and generally to behave in a socially desirable way. This can include: economic responsibilities; legal responsibilities; ethical responsibilities; and discretionary responsibilities.[177] As Dodd noted as long ago as 1932,

[173] Magdi R. Iskander, Nadereh Chamlou, *Corporate Governance: A Framework for Implementation* (World Bank Group 2000), p. vi.
[174] *Ibid*, p. v.
[175] Bob Tricker, *Corporate Governance: Principles, Policies and Practices* (2nd ed, Oxford University Press 2012), 33.
[176] Luu Trong Tuan, 'Corporate social responsibility, ethics and corporate governance' (2012) 8 *Social Responsibility Journal*, 547, 548.
[177] Archie B Carroll, 'A three-dimensional conceptual model of corporate performance (1979) 4 *Academy of Management Review*, 497, 500.

> public opinion, which ultimately makes law, has made and is today making substantial strides in the direction of a view of the business corporation as an economic institution which has a social service as well as a profit making function.[178]

Choudhury notes that this debate regarding the purpose of the firm, and hence the role of corporate governance, remains unresolved.[179] For present purposes, there is no need to provide a solution. Since this thesis is specifically concerned with Islamic finance and its dependence on conformity with *Sharia* principles, which, as will be discussed in subsequent chapters, is explicitly concerned with social justice and responsibility, it makes sense to use the more expansive view of corporate governance that takes into account the interests of society and individuals specifically affected by the firm's activities. As such, this thesis will rely on Sir Adrian Cadbury's definition of corporate governance (see above). This is a wide definition that is inclusive rather than exclusive. It allows for a context-dependent approach to corporate governance that could allow the firm discretion to determine the relevant stakeholder interests depending on the circumstances.[180] This discretion could of course be subject to external regulation.

1.6.2 Research methods

Two different methods were used to obtain the information necessary to answer the research question. These were the identification and retrieval of text-based information and the generation of information through an empirical, qualitative

[178] E. Dodd, 'For Whom Are Corporate Managers Trustees?' (1932) 45 *Harvard Law Review* 1145, 1148.
[179] Bernali Choudhury, 'Serving Two Masters: Incorporating Social Responsibility into the Corporate Paradigm' (2001) 11 *University of Pennsylvania Journal of Business Law* 631.
[180] John Kong Shan Ho, 'Economic Theories of the Firm versus Stakeholder Theory: Is there a Governance Dilemma' (2008) 38 *Hong Kong Law Journal* 399, 424.

interview-based study. These methods are two major approaches and it will be explained below.

1.6.2.1 Text-Based Approach to legal and Socio-Cultural Meanings

To understand the legal context and socio-cultural meanings of the Islamic finance terms and practices. This uses a top-down, text-based method, presuming that the words have significance in particular cultural contexts.

Methodological Aims:

The aims include (i) setting up the necessary conceptual vehicle for analysis; and (ii) establishing the essential distinctions for the production of appropriate interview questions.

How Is the Information Gathered?

Text-based sources included both primary and secondary material. Primary sources included: legislation; formal guidelines; publications by government or other public bodies; the *Qu'ran*, the *Sunnah* (records of oral teachings of Prophet Muhammad); conclusions reached through the application of *Qiyas* (a deductive analogical reasoning process for applying principles from the *Hadith* across contexts not directly considered in the *Hadith*); and information published by banks. Secondary sources included: peer-reviewed journal articles; books and book chapters; working or research papers; and newspapers. The information used was identified through the use of structured keyword searches. The keywords varied depending on the particular aspect of the question that was being addressed, but included: Islamic finance; *Sharia(h)* governance; *Sharia(h)* risk; *Sharia(h)* arbitrage; *riba*; risk; governance; regulation; United Kingdom; Saudi Arabia; Malaysia; new institutionalism/new institutional theory; and institutional logics. A range of databases were used, including: The University of Westminster library database; WorldCat; Westlaw; Heinonline; LexisNexis; Academic Search Complete; ArticleFirst; Applied Social Sciences Index and Abstracts; IngentaConnect; JSTOR; Project Muse; and ProQuest. These searches were supplemented by using the Social Science Research Network and the Bielefeld Academic Search Engine. For completeness, relevant references that were cited in one of the identified sources, but had not been identified through the search strategy, were also retrieved. Finally, Google Scholar and Google Books were used as an additional check to enhance the coverage and comprehensive nature of the search strategy.

The sources identified as most relevant to the research question were retrieved and subject to a critical interpretative analysis applying the relevant methodological approach as discussed in the subsequent section of this chapter. That analysis was then used, in combination with the information generated by the empirical study, to construct a progression of arguments that culminate in the final answer to the research question and the conclusion of this thesis. Those arguments were subsequently reviewed and edited to account for any new information that had not been available when they were initially constructed.

Having followed the steps in the first approach, we come naturally to the design and implementation of the second approach, focusing on interviews.

1.6.2.2 Empirical Qualitative Interviews

This method was to enable the researcher to gain an understanding of the specific factors affecting the interviewees' views of particular Islamic finance doctrines and other factors impacting their interpretation of Islamic finance.

This section describes the interview approach which I had undertaken in order to design and implement appropriate steps to draw out the qualitative data required to answer the research questions.

Approach Strategy:

To identfy and locate the individuals who would be most appropriate and authoritative in answering my research questions.

Aims:

- To make explicit what those questions are.
- To set up questions that draw out appropriate answers related to the research questions.
- Anticipate various type of responses given the interviewees positions, background, business or publich affiliation.

How the Information is Gathered?

The empirical study was designed to supplement the information retrieved from the text based analysis. The aim was to generate information reflecting the attitudes of professionals and academics involved in Islamic finance, its delivery and its governance. The study involved a qualitative semi-structured interview designed to initiate and encourage discussion on a number of matters relevant to *Sharia* governance, Islamic finance and *Sharia* non-compliance. The interview format was chosen over the alternative of a focus group because an interview study allows for the collection of individual data, rather than the collective data that is produced by a focus group.[181] The decision to use a semi-structured interview, which relies on a set of pre-drafted, open-ended questions, was based on the balance they offer between structure and flexibility, which makes them well suited to an inexperienced researcher. This balance of structure and flexibility allows the interviewer to easily manage the process, while allowing some freedom to iteratively react to the interviewees' responses.[182] As such, it allows a deep engagement with the interviewee.[183] Given the relatively subjective nature of the interpretations offered by various scholars on Islamic finance law, the researcher felt that any analysis that failed to take into account this diversity of perspectives in a descriptive, qualitative manner would be inadequate.

The questions were divided into three sections: the development of Islamic finance; the current challenges facing Islamic finance regarding *Sharia* governance; and the possible solutions to those challenges. The interview framework was comprised of 31 possible questions in total. Of these, 17 were selected as the primary questions for the interview, with the remaining 14 questions retained to further stimulate discussion if time permitted. The aim of the 17 primary questions was to prompt

[181] Barbara DiCicco-Bloom, Benjamin F Crabtree, 'The qualitative research interview' (2006) 40 *Medical Education* 314, 315.
[182] Gary Partington, 'Qualitative research interviews: Identifying problems in technique' (2001) 11 *Issues in Educational Research* 32, 33.
[183] Barbara DiCicco-Bloom, Benjamin F Crabtree, 'The qualitative research interview' (2006) 40 *Medical Education* 314, 315.

discussion on particular issues. As such, the discussion of Islamic finance and its relationship with conventional finance, *Sharia* governance and the problem of *Sharia* non-compliance was the ultimate focus and the questions were only used as required to move the discussion along.

Because the study involved human participants it was necessary to ensure that the study was designed and carried out consistently with the demands of research ethics. Formal ethical approval for the study was sought and obtained from the University of Westminster Research Ethics Committee. In addition to this, the research was designed and performed consistently with the requirements of the Data Protection Act 1998, the guidance provided by the Information Commissioner's Office,[184] and the *Guidelines for Conducting Ethical Socio-Economic Research* produced by the RESPECT project.[185] Of particular concern with interview studies are the privacy issues of consent, confidentiality, control of information and the risk of harm caused by the disclosure of information.[186] As such, all participants were provided with detailed information about the study, their involvement,[187] and their right to withdraw their participation.[188] Consent for the interview and use of the information was sought before the participant was interviewed. To reduce any risk of harm from disclosure, the personal identities of the interviewees were anonymised, with participants referred to by role and a number assigned by the researcher.

[184] Information Commissioner's Office, *Guide to Data Protection* (Information Commissioner's Office 2016) <https://ico.org.uk/media/for-organisations/guide-to-data-protection-2-4.pdf> accessed 01 September 2016.
[185] The RESPECT Project, *Guidelines for Conducting Ethical Socio-Economic Research* <http://www.respectproject.org/ethics/guidelines.php> accessed 01 September 2016.
[186] Mark Israel, Iain Hay, *Research Ethics for Social Scientists* (Sage 2006), 78.
[187] Rose Wiles, *What are Qualitative Research Ethics* (Bloomsbury Academic 2013), 27.
[188] Mark Israel, Iain Hay, *Research Ethics for Social Scientists* (Sage 2006), 61.

The sampling strategy was purposive and managed in three stages.[189] The first stage was to define the sampling pool, which restricted the inclusion criterion to a professional or academic in Islamic finance with experience of Islamic finance in one of the three relevant jurisdictions (see below). There was no exclusion criterion. The second stage was to determine the size of the sample. This was set at twenty interviewees. The reasons for this sample size were: to allow each participant an individual voice, while also having a sufficient number to allow the identification of generalised themes;[190] this also ensured that the study would be practicably manageable as one element of the research for this PhD. The third stage was to determine the categories of participants. In order to get a balanced view of Islamic finance and its governance, three types of professional with relevant experience of the three jurisdictions were sought for inclusion in the study. These were: academics specialising in Islamic finance; *Sharia* scholars working in Islamic finance; and Islamic finance professionals/practitioners.

The sample size was not small, with a total of 20 interviews being conducted over the course of the research. The reason for such a large sample was to ensure that a diversity of perspectives were adequately reflected in this research. Limiting the sample of interviewees would have run the risk of an excessive focus on only a few perspectives on Islamic finance.

Three jurisdictions provided the focus for interviews: the UK, Malaysia, and the KSA. These three countries were chosen for three reasons. First, they all have

[189] Oliver C Robinson, 'Sampling in Interview-Based Qualitative Research: A Theoretical and Practical Guide' (2014) 11 *Qualitative Research in Psychology* 25, 26.
[190] *Ibid*, 29.

significant Islamic finance sectors, with:[191] the UK being a leading provider of Islamic finance in the western world; Malaysia being a world leader in terms of both the industry and its regulatory structure; and the KSA being a significant provider of Islamic finance within the Middle East.

Second, and importantly from an institutional perspective, the UK, Malaysia and the KSA represent the three broad religious and cultural contexts for Islamic finance. The KSA is a Muslim country where *Sharia* law and principles form part of the country's constitution. Malaysia is a country where Muslims form the majority of the population, while England is nominally Christian but effectively secular with a significant minority Muslim population. It is important to consider these different contexts primarily because those working in these countries will be exposed to different institutional environments, which may influence their attitudes to Islamic finance and *Sharia* governance. By including participants across a range of different institutional contexts, similar responses cannot be dismissed as specific to a particular institutional environment. Furthermore, where the response are different, an explanation may be found in the different institutional influences.

Third, while it should be noted that other countries could have been chosen to fulfil the role as a representative of different institutional contexts, there are good pragmatic reasons for purposively selecting these three countries. First, too many countries would have required a far larger study than would have been practicable in the time frame of the PhD. As noted above, there are three broad institutional contexts relevant to the delivery of Islamic finance and it therefore makes sense to

[191] For more detail on the role of these three countries as providers of Islamic finance, see chapter five.

draw the interviewees from three countries that represent those contexts. Second, all three countries were readily accessible to the researcher, with no problems of language. Finally, the KSA is the researcher's home country, which makes it of interest to the researcher. The UK is the nation hosting the PhD, which again makes it a sensible, pragmatic choice.

In implementing the purposive sampling strategy, the interviewees were selected randomly from a list of the possible interviewees and then invited to participate by mail or email. The list of possible interviews was compiled from internet searches for relevant professionals and academics working in the field of Islamic finance. The interviews were carried out between January 2015 and January 2016. All interviews were conducted in English or Arabic by the researcher in person, or by Skype. Each interview was allotted a period of one hour for completion. With the interviewees' permission, the interviews were recorded and then transcribed. Interviews in Arabic were translated into English as part of the transcription process.

As a qualitative study, the intention was to identify 'patterns of interrelationship between many categories',[192] which permits a nuanced approach to interpreting the articulation of complex ideas and concepts. The investigation was aimed at discovering the way in which professionals who work in the field of Islamic finance think about the Islamic nature of the industry and its relationship with conventional finance. To achieve this, the transcripts of the interview were subjected to an interpretative analysis designed to identify any emergent patterns evident in the responses of the interviewees. The method applied follows McCracken's five stages

[192] Grant McCracken, *The Long Interview* (Sage 1988), 16.

of analysis, which was formulated in order to determine both: 'the categories, relationships, and assumptions that informs the respondent's view' and the 'patterns of inter-theme consistency and contradiction'.[193] The five stages are:[194]

1. Analysis of 'individual utterances' in isolation;
2. The development of the observations identified in stage one, relating these observations back to the discourse contained in the transcript to identify relationships of similarity and contradiction;
3. The categories, concepts and relationships are refined to identify patterns and themes;
4. Analysis of the transcript and preceding analysis to tease out general themes and the hierarchical relationships between them; and
5. a review of the stage four conclusions to bring them together to form a coherent thesis.

These five stages of analysis were applied sequentially to each of the transcripts to tease out the common themes and any associated tensions present in the interview responses.

[193] *Ibid*, 42.
[194] *Ibid*, 43-46.

1.6.3 Applying the research methodology and methods to the research question

The research methodology may be broadly categorised as socio-legal. The essence of socio-legal research is to utilise a combination of methodologies to examine law and regulation, not as an independent system, but as an integral part of society. As Schwartz explains, it relies on an interdisciplinary approach:

> using concepts and methods selectively drawn from any source within the law and the social sciences and beyond ... The premise of [Law & Society] is that no single discipline, in isolation from the others, delivers the kinds of questions or answers that can be generated by combining the methods, concepts, and data from several disciplines.[195]

By appropriately combining these different approaches, the research question may be addressed in a way that captures the interaction between society and the law and regulation that governs behaviour within that society.

As discussed above, the approach taken for the purposes of this thesis relied centrally on new institutional theory, supported by insights from risk and governance theories. In addition to these, a doctrinal approach was utilised in order to identify the relevant legal and regulatory approach adopted by each of the three jurisdictions that provided the empirical focus for this thesis. The point of using particular methodologies is to guide both the choice of methods and their application in answering the research question.

[195] Richard ED Schwartz, 'Sociolegal Evolution: An Introduction' (2006) 603 *Annals of the American Academy of Political and Social Science* 8, 9.

The research question behind this thesis is: how should *Sharia* governance be standardised in order to ensure that Islamic finance reliably provides a genuinely Islamic alternative to conventional finance? This question has a normative aspect that requires a judgment regarding the best way to regulate Islamic finance. This judgment in turn requires an understanding of Islamic finance, its goals and how it differs from conventional finance. The importance of understanding the differences between Islamic and conventional finance is to identify how far those differences create different regulatory requirements.

The purpose of regulation is to encourage desirable behaviour and discourage, or prevent, undesirable behaviour. Because behaviour is considered desirable insofar as it serves the desirable goals of the regulated activity, this connects the regulatory requirements to those goals. Thus, there is an interaction between the behaviour of individuals and organisations within an organisational field, the goals that help to define the organisational field, and the regulation that further shapes the organisational field. This interaction is particularly well-suited to an analysis from the perspective of new institutional theory, which highlights the relevance of the institutional influences of the wider environment to the behaviour of individuals and organisations within the organisational field, whether Islamic or conventional finance.

While new institutional theory provided valuable insights into the current practice of Islamic finance, it was also useful for understanding both the impact of current regulatory practices and the options for future development. Here, new institutional theory was applied alongside a reliance on risk and governance theories. This combination of approaches was particularly useful for appreciating the role that regulation and governance play in shaping the institutional logics that help to define Islamic finance as an organisational field distinct from conventional finance. Appreciating the institutional impact of governance and regulation allowed, as explained in chapter six, the proposal for reform to utilise regulation and governance as a positive force to shape Islamic finance and narrow the gap between its theoretical foundations in the *Sharia* and its delivery in a competitive capitalist environment.

The relevance of new institutional theory may be best understood if the research question is deconstructed. In addressing the question of how the regulation and governance of Islamic finance should best be standardised, a good starting point is to ask: what is the current state of Islamic finance and it's governance? This provides the focus for chapters two to five. The first purpose of chapters two and three is to explain the nature of Islamic finance as an organisational field distinct from conventional finance. The second purpose is to compare the delivery of Islamic finance to explore how well it maintains this theoretical distinction in practice. The key criticism lying behind the analysis is that Islamic finance is subject to inconsistent *Sharia* governance and a tendency to prioritise *Sharia* compliance in form over compliance in spirit. This is reflected in a reliance on Islamic financial products that resemble conventional financial products.

Through the lens of new institutional theory, the development of Islamic finance is understood as a consequence of competitive and institutional isomorphism that caused Islamic finance to diverge, under the influence of the political and economic institution of neoliberal capitalism, from its moral foundations in the *Sharia*. The question, then, is how far the regulation of Islamic finance, and *Sharia* governance in particular, has enabled the isomorphic influence of neoliberal capitalism. This is explored in chapter four, along with the question of how the governance of Islamic finance might be made more institutionally Islamic in nature.

Chapter five is used to discuss the responses made by the interviewees to the interview questions. As noted above, the questions were focused on the three jurisdictions of the UK, Malaysia and the KSA. The first part of the chapter applies a socio-legal analysis to the current regulatory and governance approaches implemented in those jurisdictions. In the second part of the chapter, the interview responses are subject to a qualitative interpretative analysis in order to identify themes that confirm or contradict the institutional analysis of the text-based sources of information that were analysed in the preceding chapters.

The interviews also engaged with the possible solutions to the deficiencies of the current system of *Sharia* governance. Again, the responses were subject to a qualitative interpretative analysis. The insights gained from the interviews were then fed into the critical consideration of how to reform the current approach to *Sharia* governance. This discussion relied on regulatory and governance theories and combined those perspectives with new institutionalism in order to develop a comprehensive system of regulation and governance aimed at enhancing the Islamic nature of Islamic finance and countering the worst elements of neoliberal capitalism.

1.7 Thesis structure and argument progression

The argument presented in this thesis progresses through a number of stages, each of which builds on the previous stage to create a progressive argument that ends with the final conclusion. The starting point is an initial explication of the socio-political context of a global financial environment structured around capitalism and conventional finance. This is followed by an analysis of Islamic finance and its governance within that institutional environment. The focus is on *Sharia* governance and sets out the basic problem of a lack of standardisation that grounds the research question. Having set out the problem, the second stage involves an examination of the possible ways in which standardisation could be improved. The final stage is to compare the strengths and weaknesses of these different options in order to identify the most appropriate solution. This argument progression is presented in the subsequent six chapters.

Chapter two focuses on providing an explanation of the socio-political context created by the global financial environment and necessarily impacting on the delivery and governance of Islamic finance. Chapter two aims to (i) explain the nature of the financial system, (ii) explain conventional banking in contrast to Islamic banking, and (iii) understand the institutional influences on current conventional financial sectors, particularly in the context of neoliberal policy.

In discussing the nature of Islamic finance and the features that distinguish it from conventional financial services, Chapter three aims to (i) explain the the relationship between Islamic finance and *Sharia* principles, (ii) to analyse how Islamic finance works in practice, and (iii) to examine the institutional on the development of those products.

Chapter four narrows the focus to consider the *Sharia* governance of Islamic financial services. The chapter aims to (i)contextualise *Sharia* governance through an analysis of risk and corporate governance in general, (ii) consider corporate governance from an Islamic perspective, and (iii) to analyse *Sharia* governance and the management of the risk of *Sharia* non-compliance.

In particular, Chapter four explains the current approach, which relies essentially on *Sharia* supervisory boards, in many countries without central oversight. It is argued that a more holistic Islamic approach would be preferable but issues are raised in the form of the lack of adequately trained Sharia scholars and the potential for conflicts of interest and the delivery of inconsistent *fatwas*.

Chapter five follows on from the analysis of *Sharia* governance in chapter four by explaining, in the first part of the chapter, the current institutional and legal frameworks for *Sharia* governance in the three specific jurisdictions of the Kingdom of Saudi Arabia (KSA), Malaysia, and England. These three jurisdictions also provide the context for the qualitative research presented in part two of chapter five. In the second half of chapter five the analysis of interview responses is set out and discussed, identifying the interviewees' attitudes to Islamic finance and *Sharia* governance and relating those attitudes to the issue of standardisation. That analysis identifies the tensions between the distinct themes that emerged from the interview.

In chapter six, and in response to the analysis presented in the previous chapters, the possible options for reforming *Sharia* governance are considered. The chapter begins with a discussion of how *Sharia* compliance should be governed. This leads into an analysis of three levels of regulation, which are: the level of the firm; the national level; and the international (including regional) level. The options available for regulation and standardisation at each of these levels are considered, including the possible roles for *hisbah*, professional regulation for *Sharia* scholars, national or international *Sharia* boards and international standard setting bodies.

In the concluding chapter, the preceding chapters are drawn together through a brief summary of the argument progression up to that point. This leads into the final part of the chapter, and the thesis, which provides a final conclusion to how *Sharia* governance should be reformed to achieve an acceptable level of standardisation and reinforce public confidence in Islamic financial services.

1.8 Conclusion

This introductory chapter has provided a historical and motivational backdrop for this thesis, which is focused on the issues of whether and how *Sharia* governance of Islamic finance should be standardised. The research question was set out and it was explained that the answer involved three stages: A descriptive analysis of Islamic finance and the current approach to *Sharia* governance; a comparison of the various possible responses; and the selection and defence of a particular solution. The originality of this research was explained as arising from: the deep engagement with the issue of *Sharia* risk and its governance; the methodological approach; and the detailed solution to the problems of inconsistent *fatwas* that focus on technical compliance rather than on the spirit of *Sharia*.

The theoretical framework grounding the research was explained. This framework consists of new institutional theory combined with a global approach to risk, a decentred approach to regulation and a relational, socially responsible approach to governance. Although these two methodological approaches are distinct, they intersect through the establishment of institutionalised responses to risk and the institutionalisation of the regulatory and governance solutions to controlling the behaviour of the regulated entities. For example, as Davis notes: 'corporate governance describes the institutional matrix that channels financial flows'.[196]

Finally, the methods used to implement the theoretic framework were explained along with the connection between the methodological approaches and the different aspects of the question. The methods used were a text-based analysis of sources identified by structured keyword searches of bibliographic electronic databases, coupled with a qualitative semi-structured interview study of a range of professionals and academics from the world of Islamic finance. The information gained from both the interviews and the text-based sources was subject to a critical socio-legal analysis, relying primarily on new institutional theory, but also relying on insights from risk, regulation and governance theories.

In the next chapter, the nature of conventional finance is explicated. This is compared, in chapter three, to Islamic finance, which includes a discussion of Islam

[196] Gerald F Davis, 'New Directions in Corporate Governance' (2005) 31 *Annual Review of Sociology* 143.

and the *Sharia* principles that govern all aspects of Islamic life. Following that, in chapter four, the current arrangements for *Sharia* Governance are examined. Then, chapter five deals with the empirical part of this project, analysing the opinions of Islamic finance professionals on the question of standardisation. Building on those opinions, in chapter six, the various options are set out and analysed before one particular solution is identified and justified. Finally, in chapter seven, the arguments are drawn together to provide a final conclusion.

Chapter Two: The Concept of a Financial System and the Institutional Influence of Capitalism on Conventional Finance

In the introductory chapter the historical development of Islamic finance and the motivations that drove the demand fuelling its expansion were explained. This provided the background context for the research question, which asks how best to deal with the problem of the inconsistent rulings made by the governing *Sharia* boards regarding the *Sharia* compliance of Islamic financial products. Having set out the backdrop for this thesis, the theoretical framework of new institutional theory informed by the discourses of risk, governance and regulation was explained. Before going on to consider the crux of the issue of *Sharia* compliance in chapter four, the nature of Islamic finance, as distinct from conventional (non-Islamic) finance, will be examined in chapter three.

In order to fully appreciate Islamic finance, it is necessary to understand its relationship with conventional finance. This in turn requires an understanding of financial systems in general and conventional financial systems in particular. In this chapter the concept of a financial system will be analysed, before the recent history of conventional financial systems is explored. It will be noted that conventional finance is a category heading subsuming a range of different types of conventional financial systems. It will also be noted that conventional financial systems are not static entities, but change over time depending on the institutions that iteratively interact with those systems to shape their nature. The second part of this chapter will be focused on explicating the key institutional influence of capitalism and its impact on the nature of conventional financial systems.

This analysis will provide a contrast to, and a context for, the development of Islamic finance and the particular issue of *Sharia* compliance. Following the exploration of conventional finance, the concept of Islamic finance itself will be examined in chapter three. This will lead into an explication of the institutional influences affecting the development of Islamic financial instruments. In particular, this will consider the interaction between conventional finance and Islamic finance, including the institutional impact of competition with conventional financial services within a capitalist environment.

2.1 Finance and financial services

2.1.1 The concept of a financial system: an introduction

A concept is a notion or an idea about a thing. It is a way of thinking about and understanding a thing that allows us to identify examples of that entity and relate it other things. This permits a categorisation of things into hierarchies that help to define the similarities and the differences between things. For example, Labradors, are categorised as a type of dog and, for example, may be distinguished from the Siamese type of cat. Both, Labrador dogs and Siamese cats, however, are categorised as types of mammal. Dogs and cats are natural kind concepts, which means that their attributes are empirically determined. Since they are both types of mammal, they share many attributes, but there are also attributes that distinguish dogs from cats. These core attributes should be explicable by the theory that underlies the concept.[197]

[197] Gregory L Murphy, Douglas L Medin, 'The role of theories in conceptual coherence' (1985) 92 *Psychological review* 289; Douglas L Medin, 'Concepts and conceptual structure' (1989) 44 *American psychologist* 1469.

While dogs and cats are natural kinds of concept, a financial system, as a product of human society, is a socially constructed concept. This means that the attributes are created rather than being empirically determined. It also means that, ontologically, the attributes may follow the theory whereas, with natural kind concepts, the theory follows the attributes as a way of understanding and explaining any particular consolidation of attributes into an identifiable entity. This is not to claim that the theory of financial systems preceded the establishment of all real examples, but, rather, that attributes can be altered, or replaced, by new attributes through the development of existing theories or the creation of new ones. Take Islamic finance, for example. As explained in chapter one, Islamic financial transactions are as old as Islam, but Islamic finance as a system, has its origins in the 1940s. The question then, is what are the distinct core attributes and explanatory theory that distinguish the Islamic financial system from the conventional concept of a financial system?

As a starting point it should be noted that, although the Islamic financial system is distinguished from the conventional finance system, there is not just a single conventional system. Rather the design of financial systems varies and there are at least two broad types, and many variant token examples, of financial systems, that might be included under the general category heading of conventional financial systems. For example, Thakor notes that, in the last quarter of the twentieth century, financial markets played a greater role in the US financial system than in European and Japanese financial systems, which tended to rely more on financial intermediaries such as banks.[198] This highlights the distinction between a parent concept, child (types of) concepts and particular examples of a type. Thus, the financial systems of individual countries are examples, with attributes that can be empirically verified. Depending on its particular attributes, each of these financial systems can be characterised as a particular type of conventional financial system, such as market-based or bank-based (see figure 1).

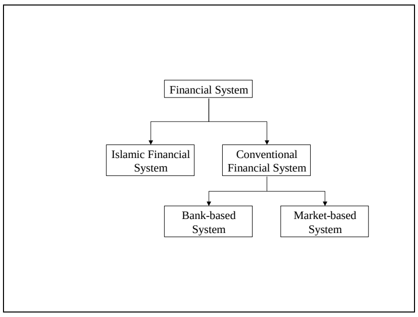

Figure 1: Simplified Financial System Hierarchy

The theories underlying these different types of financial systems are essentially variations on the basic explanatory theory of the concept of conventional financial systems. From the perspective of new institutional theory, the category, or parent, concept of conventional finance evolved because of the isomorphic influence of a dominant institution integral to the explanatory theory of that concept. The various types of child concept developed as a consequence of the secondary institutions

[198] Anjan V Thakor, 'The design of financial systems: An overview' (1996) 20 *Journal of Banking and Finance* 917, 919.

operating in the different countries. This influence may directly affect the nature of the financial system, or it may be mediated through a variation of the dominant institution (see figure 2). In other words, the existence of different types of financial system is the result of different institutional influences, including the institution of regulation.[199] This, of course, begs a number of questions regarding the nature (structure and function) of financial systems and the main institutional influences that shape them.

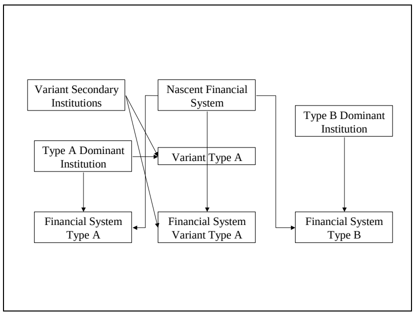

Figure 2: The Impact of Institutions on the Development of Financial Systems

Before addressing those questions, it should be noted that the isomorphic influence of institutions is not simply one way.[200] While institutions act on the various organisations within the organisational field to homogenise those entities into a unified system, this system may itself become sufficiently established to be

[199] Anjan V Thakor, 'The design of financial systems: An overview' (1996) 20 *Journal of Banking and Finance* 917, 940.
[200] See section 1.6.1.1.

characterised as an institution. If successful, the institutionalised financial system may in turn influence the institutions that shaped its initial development. This potentially creates an iterative, homogenising feedback cycle in which the success of a particular financial system legitimises and reinforces the institutions responsible for its existence and evolution. Equally, of course, a failure can undermine the legitimacy of the system and its institutional influences.

2.1.2 The concept of a financial system: an overview

As the term suggests, a financial system is fundamentally a system. Any system comprises a number of constituent element, but, borrowing from Aristotle, for any system 'the whole is something besides the parts'.[201] While a system may be described in terms of its components, and while the constituent parts can be analysed in isolation,[202] these parts operate synergistically in a way that can only be fully understood by considering the system as a whole.[203] This requires an appreciation of 'both the parts and the relations between them'.[204] As such:

> A system may be defined as a set of elements standing in interrelation among themselves and with the environment.[205]

Further to this, the Oxford Dictionaries define a systems as:

> A set of things working together as parts of a mechanism or an interconnected complex whole.[206]

Perrodon provides a similar definition of a system as:

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[201] Aristotle, WD Ross (trans), *Metaphysics* (350 BCE), Book VII, part 6, <http://classics.mit.edu/Aristotle/metaphysics.8.viii.html> accessed 1 October 2014.
[202] DC Phillips, 'Systems Theory - A Discredited Philosophy' (1969) 5 *Abacus* 3, 7.
[203] Asad Kamran Ghalib, 'Systemic Knowledge Management: Developing a Model for Managing Organisational Assets For Strategic and Sustainable Competitive Advantage' (2004) 5 *Journal of Knowledge Management Practice* 1, 4.
[204] Ludwig von Bertalanffy, 'The History and Status of General Systems Theory' (1972) 15 *The Academy of Management Journal* 407, 411.
[205] *Ibid*, 417.
[206] *Oxford Dictionaries* (2014) <http://www.oxforddictionaries.com/definition/english/system> accessed 2 October 2014.

a group of dynamically-interacting components organised to achieve a purpose.[207]

These basic definitions of a system identify two distinct aspects that must be understood, although not necessarily with equal emphasis. The first, or internal aspect, is the structure of the system. The second, or external aspect, is the function of the system.[208] Such an approach will enable financial systems to be distinguished from other types of system, and will allow the different kinds of financial system to be distinguished from one another. For present purposes, however, this is insufficient. In order to fully appreciate the nature and ongoing development of Islamic finance, as a system distinct from conventional finance, it is also necessary to understand the main influences that shape the two systems, which requires an analysis of the interaction between the systems and the institutions that act on them.

A financial system is not a discrete concrete entity in the sense of a car, or a dog. At its most abstract, a financial system is a category concept, useful as a tool for characterising real systems that can be identified as such on the basis of the characteristics of the abstract concept. Thus, one can identify the UK, or US, or German financial system on the basis of the structure and function that define them as distinct types of financial systems. Similarly, conventional financial systems and Islamic financial systems are abstract concepts that can be applied to characterise real systems. As will be discussed later, however, the situation is complicated by the coexistence of the two systems within individual countries, which raises the question of whether they exist as two discrete systems or as a mixed or hybrid system. The

[207] A Perrodon, 'Petroleum Systems: Models and Applications' (1992) 15 *Journal of Petroleum Geology* 319.
[208] Ludwig von Bertalanffy, 'The History and Status of General Systems Theory' (1972) 15 *The Academy of Management Journal* 407, 420.

situation is further complicated by the connections between national financial systems creating a global network.[209] These complications are important, not least because of the possible implications for regulation, which is an issue that will be addressed in subsequent chapters.

A financial system is a socio-cultural system.[210] This is simply to say that such a system is a human construct shaped by the cultural influences of the social institutions within the particular community. As a social construct, financial systems are designed to meet the needs of the community and reflect the ideologies and conventions of that community. Even the very existence of a financial system is contingent on the conventions of money and property. To understand a particular financial system, one also needs to understand the meaning and value of money within that community. This will be returned to later, when considering the nature of conventional finance.

As a social system, the roles that people play within the system comprise its basic units,[211] although these roles may be aggregated into the units of functional organisations. The roles that comprise these basic units are determined by the purpose or function of the system as a whole. The types of unit, and the interaction between them, are coordinated by a particular world view, mediated through the

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[209] The origins of this global financial system lie in the 1970s and 1980s as the neo-liberal capitalist agenda pursed a programme of deregulation: See, Rainer Grote, Thilo Marauhn, *The Regulation of International Financial Markets: Perspectives for Reform* (Cambridge University Press 2006), 39-40; See also, Larry Allen, *Global Financial System 1750-2000* (Reaktion books 2001), 14. Helleiner situates the origins in the late 1950s, but also notes the importance of deregulation in the 1970s, with the UK and the US playing a leading role in the process: Eric Helleiner, *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s* (Cornell University Press 1994), 8-9.
[210] Ludwig von Bertalanffy, *General System Theory: Foundations, Development, Applications* (George Brazillier 1968) 29.
[211] Kenneth E Boulding, 'General systems theory: The skeleton of science' (1956) 2 *Management Science* 197, 205.

various key institutions, to create a system that should then reflect that world view. There are, therefore, three basic aspects of the system that must be considered: the function/purpose of the system; the relational units that comprise the structure of the system; and the institutional influences that shape the specific structure and function of the particular system.

2.1.3 The purpose and function of a financial system

In constructing the theory and core attributes of a socially constructed concept, it is necessary to consider how the concept is socially understood. This makes it important to consider how social commentators use it. Unless the concept is essentially contested, it is likely that there will be some variations in the understanding of the conception, but that the individual conceptions will overlap to identify a common understanding characterising the essence of the concept. Space precludes an exhaustive examination, but the following should suffice for present purposes.

Allen states that:

> A financial system is a framework that facilitates financial transactions, and these transactions require an accepted form of money, something that can serve as a medium of exchange, a unit of account, a store of wealth, and a standard of deferred payment.[212]

As the Organisation for Economic Cooperation and Development (OECD) report on *The Role of Banks* states: '[t]he financial sector plays an essential role in providing

[212] Larry Allen, *Global Financial System 1750-2000* (Reaktion books 2001), 10.

and channelling financing for investment'.[213] Similarly, Allen and Gale explain that in developed countries:

> Financial systems are crucial for the allocation of resources in a modern economy. They channel household savings to the corporate sector and allocate investment funds among firms. They allow intertemporal smoothing of consumption by households and expenditure by firms. They allow both firms and households to share risks.[214]

Rather than try to encapsulate the concept of a financial system in general terms, Neave isolates the principal specific roles of a financial system, which include:

> clearing and settling payments, pooling resources, acting as a store of value, transferring financial resources across regions and through time, managing and transferring risks, developing transaction information, and managing incentives.[215]

Similarly, Allen notes that key functions of the financial system include: risk sharing (markets sharing risks equally, while households are exposed to lower risks in a bank-based system);[216] provision of information; resource allocation; and the financing of new firms.[217] More generally, Davies et. al note that there are three, 'relatively timeless', main types of service offered by organisations within the financial system: payment, settlement and transaction; intermediation; risk transfer;

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[213] OECD, *The Role of Banks, Equity Markets and Institutional Investors in Long-Term Financing for Growth and Development: Report for G20 Leaders* (OECD 2013), 4, <http://www.oecd.org/pensions/private-pensions/institutionalinvestorsandlong-terminvestment.htm>, accessed 24 July 2014.

[214] Franklin Allen, Douglas Gale, *Comparing Financial Systems* (MIT Press 2001), 3-4.

[215] Edwin H Neave, *Modern Financial Systems: Theory and Applications* (John Wiley 2009), 9.

[216] Franklin Allen, 'The Structure of Financial Systems and Financial Stability' (Launching Workshop of the ECB-CFS Research Network on "Capital Markets and Financial Integration in Europe", Frankfurt, 29-30 April 2002), 2.

[217] *Ibid*, 2-3.

and insurance.[218] Of these, Corrigan emphasises the importance of the efficient channelling of savings and the provision of instruments and mechanisms for ensuring payments can be made with confidence.[219] More specifically, Bain suggests that, in performing these services, the primary role of the financial system is to act as intermediary between lenders and borrowers. This allows it to perform the two crucial functions of facilitating payments and the efficient accumulation of capital for investment.[220] In order to efficiently channel funds from savers to borrowers, the financial system performs the additional crucial function of transforming low value, liquid credit to higher value, but more illiquid debt.[221]

Beyond these general and specific functions, a crucially important element of the design of a financial system is financial stability. Allen provides a brief sketch of the history of regulation and financial crises and suggests that the regulatory responses to the crises 'stifled the basic function of a financial system, which is the efficient allocation of resources'.[222] This suggests that financial stability is both a function of external regulation and the financial system itself. Allen further notes that, while competition is generally seen as desirable, a competitive market might make financial intermediaries 'more susceptible to financial instability'.[223] The International Monetary Fund has provided general guidelines on how financial stability is attained. In brief, financial stability is made robust through (i)

[218] Richard Davies, Peter Richardson, Vaiva Katinaite, Mark Manning, 'Evolution of the UK banking system' (2010) *Bank of England Quarterly Bulletin* 321, 321-322.
[219] E Gerald Corrigan, 'The Role of Central Banks and the Financial System in Emerging Market Economies' (1990) Summer *FRBNY Quarterly Review* 1, 2.
[220] AD Bain, *The Economics of the Financial System* (2nd ed, Blackwell Publishers 1992), 4.
[221] Francesco Giavazzi, Alberto Giovannini, 'Central Banks and the Financial System' (2010) *NBER Working Paper 16228*, 16.
[222] Franklin Allen, 'The Structure of Financial Systems and Financial Stability' (Launching Workshop of the ECB-CFS Research Network on "Capital Markets and Financial Integration in Europe", Frankfurt, 29-30 April 2002), 4-5.
[223] *Ibid*, 7.

strengthening the international financial architecture; (ii) enhanced surveillance of capital markets and assessments of external vulnerability; (iii) developing mechanisms for transparency; and (iv) establishing crisis resolution systems.[224]

These views highlight that the purpose of the financial system may be conceived narrowly as a the facilitation of financial transactions. It makes the exchange of goods and services more efficient and has allowed the development of a more complex society in which the financial system is essential to the smooth functioning of that society.[225] As Vitols notes:

> A crucial aspect of the industrialization process is the development of an autonomous financial system: that is, a set of specialized organizations and institutions dealing with the transfer of payments and mediating the flow of savings and investment.[226]

This quote reveals a broader view of financial systems, which characterises it as a mechanism for connecting savers and borrowers, facilitating the movement of money between households and businesses. In other words, the financial system is essentially concerned with the flow of money within society. In order to efficiently perform this role, it provides a number of functions, noted above, that allow money to be saved, invested, borrowed, and traded.

These narrow and broad views of a financial system characterise it as a self-contained and isolated system. Thus, the financial system facilitates financial

[224] Shigemitsu Sugisaki, Achieving Financial Stability: An International Perspective (2002), IMF.
[225] Larry Allen, *Global Financial System 1750-2000* (Reaktion books 2001), 10.
[226] Sigurt Vitols, 'The Origins of Bank-based and Market-Based Financial Systems: Germany, Japan, and the United States', in Wolfgang Streeck, Kozo Yamamura (eds), *The Origins of Nonliberal Capitalism (Cornell University Press* 2001), 171.

transactions and 'mediat[es] the flow of savings and investment'. As suggested by the quote from Vitols, however, the financial system plays a crucial role in the wider economy. Sylla, for example, notes that in modern economic history there have, at different times, been three leading economies: the Dutch; the British; and the US. He goes on to explain that all three of these leading economies had '"Financial Revolutions" that encompassed putting into place ... six key components of a modern financial system *before* they went on to become economic leaders'.[227] Based on this, and based on the development of the Japanese financial system, he explains the important role that a strong financial system plays in economic growth and development. This view is supported by empirical work showing that in the UK, the US, France, Germany and Japan economic growth followed growth and development of the financial system.[228] The connection between the financial system and the wider economy represents the broadest view of a financial system, going beyond its role in the mediation of financial transactions and the flow of money, and characterising it as essential to the well-being of society as a whole.

2.1.4 The structure of a financial system

There are a number of different ways in which the structure of a financial system may be characterised. For example, Sylla relies on an historical enquiry to identify six essential elements of a modern financial system:

> ... sound public finances and public debt management; stable monetary and payment arrangements; sound banking systems (more generally institutional lenders); an effective central bank;

[227] Richard Sylla, 'Financial Systems and Economic Modernization' (2002) 62 *The Journal of Economic History* 277, 281.
[228] The exception was Korea, where financial system growth followed economic growth: Bong-Soo Lee, 'Bank-based and market-based financial systems: Time-series evidence' (2012) 20 *Pacific-Basin Finance Journal* 173.

good securities market for debt, equity and money-market instruments; and sound insurance companies (more generally, institutional investors).[229]

Taking a more narrow and contemporary view of financial systems, Neave identifies "institutions" and markets as two common elements.[230] Allen goes even further and suggests that the

> fundamental unit in ... [the financial system] is the market, an economic crossroads intelligently harmonizing the wishes of groping buyers and sellers, maintaining a precarious balance between the hidden forces of supply and demand.[231]

In principle, according to modern financial theory, which provided the basis for the development of financial systems since the 1950s, a financial system could be structured solely around efficient capital markets as the hub of a network connecting households and businesses. These efficient markets offer stock at a price that already provides a fair reflection of the rate of return, obviating the need for financial intermediaries.[232] As Simon notes: '[i]n classical and neoclassical economic theory, markets are at the center of the stage'.[233] However, as Allen rightly observes, this approach:

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[229] Richard Sylla, 'Financial Systems and Economic Modernization' (2002) 62 *The Journal of Economic History* 277, 280.
[230] Edwin H Neave, *Modern Financial Systems: Theory and Applications* (John Wiley 2009), 7. Note that the term "institution" is not here being used in the sense of an institution under institutional theory.
[231] Larry Allen, *Global Financial System 1750-2000* (Reaktion books 2001), 40.
[232] Richard A Bettis, 'Modern Financial Theory, Corporate Strategy and Public Policy: Three Conundrums' (1983) 8 The Academy of Management Review 406, 407.
[233] Herbert A Simon, 'Organisations and Markets' (1991) 5 *Journal of Economic Perspectives* 25.

is based on an idealized view of the way in which markets operate. Transaction costs, asymmetric information and the market incompleteness associated with them are assumed away.[234]

Currently, financial systems throughout the world rely, to a greater or lesser extent, on both markets and the organisations that function as financial intermediaries. It is precisely the balance between these two elements, and the emphasis placed on one or the other, that distinguish one national financial system from another.[235] Broadly speaking, financial systems may be essentially market-based, such as in the UK and the US, or bank-based, such as in Germany, France and Japan.[236]

Taking the wide view of the financial system as an economic system, an alternative is to utilise a mechanistic approach. Following Gregory and Stuart, Nomani and Rahnema identify four characteristic mechanisms: decision-making; information provision and the coordination of financial transaction decisions; property rights; and material and moral incentives as regulators. On the basis of these mechanisms they identify two extreme categories of economic systems: a market economic system with decentralised decision-making, free market pricing, private property, and a reliance on 'private material incentives'; and a centrally planned command system with central decision-making, state regulated pricing, state ownership, use of both public and private material and moral incentives.[237]

[234] Franklin Allen, 'The Structure of Financial Systems and Financial Stability' (Launching Workshop of the ECB-CFS Research Network on "Capital Markets and Financial Integration in Europe", Frankfurt, 29-30 April 2002), 1.
[235] Edwin H Neave, *Modern Financial Systems: Theory and Applications* (John Wiley 2009), 7.
[236] This is not to say that the market is unimportant in bank-based system. There is evidence that, despite being traditionally classified as a bank-based system, economic growth in Japan was more dependent on the stock market than the banks: Bong-Soo Lee, 'Bank-based and market-based financial systems: Time-series evidence' (2012) 20 *Pacific-Basin Finance Journal* 173, 196.
[237] Farhad Nomani, Ali Rahnema, *Islamic Economic Systems* (Zed Books Ltd 1994), 41-43.

A final option would be to take a more atomistic approach based on the structure of any socially constructed system. This connects structure and function,[238] and builds on all of these other approaches to construct a more fully defined system comprised of three essential elements: the basic units or roles; the processes utilised by the basic units to fulfil their roles and the network of relationships that connect the units internally; and the system as a whole to other systems and agents externally. Understanding the interaction of the relevant networks is an important part of understanding the system as a whole.[239]

The two roles that are fundamental and common to all financial systems are: financial intermediation, including 'payment settling and transaction services';[240] and trading or investment. Other roles include: accounting and auditing; information provision; innovation; risk management; and governance. These roles are provided for by networks of individuals within organisations and by networks of the organisations themselves. These organisations can be categorised according to the type of fundamental role that they support. Thus, there are organisations that support the network of individuals necessary to fulfil the role of financial intermediation. This category includes banks (commercial, investment and universal), building societies, and insurance companies. Operating alongside these financial

[238] Robert C Merton, Zvi Bodie, 'Design of Financial Systems: Towards a Synthesis of Function and Structure' (2005) 3 *Journal of Investment Management* 1, 13.
[239] J Doyne Farmer, M Gallegati, C Hommes, A Kirman, P Ormerod, S Cincotti, A Sanchez, D Helbing, 'A complex systems approach to constructing better models for managing financial markets and the economy' (2012) 214 *The European Physical Journal* (Special Topics) 295, 310-311.
[240] Richard Davies, Peter Richardson, Vaiva Katinaite, Mark Manning, 'Evolution of the UK banking system' (2010) *Bank of England Quarterly Bulletin* 321.

intermediaries is the network of market trading, which includes the stock exchange, the foreign exchange market, the securities market, and the money market.[241]

2.1.4.1 The roles played by financial intermediaries

Financial intermediation is an aggregate term for a number of savings and investment roles essential to the functioning of the financial system. In general, they may be defined as: 'agents, or groups of agents, who are delegated the authority to invest in financial assets. In particular, they issue securities in order to buy other securities'.[242] Thus, they provide a service mediated through the creation of '"secondary" financial assets [used] to buy "primary" financial services'.[243] This may include the exchange of financial assets for their own benefit or on behalf of customers, and the creation and sale of financial assets on behalf of customers.[244]

Banks, as financial intermediaries are an important source of external funding for firms. Because such funding, unlike corporate bonds, is on the basis of a discrete relationship between the bank and the firm, banks can also play an important role in the corporate governance of the firm.[245] Providing loans is one side of the nominal role of financial intermediaries. The loans are made possible by these organisations "borrowing" from other groups within the community. Banks, for example, take deposits from customers using a range of accounts (e.g. current and saving accounts) and services that provide the customer with some value. These include the facility of saving and safekeeping, the payment of interest on savings, and the provision of

[241] Edwin H Neave, *Modern Financial Systems: Theory and Applications* (John Wiley 2009), 7.
[242] Douglas W Diamond, 'Financial Intermediation as Delegated Monitoring: A Simple Example' (1996) 82/3 *Federal Reserve Bank of Richmond Economic Quarterly* 51.
[243] *Ibid*, 52.
[244] Frank J Fabozzi, Fanco Modigliani, Michael G Ferri, *Foundations of Financial Markets and Institutions* (Prentice-Hall International 1994), 20.
[245] Gary Gorton, Andrew Winton, 'Financial Intermediation' (2002) NBER Working Paper 8928, 1.

money exchange mechanisms (cheques, credit/debit cards, digital transfer). Both the loan and borrowing activities that comprise the intermediation are debt contracts.[246]

The advantage of operating through an intermediary is that the deposits can be pooled to reduce transaction costs and to allow greater efficiency and flexibility in providing loans that meet the needs of the community. In other words, the intermediary acts to transform the terms of the deposits made by lenders into loan instruments characterised by different structures and terms involving the 'maturity, risk and size of the claims'.[247] For example, deposits tend to be highly liquid short arrangements with immediate or minimally restricted access to the funds. Loans, on the other hand, are less liquid with access to the money only on the terms of a pre-arranged agreement. These loans do not appear to function as simply a passive provision of funds readily replaced by an alternative source. Rather, there is a relationship between the company borrowing the funds and the financial intermediary that can influence share prices, may allow some restructuring of debt, and can affect the firm's liquidity constraints.[248]

In transforming the financial instruments (claims) best suited to organisations requiring capital to financial instruments best suited to savers or investors, financial intermediaries create financial assets. In all cases, these assets are different forms of debt. In the case of financial intermediaries within the monetary system, such as banks, these financial assets are a form of money.[249] This endogenous form of

[246] *Ibid*, 2.
[247] Mike Buckle, John Thompson, *The UK financial system: Theory and practice* (4th ed, Manchester University Press 2004), 38.
[248] Gary Gorton, Andrew Winton, 'Financial Intermediation' (2002) NBER Working Paper 8928, 7.
[249] John G Gurley, Edward S Shaw, *Money in a Theory of Finance* (The Brookings Institute 1960), 198.

money,[250] existing as a means of payment,[251] is only temporary. As Rossi notes 'money is created when a bank grants credit to one of its clients and is destroyed when this loan is reimbursed to the bank'.[252]

Other roles played by financial intermediaries include: [253]

- the monitoring of borrowers, which reduces the risk of moral hazard and is made efficient by diversification and the economy of scale;[254]
- more efficient production of information, which is similarly a consequence of the scale of financial intermediaries, along with the development over time of a relationship between the intermediary and the borrowing firms. Such information tends to be utilised privately by the banks (to guide their own activities or to provide investment advice to customers), in comparison to the more public provision of information by the markets.[255] This greater access to information reduces the risk of adverse selection where investment is made in higher risk projects;[256]
- consumption smoothing, which is facilitated by the provision of differential rates of return and liquidity that allows a depositor to unexpectedly withdraw

[250] L Randall Wray, 'The Endogenous Money Approach' (2001) CFEPS Working Paper No 17 <http://www.cfeps.org/pubs/wp-pdf/wp17-wray.pdf> accessed 10 October 2014.
[251] Malcolm Sawyer, 'Money: Means of Payment or Store of Wealth', in Louis-Philippe Rochon, Sergio Rossi (eds), *Modern Theories of Money: The Nature and Role of Money in Capitalist Economies* (Edward Elgar Publishing Ltd 2003) 3, 6-9.
[252] Sergio Rossi, 'Money and Banking in a Monetary Theory of Production', in Louis-Philippe Rochon, Sergio Rossi (eds), *Modern Theories of Money: The Nature and Role of Money in Capitalist Economies* (Edward Elgar Publishing Ltd 2003) 339, 340.
[253] Gary Gorton, Andrew Winton, 'Financial Intermediation' (2002) NBER Working Paper 8928, 11-26.
[254] Douglas W Diamond, 'Financial Intermediation and Delegated Monitoring' (1984) 51 *Review of Economic Studies* 393. Moral hazard refers to the risk that the borrower will use the loan to engage in behaviour that threatens the borrower's ability to repay the loan.
[255] Reinhard H Schmidt, Marcell Tyrell, 'What constitutes a financial system in general and the German financial system in particular?' (2003) Johann Wolfgang Goethe Universitat Finance and Accounting Working Paper No 111, 36.
[256] Mike Buckle, John Thompson, *The UK financial system: Theory and practice* (4th ed, Manchester University Press 2004), 40-41.

funds on short notice while minimising, or insuring, against the total loss of any return;

- the provision of liquidity, which is made possible by the use of claims or securities that function as a medium of exchange. It reflects the banks' role within the system of payments and allows a buyer to purchase goods on the basis of a promise to pay, which can then be honoured when the buyer sells on the goods so purchased;
- a commitment mechanism, which relies on the fragility of the bank deposit system. It requires the bank to protect the value of investment projects through a commitment to those projects in order to maintain the confidence of depositors and avoid a bank run; and
- managing customer portfolios.[257]

Allen and Santomera observe that many theories of financial intermediaries explain their existence as necessary to reduce the transaction costs and asymmetric information absent from the idealised Arrow-Debreu model of resource allocation, and the Modigliani-Miller theorem, in which financial markets function efficiently without the need for intermediation.[258] These economic theories fail to reflect the history of financial systems in which banks have always existed and traditionally have played a far greater role than markets. They go on to note that financial systems in the more developed economies have recently transformed financial innovation, creating a range of new products and with financial markets becoming increasingly important. This increase in the importance of financial markets has been paralleled

[257] Frank J Fabozzi, Fanco Modigliani, Michael G Ferri, *Foundations of Financial Markets and Institutions* (Prentice-Hall International 1994), 20.
[258] Franklin Allen, Anthony M Santomero, 'The theory of financial intermediation' (1998) 21 *Journal of Banking & Finance* 1461, 1462-1463.

by an expansion of new types of financial intermediaries, reducing the role of deposit taking and increasing reliance on securities.[259] These changes have been accompanied by a reduction in transaction costs and easier access to information, but the demand for financial intermediation remains.

After reviewing the data relating to markets and trading, Allen and Santomera note that the traditional distinction between markets and intermediaries has become blurred, with financial intermediaries taking a dominant role in financial markets and asset trading, using the newer markets in futures and options as a way of shifting and managing risk. The financial intermediaries offer firms looking to manage financial risk the value of reducing the costs of participating in market trading.[260] Thus, additional roles are:

- the reduction of participation costs; and
- the shifting and management of financial risks.

This risk management role includes 'intertemporal smoothing', which is achieved through the accumulation of assets when returns are high so that there is a reserve available for periods of low return. The effectiveness of this mechanism is reduced in mixed financial systems where markets compete more effectively for investments during the high return periods, limiting the size of the reserve that can be accumulated.[261] Financial intermediaries are also able to reduce the risk through the diversification of investments, which is made possible by the pooling of funds.[262]

2.1.4.2 The roles played by markets

[259] *Ibid*, 1464.
[260] *Ibid*, 1474-1478.
[261] Franklin Allen, Douglas Gale, 'Financial Markets, Intermediaries and Intertemporal smoothing' (1997) 105 *Journal of Political Economy* 523.
[262] John G Gurley, Edward S Shaw, *Money in a Theory of Finance* (The Brookings Institute 1960), 194.

A financial market facilitates the trading or exchange of financial assets.[263] Although financial market transactions are mediated by brokers, they nevertheless provide a far more direct connection between those with an excess of capital and those seeking to raise capital. These brokers will reduce the cost of searching for suitable capital transfer partners, but not to the extent made possible by the use of financial intermediaries, who are also better able to reduce the risks of adverse selection and moral hazard.[264] These risks, however, may be limited by the use of a clearinghouse (also known as central counterparties)[265] to ensure that payments are made and contracts fulfilled.[266]

Financial intermediation takes the following three forms:

- credit transformation: Banks act as intermediaries by collecting deposits from credit-worthy savers (e.g. with credit ratings of AAA) and manage the transformation of that credit into borrower debt held by less creditworthy borrowers (e.g. with credit ratings of AA). If a bank's view is that there is a mismatch between the credit of the savers and the credit of the borrowers, it will avail itself of the spread between the rates it can charge to borrowers and pay to savers to remain profitable;
- maturity transformation: Banks borrow or take deposits on an ostensibly short-term basis and provide funding for projects which promise returns on

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[263] Frank J Fabozzi, Fanco Modigliani, Michael G Ferri, *Foundations of Financial Markets and Institutions* (Prentice-Hall International 1994), 6.
[264] Mike Buckle, John Thompson, *The UK financial system: Theory and practice* (4th ed, Manchester University Press 2004), 36-37.
[265] Amandeep Rehlon, Dan Nixon, 'Central counterparties: what are they, why do they matter and how does the bank supervise them?' (2013) Q2 *Bank of England Quarterly Bulletin* 1.
[266] Merton H Miller, 'Financial Innovation: The Last Twenty Years and the Next' (1986) 21 *Journal of Financial and Quantitative Analysis* 459, 465; Yuval Millo, Fabian Muniesa, Nikiforos S Panourgias, Susan V Scott, 'Organised detachment: Clearinghouse mechanisms in financial markets' (2005) 15 *Information and Organisation* 229; Randall S Kroszner, 'Can the Financial Markets Privately Regulate Risk? The Development of Clearinghouses and Recent over-the-Counter Innovations' (1999) 31 *Journal of Money, Credit and Banking* 596, 602-603.

projects in the long-term. Banks thereby transform debts with maturities of a few months into loans with maturities of many years, making a profit from the spread between interest rates owed to depositors and owed to the bank by long-term borrowers.

- liquidity transformation: As depositors are given almost instant access to their savings, these are liquid obligations. The loans made on the basis of these deposits, being longer-term loans associated with projects with longer gestation periods, are less liquid. The banking system operates on the belief that all savers will not simultaneously withdraw their funds (as would be the case in a 'bank run'). If such a run were to occur in the case of a liquidity shock, most savers would lose their deposits and the bank would enter insolvency. Under normal circumstances, however, the liquidity requirements of depositors align with the banks' lending policies and the fractional reserves it holds onto to allow withdrawals to be made in the ordinary course of market behaviour.

As well as reducing the transaction costs of searching for a suitable trading party, markets also reduce information costs by promoting the above transformations. The prices of the financial assets for trade derive from the information held by all of the participants, which means that individual traders do not have to personally collect all of the information themselves. Beyond the reduction of transaction costs, the markets play two further roles. First, through the process of price discovery, they determine the price, or return, on a financial asset. Second, they offer liquidity by allowing owners to sell their financial assets without needing to wait until the instrument matures.[267]

The core functions of the market are provided by a number of organisations identified as financial market infrastructures (FMIs).[268] These FMIs may be collectively defined as:

> the channel through which virtually all financial transactions are cleared, settled and recorded. They allow consumers and firms to safely and efficiently purchase goods and services, make financial investments and transfer funds.[269]

A more technical definition is:

> a multilateral system among participating financial institutions, including the operator of the system, used for the purposes of recording, clearing, or settling payments, securities, derivatives or other transactions.[270]

They essentially consist of a collective organisation of participating financial entities that, through the multilateral relationships bounded by the system, cooperate to improve the efficiency and manage the risks of market activity. Thus, they are constituted by:

[267] Frank J Fabozzi, Fanco Modigliani, Michael G Ferri, *Foundations of Financial Markets and Institutions* (Prentice-Hall International 1994), 6-7.
[268] Ruben Lee, *The Governance of Financial Market Infrastructure* (Oxford Finance Group 2010), 8.
[269] Darcey McVanel, Joel Murray, 'The Bank of Canada's Approach to Adopting the Principles for Financial Market Infrastructures' (December 2012) *Bank of Canada Financial System Review* 51.
[270] Committee on Payment and Settlement Systems, Technical Committee of the International Organization of Securities Commissions, *Principles for financial market infrastructures*, Consultative Report (Bank for International Settlements 2011), 7.

> sets of rules, contracts, processes and operational arrangements for managing, reducing and allocating risk arising from transactions between market participants.[271]

They may be operated by a public central bank, or privately organised by profit or non-profit making bodies. They include: exchanges and other trading systems; payment systems; central securities depositories; securities settlement systems; and central counterparties.[272] The organisations that function as part of these systems, provide and coordinate services vital to the stability of the financial system as a whole.[273]

2.1.4.3 Participants and financial instruments

Within the system, providing or making use of the services and functions, there are five types of participant: savers; borrowers (including investors); financial intermediaries; brokers and advisers; and regulators.[274] The savers and borrowers, who provide and utilise the funds, justify the existence of the financial intermediaries, the brokers and advisers. The role of the financial intermediaries is to provide effective and efficient mechanisms for meeting the needs of both groups of end users. In forming an indirect connection between the saver and the borrower, these intermediaries, which include the banks, convert deposits of money in the form most convenient to the saver into loans that are designed to be in a form suitable for the borrower. In so doing, the financial intermediaries utilise the economies of scale and scope that would not be available with a direct connection between the saver and

[271] Bank of England, *The Bank of England's approach to the supervision of financial market infrastructures* (Bank of England 2012), 1.
[272] Committee on Payment and Settlement Systems, Technical Committee of the International Organization of Securities Commissions, *Principles for financial market infrastructures*, Consultative Report (Bank for International Settlements 2011), 7.
[273] HM Treasury, *A new approach to financial regulation: judgment, focus and stability* (Cm 7874, 2010), 41.
[274] AD Bain, *The Economics of the Financial System*, 2nd ed (Blackwell Publishers 1992), 4.

the borrower. For example, pooling funds for a large number of short term deposit and current accounts allows longer term loans to be offered while still preserving the liquidity required by the savers.

To the end users, financial intermediaries are useful beyond their ability to pool funds. Financial transactions carry a cost to the parties. This arises from the uncertainty, and complexity of the transaction, compounded by the informational asymmetry that is likely to exist within the imperfect financial markets. By bringing relevant expertise, bargaining power and a single governance structure, these imbalances can be more effectively managed and the transaction costs reduced.[275]

At the centre of the interaction between the saver, the borrower and the financial intermediaries are the financial instruments that provide the substance of the transactions. As Bain notes, '[t]hese are mostly more or less sophisticated forms of IOUs or claims - they are an asset of one party and a liability of another'.[276] These financial instruments are characterised by three key variables: risk; liquidity (the speed and ease of accessing the monetary value of the product); and the certainty or stability of the real-value of the product in the face of inflation.[277] In the conventional finance system, deposits and short-term loans are generally seen as low risk products that rely on the repayment of capital with interest, have high liquidity (the longer the loan, the lower the liquidity), and low certainty of value in real terms. Company shares, on the other hand are higher risk, but also carry a greater likelihood of gain, have high liquidity, and are better than deposits at preserving or increasing the real value of the product when inflation is allowed for.

[275] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 66-67.
[276] AD Bain, *The Economics of the Financial System*, 2nd ed (Blackwell Publishers 1992), 6.
[277] *Ibid* 7.

2.1.4.4 Financial innovation

Financial innovation, which may be characterised as unpredicted, dramatic developments rather than gradual, foreseen changes,[278] generates new financial products and the strategies to use them.[279] The process engages the financial system as a whole and has been increasingly prevalent since the 1960s.[280] Writing in 1986, Miller characterised the previous twenty years as something of a revolution.[281] This surge in activity has seven main causes: economic volatility; technological advances allowing faster and more efficient communication; distribution of global wealth; better educated and increasingly sophisticated professionals; competition between financial organisations; the regulatory approach;[282] and the tax structure.[283]

These causes may be characterised as providing either motivation or opportunity.[284] For example, competition and economic volatility provides motivation for innovation to capitalise on, or to reduce the risks of rapid changes in interest or exchange rates. Tax laws, and changes in these laws, also provide a motivation to reduce the tax burden and so increase profits. A relaxation of, or a gap in regulation, more sophisticated financial professionals, and advances in computer technologies, on the other hand, provide opportunity for innovation. These ultimate causes are perhaps

[278] Merton H Miller, 'Financial Innovation: The Last Twenty Years and the Next' (1986) 21 *Journal of Financial and Quantitative Analysis* 459, 460.
[279] Stephen A Ross, 'Institutional Markets, Financial Marketing and Financial Innovation' (1989) 44 *The Journal of Finance* 541; Colin Mayer, 'Financial Innovation: Curse or Blessing?' (1986) 2(4) *Oxford Review of Economic Policy* i, ii.
[280] Frank J Fabozzi, Fanco Modigliani, Michael G Ferri, *Foundations of Financial Markets and Institutions* (Prentice-Hall International 1994), 28.
[281] Merton H Miller, 'Financial Innovation: The Last Twenty Years and the Next' (1986) 21 *Journal of Financial and Quantitative Analysis* 459.
[282] Ian Cooper, Innovations: New Market Instruments' (1986) 2(4) *Oxford Review of Economic Policy* 1, 8.
[283] Merton H Miller, 'Financial Innovation: The Last Twenty Years and the Next' (1986) 21 *Journal of Financial and Quantitative Analysis* 459, 461.
[284] Some, such as tax and regulation, may be characterised as providing both motivation and opportunity.

mediated through more direct causes such as an ongoing pressure to lessen a firm's financial constraints and optimise profits. These constraints may arise externally from government regulation and the demands of the market, but may also arise internally through target setting and governance.[285]

Consistently with the driving force of innovation resting in competition,[286] in a study of financial innovation between 1990 and 2002, Lerner found that smaller, less profitable firms tend to innovate more, enjoying an increase in profitability as a consequence. The other type of firm that tends to innovate is the older, less leveraged firm situated in areas of high financial innovation.[287] This suggests that the isomorphic mimicry of successful strategies within the competitive environment is an important factor in determining the involvement of a firm in the process of innovation. From this competitive perspective, financial innovation may be useful for a number of reasons, including: an increase in the range and choice of financial instruments; improved liquidity; the encouragement of direct investment, e.g. through the development of securities; the provision of alternative funding sources; a reduction in cost; and a reduced reliance on banks.[288] The impact of financial innovation, however, is not always positive.

While many innovations can be useful, the pressure to continue to innovate may encourage excessive risk taking (see later). Furthermore, financial innovations may:

[285] William L Silber, 'The Process of Financial Innovation' (1983) 73 *The American Economic Review* 89, 89-90.
[286] Syoum Negassi, Tsu-Yi Hung, 'The nature of market competition and innovation: does competition improve innovation output?' (2014) 23 *Economics of Innovation and New Technology* 63.
[287] Josh Lerner, 'The new new financial thing: The origins of financial innovations' (2006) 79 *Journal of Financial Economics* 223.
[288] Colin Mayer, 'Financial Innovation: Curse or Blessing?' (1986) 2(4) *Oxford Review of Economic Policy* i, v.

increase uncertainty regarding monetary policy; contribute to the volatility of asset prices; reduce liquidity when it is most needed by stressed firms; encourage commercial banks to engage in investment banking activity, with possible conflicts of interest (see later); affect the accuracy of pricing due to inexperience with the new products; affect the ability to regulate effectively; and may concentrate risks in the few financial organisations that underwrite the new instruments.[289]

2.1.4.5 The relationships of the financial system

A key aspect of any system is the relationships that help to define its nature and extent. These relationships may be internal or external to the system. Internal relationships may be co-operative, competitive or regulatory, and include the cooperative relationships between the saver, the financial intermediary, the market and the borrowers, the cooperative relationships between the financial intermediaries, the markets and the FMIs, and - in a capitalist environment - the competitive relationships between organisations seeking to maximise profit. External relationships include those between the financial system, the government as policy maker and the wider economy, those between the financial system and the legal system, and those between different national financial systems and the global financial system. In systems with a central bank (see below), the central banks straddle the boundary of the financial system with both internal and external relationships. Space precludes a fuller discussion of these relationships which are perhaps best represented diagrammatically (see figure 3).

[289] Colin Mayer, 'Financial Innovation: Curse or Blessing?' (1986) 2(4) *Oxford Review of Economic Policy* i, v-vi.

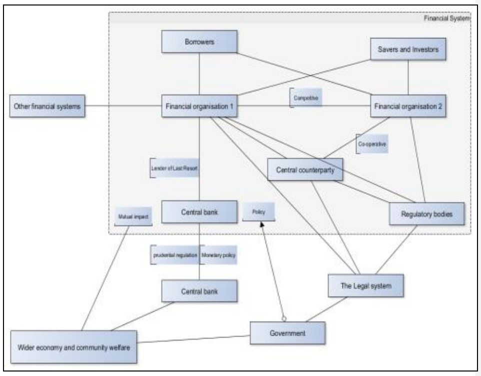

Figure 3: Financial System Relationships

2.1.5 The basic concept of a financial system

At this juncture, it is worth consolidating the discussion so far in order to start constructing the concept of a financial system (see figure 4). The structure of a concept comprises three elements: an underlying theory that provides explanatory force for the core attributes; the core attributes that serve to identify the concept; and the peripheral attributes that widen the variety of distinct token examples existing under the umbrella of the broad category concept. The first step in this process is isolating the explanatory theory from the previous discussion.

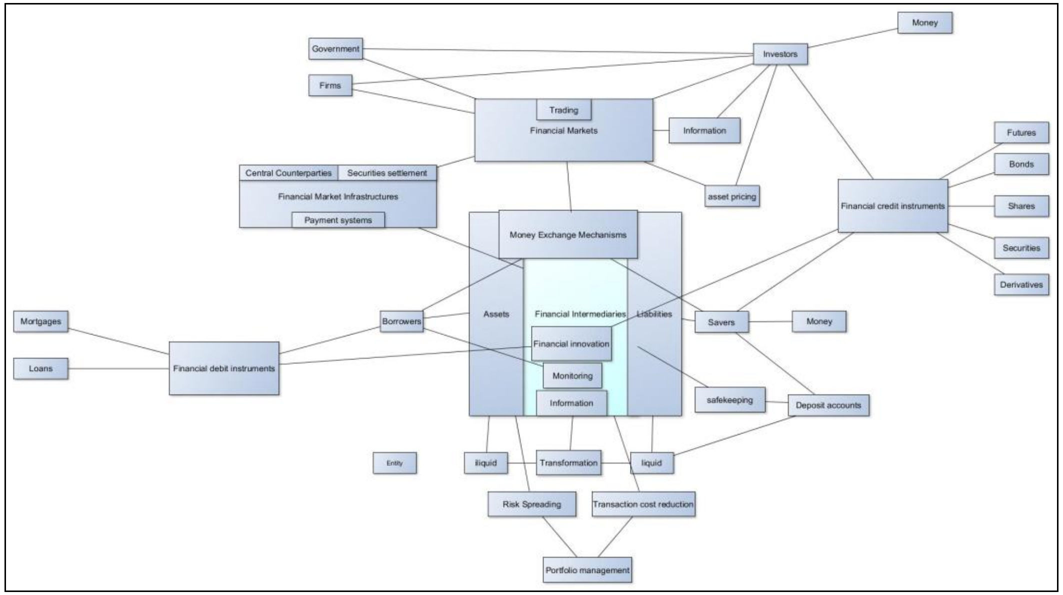

Figure 4: The Concept of a Financial System

I noted earlier that the financial system is a socio-cultural entity. Such a system is comprised of inter-dependent units, which were identified as the roles determined, and required, by the purpose of the system. This suggests that the theory of such a system must be centred on its core purpose. Based on this, the underlying theory of the concept of a financial system is:

> *A complex socio-cultural system comprising a relational network of interdependent roles coordinated to facilitate the flow of money within the community served by that system.*

The core attributes of the concept, which may be identified from the previous discussion, include: the purpose or rationale for the system, which is to generate profit and economic growth by facilitating the flow of money; the actors involved as users or providers of the services and products; the functions of the system, which include the safekeeping of money, the management of risk, information and transaction costs; the provision of liquidity and the innovation of new products and services; the internal and external relationships of the system, including those with the community and the system of regulation; and the stability of the system.

Peripheral attributes, by their nature, are not essential to the concept of a financial system. They may, or may not, exist without affecting the characterisation of the entity as a financial system. Although not crucial to the concept, they may nevertheless engage with important functions in practice. It is, therefore, worth mentioning at least a few of these elements. It was noted earlier that the financial system could be analysed in isolation, or as part of a wider economic system. These different approaches identify the peripheral attribute of secondary purpose, with possible values including: economic growth; and societal well-being. Another important peripheral attribute is regulation. For present purposes, only a brief explanation is provided, sufficient to explain its role as a peripheral attribute.[290]

Regulation provides oversight to reduce the risk of unethical or illegal activity, such as fraud, insider trading, money laundering, negligent practices. This is essential to, 'sustain systemic stability'; 'maintain the safety and soundness of financial institutions'; and to protect the interests of the consumer and other participants in the financial system.[291] Given the importance of the financial services to the economy, regulation is also important to protect the interests of the state as a whole.[292] The need for effective regulation, both national and global,[293] was most recently illustrated by the global financial crisis of 2007,[294] which required, for example, the UK government to step in to prevent certain banks, such as the Royal Bank of Scotland, from collapsing.[295] Regulation can be both internal and external to the individual organisations. Internal regulation is achieved through corporate governance. External regulation is provided by public or private regulatory bodies backed by statutory law and is justified by the need to support internal regulation; to

[290] See also, the introduction to regulation and governance in section 1.6.1.3 and the discussions of governance and regulation in chapters four and six.
[291] David Llewellyn, *The Economic Rationale for Financial Regulation*, FSA occasional paper (1999), 9. <http://finra.complinet.com/net_file_store/new_rulebooks/f/s/FSA_Occasional_Paper1_Economic_Rationale_for_Regulation_99.pdf>, accessed 22 July 2014.
[292] Richard Davies, Peter Richardson, Vaiva Katinaite, Mark Manning, 'Evolution of the UK banking system' (2010) *Bank of England Quarterly Bulletin* 321.
[293] Financial Services Authority, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (2009), 36.
[294] Manuela Moschella, Eleni Tsingou, 'Regulating finance after the crisis: Unveiling the different dynamics of the regulatory process' (2013) 7 *Regulation and Governance* 407.
[295] National Audit Office, *Taxpayer support for UK banks: FAQs*, <http://www.nao.org.uk/highlights/taxpayer-support-for-uk-banks-faqs/>, accessed 22 July 2014.

protect the public against 'monopolistic exploitation'; to protect less powerful and less well informed individuals or organisations; and to provide systemic stability.[296]

2.1.6 Central banks and their roles within a financial system

Although not essential to the core concept of a financial system, central banks currently play a crucial role in most modern financial systems. They are relatively new entities. At the beginning of the twentieth century, there were just 18 central banks, but by the end of that century there were 172.[297] The number continues to rise, with currently 190 national central banks listed on the Central Bank News website.[298] Historically, some central banks, such as the Bank of Prussia, were created to allow the sovereign to exploit the economy, but others, such as the Reichsbank and the Banca d'Italia, were created to improve the payments system for the benefit of the community.[299] Today, central banks are very different from their ancestors and play a number of roles that may be seen as straddling the boundary between the financial system and the wider economy.[300]

Singleton notes that:

> The narrowest definition of a central bank is a bank at which other banks hold deposits and use them for the settlement of interbank payments. However, all central banks have additional functions, several of which are of at least equal importance.[301]

[296] Charles Goodheart, Philipp Hartmann, David Llewellyn, Liliana Rojas-Suarez, Steven Weisbrod, *Financial Regulation: Why, how and Where Now?* (Routledge 1998), 4.
[297] Curzio Giannini, *The Age of Central Banks* (Edward Elgar 2011), xx.
[298] Central Bank News, 'Central Bank Governors' (6 October 2014) <http://www.centralbanknews.info/p/central-bank-governors.html> accessed 31 October 2014.
[299] Curzio Giannini, *The Age of Central Banks* (Edward Elgar 2011), xxi.
[300] Ben O'Neill, 'The Lender of Last Resort: A Comparative Analysis of Central Banking and Fractional-Rserve Free Banking' (2013) 5 *Libertarian Papers* 163, 177.
[301] John Singleton, *Central Banking in the Twentieth Century* (Cambridge University Press 2011), 4.

These include:[302]

- Issuing legal tender banknotes and coins;
- Formulating and implementing monetary policy, including the setting of discount interest rates; the purchase and sale of securities; the availability of loans to commercial banks; and administrative measures such as imposing limits on commercial interest rates;
- Government banking and agency services, including the management of the public debt;
- Maintaining financial system integrity, including acting as a lender of last resort and as a prudential regulator;
- Managing national reserves and exchange rate policies;
- Promoting economic development;
- Advising on economic policy; and
- Cooperating in the management and regulation of global finance.

Arguably, the most important current role of a central bank is to maintain financial stability, or at least to do what it can to counter the inherent fragility of financial systems arising from 'liquidity transformation'.[303] This is necessary to maintain the confidence of the community, which is essential to reducing the risk of a financial crisis and preserving the effectiveness of the system.[304] It requires appropriate monetary policy, the prudent supervision of financial organisations, and rational use of funds in its role as lender-of-last-resort to support those solvent organisations

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[302] *Ibid*, 5-9.
[303] Francesco Giavazzi, Alberto Giovannini, 'Central Banks and the Financial System' (2010) *NBER Working Paper 16228*, 16.
[304] E Gerald Corrigan, 'The Role of Central Banks and the Financial System in Emerging Market Economies' (1990) Summer *FRBNY Quarterly Review* 1, 3-4.

through periods of illiquidity without incentivising excessive risk-taking.[305] Through effective monetary policy, the central bank can manage inflation and price stability.[306] Through macroprudential supervision,[307] the provision of emergency liquidity and regulatory participation in the payments system, the central bank provides a 'safety net' against the potential loss entailed by the unavoidably risky activity of any financial system.[308] Although monetary policy and the setting of interest rates may be managed by a central bank, the 'essence of central banking', as Goodhart notes, is its 'essential role of liquidity management'.[309]

2.1.7 Conventional Banks

For the purposes of this thesis, the primary, although not exclusive, focus is on the banks. There are three reasons for this. First, a restrictive focus will allow sufficient depth of analysis. Second, banks play a 'pivotal' role in the financial services system and carry a greater risk of systemic failure from the contagion effect that accompanies bank runs.[310] Third, the development of Islamic finance, and the accompanying literature, is centred on Islamic banks. Because the later analysis will be centred on banks, it is worth explaining their nature and function in more detail.

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[305] Frederic S Mishkin, 'What Should Central Banks Do?' (Nov/Dec 2000) *Review of the Federal Reserve Bank of St Louis* 1, 8; Larry D Wall, 'Central Banking for financial stability: Some lessons from the recent instability in the US and euro area' (2012) 8 *Public Policy Review* 247, 247-248.
[306] Charles AE Goodhart, 'What Should Central Banks Do? What Should Be Their Macroeconomic Objectives and Operations?' (1994) 104 The Economic Journal 1424.
[307] Benjamin Geva, 'Systemic risk and financial stability: the evolving role of the central bank' (2013) 28 *Journal of International Banking Law and Regulation* 403, 410.
[308] E Gerald Corrigan, 'The Role of Central Banks and the Financial System in Emerging Market Economies' (1990) Summer *FRBNY Quarterly Review* 1, 6; Hyman P Minsky, 'Central Banking and Money Market Changes' (1957) 71 *The Quarterly Journal of Economics* 171, 187.
[309] CAE Goodhart, 'The changing role of central banks' (2011) 18 *Financial History Review* 135, 146-147.
[310] Charles Goodheart, Philipp Hartmann, David Llewellyn, Liliana Rojas-Suarez, Steven Weisbrod, *Financial Regulation: Why, how and Where Now?* (Routledge 1998), 10.

Banks are organisations with a number of different financial roles. Their primary roles are to accept money from depositors, pool the funds, and lend money to borrowers. Under s 2 of the UK Banking Act 2009, a bank is an institution with the legal permission afforded by Part 4A of the Financial Services and Markets Act 2000 'to carry on the regulated activity of accepting deposits'.[311] This latter Act does not define a bank, but includes a number of threshold conditions that must be met for the institution to be granted permission to function as a bank. Banks may be characterised as commercial banks, 'whose main business is deposit-taking and making loans', and investment banks, 'whose main business is securities underwriting, M&A advisory,[312] asset management and securities trading'.[313] The distinction, however, has not always been clear cut in practice with large organisations (universal banks) often carrying out both roles. Furthermore, banks characterised as commercial in nature may still carry out investment activities.

Through the pooling of funds, banks are able to convert short term deposits into longer term loans, which is known as maturity transformation. In other words, banks act as financial intermediaries facilitating the movement of money between those who have a surplus and those with a deficit.[314] They also have the important role of providing payment facilities, which gives banks a central position in the financial system.[315] Functionally, then, banks may be defined as organisations that offer 'three

[311] Building societies, credit unions and any other institution so ordered by the Treasury, are excluded from the definition (Banking Act 2009, s 2(2)).
[312] M&A stands for Mergers and Acquisitions.
[313] Financial Times, 'Definition of commercial bank' (2014) *Lexicon*, available at: <http://lexicon.ft.com/>, accessed 05 September 2016.
[314] Jeanne Gobat, 'What is a Bank?', March 2012, *Finance and Development* 38; Shelagh Heffernan, *Modern Banking in Theory and Practice* (John Wiley & Sons 1996, 2003), 15-16.
[315] AD Bain, *The Economics of the Financial System*, 2nd ed (Blackwell Publishers 1992), 179.

basic services: lending facilities, saving facilities and payment services'.[316] Furthermore, through a process of lending and recycling money, banks go beyond the role of financial intermediaries and create money.[317] This process, which accounts for about 97% of the 'broad money' in circulation,[318] is limited by 'prudential regulation' and the monetary policy of the central bank.[319]

The conventional financial market relies on the payment of interest and banks generate income by charging more interest on loans than the interest they pay out to depositors. This may be supplemented by bank fees, the sale of a variety of financial products including insurance and mutual funds, and the trading of securities, which are documents representing an interest in something of value such as shares, bonds, debts.[320] Securitisation involves the pooling of loans (e.g. mortgages, car-purchase loans, student loans), which are then sold on to an administrator (commercial or investment bank subsidiary). The administrator creates a special purpose vehicle (SPV) to hold the loans and then issues securities against the loans. The securities are then usually sold to an underwriter (e.g. investment bank), which sells them on to the final investor (see figure 6 and the discussion of shadow banking, below).[321]

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[316] Rohini Pande, Shawn Cole, Anitha Sivasankaran, Gautam Gustav Bastian, Katherine Durlacher, *Does poor people's access to formal banking services raise their incomes?* (EPPICentre, Social Science Research Unit, Institute of Education, University of London 2012), 8.

[317] This is a feature of capitalist economics in which debt creates money and repayment destroys it: Hyman P Minsky, 'Capitalist Financial Processes and the Instability of Capitalism' (1980) *14 Journal of Economic Issues* 505, 506.

[318] Narrow money is 'the sum of currency in circulation and demand deposits with banks'. Broad money includes both narrow money and the longer term or 'time deposits': 'What are narrow and broad money?', January 6, 2003, *The Economic Times* <http://articles.economictimes.indiatimes.com/2003-01-06/news/27528765_1_demand-deposits-banking-system-cash-holdings>, accessed 24 July 2014.

[319] Michael McLeay, Amar Radia, Ryland Thomas, 'Money creation in the modern economy' (2014) 1 *Bank of England Quarterly Bulletin* 1, 1-2.

[320] Jeanne Gobat, 'What is a Bank?' (March 2012) *Finance and Development* 38.

[321] Bryan J Noeth, Rajdeep Sengupta, 'Is Shadow Banking Really Banking?' (October 2011) *The Regional Economist* 8, 10-11.

For the most part, the banks, and the financial system generally, functions relatively smoothly. Like any commercial business, however, banking is associated with a number of risks, such as liquidity risks (the risk of a bank being affected by a cash flow shortfall), credit risks (the risk of a borrower defaulting), and operational risks (the risk of loss caused by a failure of the mechanics of the banking system).[322] If these risks materialise, then a bank may fail and, because of the interconnectedess of banking and the financial system, this failure may spread in a way that has been described as a 'contagion'.[323] A bank failure, if it occurs, is likely to be caused or exacerbated by a loss of trust and confidence in the bank. This, in turn, may cause depositors and investors to seek to liquidate their assets (the bank's liabilities), which may gain sufficient momentum to amount to a bank run.[324] This risk of failure, and the systemic risk inherent to the financial system highlight the need for, and justify, regulation. Having explained the basics of financial systems, the analysis turns now to the institutional influences that shape conventional finance.

2.2 The institutional influences shaping conventional financial services[325]

Through an iterative isomorphic process,[326] the way in which the organisations and actors within any system behave is dependent upon the dominant institutions that inform and constrain that behaviour. In chapter one, an institution was defined as a:

> *socially constructed ... essentially taken-for-granted and relatively resistant system of cultural rules and behavioural scripts that establishes a social order and normative framework*.

[322] For formal definitions of these risks and further discussion of the risks facing Islamic banks see section 4.2.
[323] Franklin Allen, Douglas Gale, 'Financial Contagion' (2000) 108 *Journal of Political Economy*, 1.
[324] Jeanne Gobat, 'What is a Bank?', March 2012, *Finance and Development* 39.
[325] Note that the point of this account, including the discussion of the financial crisis, is not to provide a complete and detailed analysis, which is beyond the scope of this work, but to sketch an impression for the purpose of more fully understanding the different approach of Islamic finance.
[326] See the discussion in section 1.6.1.1.

These institutions influence behaviour through self-regulatory mechanisms that impose transactional costs on behaviour that deviates from the institutional norms.[327] The costs include an increased risk in an economic context, greater thought in a cognitive context, and loss of legitimacy and its associated benefits in a social context.[328] The conventional financial system, which is itself an institution with its own cultural rules and behavioural scripts, will be influenced by a number of other institutions, including professionalism,[329] and the legal and regulatory systems.[330] Of the institutions affecting the conventional financial system, perhaps the most important institutionalised discourse[331] is capitalism, which may be broadly defined as '[a]n economic and political system in which a country's trade and industry are controlled for profit ...'.[332]

2.2.1 The pre-crisis position and the emergence of neoliberal capitalism as an institutional influence

The aim of this part of the chapter is to determine the influence of capitalism on the development of conventional financial systems. The discussion in this section will consider financial systems from the latter part of the twentieth century, leading up to the 2007 financial crisis. The crisis itself, and the causes, will then be analysed in the subsequent section. The analysis begins by considering the broad distinction between bank-based and market based financial systems, using the US and the UK as

[327] Nelson Phillips, Thomas B Lawrence, Cynthia Hardy, 'Discourse and Institutions' (2004) 29 *Academy of Management Review* 635, 637-638.
[328] Nelson Phillips, Thomas B Lawrence, Cynthia Hardy, 'Interorganizational collaboration and the dynamics of institutional fields' (2000) 37 *Journal of Management Studies* 23, 28.
[329] Michael Lounsbury, 'Institutional Transformation of Status Mobility: The Professionalization of the Field of Finance' (2002) 45 *Academy of Management Journal* 255.
[330] The influence of law and regulation will be addressed in subsequent chapters.
[331] For the relationship between discourse and institutions see: Nelson Phillips, Thomas B Lawrence, Cynthia Hardy, 'Discourse and Institutions' (2004) 29 *Academy of Management Review* 635.
[332] Oxford Dictionaries (2014), available at: <http://www.oxforddictionaries.com/definition/english/capitalism>, accessed 27 July 2014.

examples of market based systems and France and Germany as examples of bank based systems.

From the start it should be noted, that in the context of financing businesses between 1970-1985, Mayer found that 'banks are the dominant source of external finance' regardless of whether the financial system is bank or market based. In France, Germany, Italy and Japan, bank finance accounted for around 40%, while in the UK and the US the figure is nearer 20%.[333] In the UK this falls to 8% when deposits are 'nett[ed] off'.[334] Rather than rely on bank finance, the UK tended to rely on trade credit, utilising retentions and ploughing earnings back into the businesses. The US, on the other hand, was more reliant on the bond market. Mayer also notes that the source of external funding varied depending on the size of the firm, with small to medium size UK firms being far more reliant on bank funding than the larger firms.[335] Mayer goes on to argue that these differences were not explicable on the basis of the Modigliani and Miller proposition that the source of industry financing is a matter of indifference. Nor could they be explained on the basis of transaction costs or favourable taxation. Rather, he suggests that the differences can be partly explained on the basis of asymmetric information and risk, but, that the reliance on bank financing is best explained by 'their ability to intervene and take control at comparatively low cost'.[336]

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[333] Colin Mayer, 'Financial Systems, Corporate Finance, and Economic Development' in R Glenn Hubbard (ed) *Asymmetric Information, Corporate Finance and Investment* (University of Chicago Press 1990).

[334] Colin Mayer, 'Financial Systems, Corporate Finance, and Economic Development' in R Glenn Hubbard (ed) *Asymmetric Information, Corporate Finance and Investment* (University of Chicago Press 1990) 307, 313.
[335] *Ibid*, 317.
[336] *Ibid*, 326.

While Mayer's analysis reflects the situation in the late 1970s to early 1980s, the differences in the use of the financial system for funding are not static. Rajan and Zingales, for example, found that, in 1913, France's reliance on stock market funding was just under twice that of the US when measured as a fraction of GDP (0.78/0.39), by 1980 the ratio was more than reversed (0.09/0.46) and by 1999 the two countries had largely converged (1.17/1.52).[337] These differences, and the changes with time, they suggest, are not fully explicable by differences in structure, or in the legal systems of the countries. Rather, they argue, these partial explanations need to be supported by a theory centred on the political factors influencing the development of the financial system and the wider economy. Their argument will be critically summarised in the following paragraphs.

Commented [A1]: Supervisor comment 2.23.1 refers to a bank financing in Germany being mentioned on this page but this doesn't appear here.

Rajan and Zingales note that, in general, financial systems across a range of countries, including the UK, the US, France and Germany, were more functionally developed in 1913 than in the 1940s. The depression of these financial systems continued until the 1970s-1980s, which period provided a turning point for a recovery with the most marked increase in the functional development of the financial system occurring through the 1980s and 1990s.[338] In setting the foundations for explaining the changes in the financial systems throughout the twentieth century, Rajan and Zingales postulated that the development of a financial system increases competition by facilitating the emergence of new ventures and businesses, which may, on balance, work against the interests of well-established companies. They go on to show that financial underdevelopment is often accompanied by bureaucratic

[337] Raghuram G Rajan, Luigi Zingales, 'The great reversals: the politics of financial development in the twentieth century' (2003) 69 *Journal of Financial Economics* 5, 7.
[338] *Ibid*, 17.

barriers to new entrants 'suggest[ing] a common purpose'.[339] The political power held by the well-established firms is such that financial development is possible only with their cooperation or with a dramatic change in the country's politics.

In periods of political stability, Rajan and Zingales argue, the key determinants are the degree of foreign cross-border competition and capital flow. Cross-border trade and capital flows combined are likely to create a demand for financial development from the well-established and powerful domestic firms. As competition increases, so do the demands for information and the risks of investing. Furthermore, the more liberal the trade and capital flows, the less opportunity there is for the government to intervene to provide subsidised loans to favoured domestic firms. These factors lead to an increased need for external funding and an interest in the development of the domestic financial system. This process creates a positive feedback loop: the availability of foreign credit and competition from foreign firms increases competition; this increase in competition creates a demand for external finance and the need for a better developed financial system; a better developed financial system creates the opportunity for new and riskier entrants; this increases competition and reinforces the demand for a better developed financial system.

Rajan and Zingales acknowledge the problems of providing objective data to support this process, but give the development of the French financial system, initiated in 1983 as an example of a system that has maintained a competitive edge in the context of free trade within the European Community. They further point to globalisation and the free flow of capital as providing political motivation for otherwise resistant

[339] *Ibid*, 21.

countries to allow capital flows across their own borders, thereby creating the conditions that fuel the demand for a more developed financial system. This opening up began with the US in the mid 1970s, the UK in 1980 and subsequently European countries such as France and Germany in the later part of the 1980s. Their hypothesis that the development of financial systems is most marked when there is open trade and cross border capital flow is supported by the evidence they present from 1913 and the late 1990s. In between these periods, from the Great Depression of the 1930s until the end of the Bretton Woods agreement, countries were relatively closed to cross border flows, which is reflected in under developed financial systems. The question is, for the purposes of the present discussion, what caused the change in policy that resulted in the development of financial systems in the latter parts of the twentieth century.

Although international trade expanded in the years after the Second World War, cross border capital flow was restricted to allow the finances of the various governments to recover and to enable them to provide the demanded welfare insurance. This effectively restricted the development of financial markets. Free flow of capital began to return with the end of the Bretton Woods Agreement triggered in 1971 by the US disconnecting the dollar from the gold exchange standard making the dollar a fiat currency.[340] By 1990, the control of cross border capital flow had been removed in the US and throughout western Europe.

Rajan and Zingales finally note that the development of financial systems appears to be influenced by a number of factors, including the legal system, culture and

[340] Michael D Bordo, 'The Bretton Woods International Monetary System: A Historical Overview' in Michael D Bordo, Barry Eichengreen (eds), *A Retrospective on the Bretton Woods System: Lessons for International Monetary Reform* (NBER 1993) 3, 74.

religion. Rather than acting directly, however, these institutions act to modify the impact of the political influence that private interest groups are able to wield. As already discussed, private interest groups, in the form of powerful, well-established companies and financial firms are likely to push for the development of the financial system when faced with the increased competition that follows open trade and cross border capital flows. The positive feedback loop of competition and development of the financial system is consistent with the process of competitive isomorphism. As discussed in chapter one, competitive isomorphism tends to precede, and then accompany, the institutional processes of normative and mimetic isomorphism.

Rajan and Zingales' account provides a reasonable explanation for the mechanics of the changes in financial systems through the twentieth century. Their narrative, however, fails to explain the liberalisation of, in particular, cross border capital flows. For this, one must look to the political developments and change in policies that opened up the flow of capital and fostered competition. Space precludes a full analysis of the financial developments that led up to the 2007 financial crisis and the ideological policies that facilitated the process. While other developments may be referred to, the discussion will focus on shadow banking as a precursor to that crisis. The aim is to illustrate the relationship between the institution of capitalism, whether direct or indirect through regulation and professionalism, and the development of this parallel, but connected, system. As part of this, the analysis will highlight the effect of neoliberalism on capitalist ideologies, the mimetic and normative isomorphism that facilitated the rapid growth and legitimisation of risky financial products, the iterative reinforcement of the ideological policies by the success of those innovations, and the contagion of illegitimacy that follows an aggregate failure of an organisation or the products it sells.[341] The analysis begins with the nature of capitalism and the development of neoliberal capitalism before turning to the impact of that ideology on conventional financial systems.

2.2.1.1 Capitalism and neoliberal capitalism

Capitalism is identified, in its idealised form, with a free market economy, but it 'has never existed in pure form'.[342] Nevertheless, the pure idea of capitalism forms the basis for the variations on the theme that have become institutionalised or argued for by reformists and commentators.[343] Thus, Milton Friedman defines the role of 'competitive capitalism' as 'the organization of the bulk of economic activity through private enterprise operating in a free market'.[344] Capitalism is also closely identified with a liberal philosophy,[345] which prioritises the freedom of the individual conceptualised as autonomous within a loosely aggregated and minimally governed society.

The version of capitalism that arises from combined influences of liberalism and a free market philosophy is neoliberal capitalism. Although different varieties of capitalism may be identified,[346] it is neoliberalism, at least since replacing welfare and managerial capitalism in the 1970s through Thatcher in the UK and Regan in the

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[341] See the discussion in: Suhaib Riaz, 'The global financial crisis: an New institutional theory analysis' (2009) 5 *Critical Perspectives on International Business* 26.
[342] John C Weaver, 'The Meaning of Capitalism' (1946) 5 *American Journal of Economics and Sociology* 402.
[343] See, for example the five types of capitalism (market-based; social-democratic; Continental European; Mediterranean; Asian) identified in: Bruno Amable, *The Diversity of Modern Capitalism* (Oxford University Press 2003), 13.
[344] Milton Friedman, *Capitalism and Freedom: Fortieth Anniversary Edition* (University of Chicago Press 2002), 4.
[345] *Ibid*, 5.
[346] Peter A Hall, David Soskice, 'Introduction', in Hall PA, Soskice D (eds), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford University Press 2001) 1, 8-9; Bruno Amable, *The Diversity of Modern Capitalism* (Oxford University Press 2003) 14.

US,[347] that has provided the dominant discourse.[348] Harvey explains neoliberalism as:

> a theory of political economic practices proposing that human well-being can best be advanced by the maximization of entrepreneurial freedoms within an institutional framework characterized by private property rights, individual liberty, unencumbered markets and free trade.[349]

In other words, neoliberalism preaches the 'unbridled pursuit of self-interest' as the most efficient approach to the market and ultimately economic prosperity.[350] The politics of neoliberal capitalism conceptualises wealth as a value, prioritises individualism, rewards competitive success and creates an environment that encourages innovation and risk taking.[351] Thus, its agenda includes privatisation, deregulation, tax incentives to stimulate investments, and a belief in competition and 'the importance of the profit motive'.[352]

Countering the neoliberal agenda are those who argue that financial markets need regulatory oversight to provide formal structure to the financial system and to minimise the likelihood of excessive risk taking resulting in speculative boom and

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[347] Ronald Dore, William Lazonick, Mary O'Sullivan, 'Varieties of Capitalism in the Twentieth Century' (1999) 15 *Oxford Review of Economic Policy* 102, 111; Desmond King, Stewart Wood, 'The Political Economy of Neoliberalism: Britain and the United States in the 1980s' , in Herbert Kitschell, Peter Lange, Gary Marks, John D Stephens (eds), *Continuity and Change in Contemporary Capitalism* (Cambridge University Press 1999), 371.
[348] David Harvey, 'Neoliberalism as Creative Destruction' (2007) 610 The *Annals of the American Academy of Political and Social Science* 22, 23.
[349] David Harvey, 'Neoliberalism as Creative Destruction' (2007) 610 The *Annals of the American Academy of Political and Social Science* 22.
[350] John L Campbell, 'Neoliberalism in Crisis: Regulatory Roots of the US Financial Meltdown' in, Michael Lounsbury, Paul M Hirsch (eds), *Markets on Trial: The Economic Sociology of the US Financial Crisis, Part 2* (Emerald Group Publishing Ltd 2010) 65, 66.
[351] Peter A Hall, David Soskice, 'Introduction', in Hall PA, Soskice D (eds), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford University Press 2001) 1, 39-41.
[352] Ronald Dore, William Lazonick, Mary O'Sullivan, 'Varieties of Capitalism in the Twentieth Century' (1999) 15 *Oxford Review of Economic Policy* 102, 113-114.

bust scenarios. From the 1970s, however, the social circumstances were such that the neoliberal advocates saw their policies adopted with significant changes to the system of regulation facilitating the development of new financial products that ultimately resulted in the 2007 global financial crisis.[353] Particularly noteworthy are: (i) the reform of banking regulation allowing the development of what is currently referred to as "shadow banking"; (ii) the lack of regulation for the over-the-counter, asset-backed securities markets; and (iii) the approach of credit rating agencies whose 'extremely rosy assessments' of these financial products lulled investors into a false sense of security.[354] Before considering the development of shadow banking and the events that led up to the 2007 crisis, the institutionalisation of neoliberal capitalism in the US will be discussed. As a caveat to this discussion, it should be borne in mind that politics in practice rarely, if ever, represents a pure ideology. Rather, the process of institutionalisation of neoliberal capitalism is one of ongoing conflict with competing ideologies that may, for historical and political reasons, coexist in the practices and structures of the state.[355]

2.2.1.2 The institutionalism of neoliberal capitalism

In the 1970s, the developed world was in the middle of a deep recession coupling high inflation with economic stagnation, commonly referred to by the concatenated term "stagflation". In the US, taxation, the regulatory structure, and the costs of labour had reduced net profits from 13.7% in 1966 to 8.7% in 1973 and 7.6% in 1979. The response to this was a concerted 'political mobilization' by the "capitalist

[353] John L Campbell, 'Neoliberalism in Crisis: Regulatory Roots of the US Financial Meltdown' in, Michael Lounsbury, Paul M Hirsch (eds), *Markets on Trial: The Economic Sociology of the US Financial Crisis, Part 2* (Emerald Group Publishing Ltd 2010) 65, 66-68.
[354] John L Campbell, 'Neoliberalism in Crisis: Regulatory Roots of the US Financial Meltdown' in, Michael Lounsbury, Paul M Hirsch (eds), *Markets on Trial: The Economic Sociology of the US Financial Crisis, Part 2* (Emerald Group Publishing Ltd 2010) 65, 68-69.
[355] Neil Brenner, Nik Theodore, 'Cities and the Geographies of "Actually Existing Neoliberalism"' (2002) 34 *Antipode* 349, 360-361.

class", with a massive growth in organised corporate political action committees and lobbying networks, including the influential Business Roundtable. The impact of this unified effort resulted in a 'transformation of US economic policy between 1974 and 1981'.[356]

As an institution, managerial capitalism coexisted with unionised welfare capitalism[357] in the context of the "monster" of adversarial relations between the workforce (and unions) and their employers that was blamed for the stagflation. Following the problems of employment insecurity for non-managerial workers that escalated during the Great Depression, and facilitated by the Wagner-Connery National Labor Relations Act 1935, unions had grown in size and power.[358] In the period between the end of the second World War and the 1960s, the Committee for Economic Development (CED), involving businessmen and officials from the Commerce Department, promulgated a Keynesian economic approach and emphasised the need for businesses to act responsibly to help maintain economic stability. The policies of the CED were opposed by the National Association of Manufacturers, who preferred liberal individualism and free markets to collective decision-making and government intervention. The CED policies dominated until the 1970s, when they hit the wall of stagflation and the more effective competition of the Business Roundtable, formed in 1972 (see below).[359]

[356] Patrick J Akard, 'Corporate Mobilization and Political Power: The Transformation of US Economic Policy in the 1970s' (1992) 57 *American Sociological Review* 597, 597-602.
[357] See, Michael K Brown, 'Bargaining for Social Rights: Unions and the Reemergence of Welfare Capitalism. 1945-1952' (Winter, 1997-1998) 112 *Political Science Quarterly* 645. See also the discussion of the role that business interests played in the shaping of the Social Security Act 1935, in: Jill S Quadagno, 'Welfare Capitalism and the Social Security Act of 1935' (1984) 49 *American Sociological Review* 632.
[358] William H Becker, 'Managerial Capitalism and Public Policy' (1992) 21 *Business and Economic History* 247, 252.
[359] Todd Schiefling, 'Defense against Recession: US Business Mobilisation, 1950-1970' (2013) 119 *American Journal of Sociology* 1, 2-9.

During the first twenty or so years after the Second World War, US corporations continued to dominate the market, but during the 1960s and 1970s that dominance declined in the face of international competition from, in particular, Japan.[360] This was coupled with a trend to reward managers with company stock, turning them into 'substantial owners' and increasing the pressure for improvements in 'short-run market performance' rather than a more long-term strategy of sustained innovation. This pressure was exacerbated by the organisational shift towards conglomerates, with conglomerate bosses more concerned with 'individual aggrandizement' than the long-term success of the corporations.[361] Taken together, the stagnation in growth and productivity, the high wages, the costs of workers' welfare benefits and the power of the unions, and an organisational structure that favoured short term profit and individual wealth maximisation, all provided the capitalist classes with the motivation to organise and push for political change, which came in the form of neoliberalism.

Brown notes that, although 'business did come to accept ... [fringe benefits] as part of the wage contract and collective bargaining', it is 'doubtful that business fully accepted the labor ideology of welfare capitalism'.[362] This suggests that corporations, their managers and owners, were faced with what they would perceive as a contradiction of values. While the corporations remained competitive and successful, the existing institutionalised political ideology survived and continued to shape behaviour. In the 1960s and 1970s, however, when the US corporations started to

[360] William Lazonick, 'Organizational Capabilities in American Industry: The Rise and Decline of Managerial Capitalism' (1990) 19 *Business and Economic History* 35, 44-48.
[361] *Ibid*, 51.
[362] Michael K Brown, 'Bargaining for Social Rights: Unions and the Reemergence of Welfare Capitalism. 1945-1952' (Winter, 1997-1998) 112 *Political Science Quarterly* 645, 657.

fare less well in a society burdened with high inflation and a stagnant economy, such a conflict was always more likely to trigger or reinforce other motivations for institutional change.[363]

As Greenwood explains, given the right combination of circumstances even well-embedded agents able to mobilise sufficient resources may utilise them to promote an alternative vision and push for a change to the institution.[364] The stagflation of the 1970s provided an 'exogenous jolt' that pushed the conflict over the edge and motivated corporate and other interested agents to cooperate to alter the institution of unionised welfare and managerial capitalism. This jolt was enhanced by the boundary bridging, boundary misalignment, and increased competition that followed the globalising effect of liberal cross-border capital flows accompanying the end of the Bretton Woods Agreement. It was the combined efforts of these parties, organised into bodies such as the US Chamber of Commerce[365] and the Business Roundtable,[366] that constructed a neoliberal economic rationality, helped to spread that rationality through the process of mimetic isomorphism to shape corporate decision-making and 'develop mutual understandings of profitiable strategies'.[367] In effect, they acted as elite institutional entrepreneurs to push back the norms of unionised welfare, managerial capitalism and Keynesian economics allowing the

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[363] Royston Greenwood, Roy Suddaby, 'Institutional Entrepreneurship in Mature Fields: The Big Five Accounting Firms' (2006) 49 *Academy of Management Journal* 27, 29.
[364] *Ibid*.
[365] US Chamber of Commerce, 'About the US Chamber' <https://www.uschamber.com/about-us/about-us-chamber> accessed 2 December 2014.
[366] The Business Roundtable, which was established in 1972 as an association of chief executive officers of key US corporations, aims to promote 'policies to improve US competitiveness, strengthen the economy, and spur job creation'. See: The Business Roundtable, 'About', <http://businessroundtable.org/about> accessed 2 December 2014.
[367] Todd Schiefling, 'Defense against Recession: US Business Mobilisation, 1950-1970' (2013) 119 *American Journal of Sociology* 1, 12, 29.

insurgence of the neoliberal ideal (see figure 5).[368] As Akard noted, '"[s]tagflation" undermined the Keynesian principles underlying postwar economic policy and upset the political balance between capital, labor, and the state that was predicated on continuous economic growth'.[369] This triggered a push for a change in the policies constituting the existing ideological institution with the socio-economic circumstances uniting capitalist interests to rally against existing and proposed government policies that, in their view, misdirected resources towards welfare causing inflation and a damaging shortage of capital for investment. The result was that:

> by the early 1980s, US policy favoured greater reliance on market allocation of resources, a reduction of taxes and nondefense government expenditures, and a rollback of recently-enacted regulations affecting industry.[370]

The relevance of neoliberalism to government policies and the dominant ideological institution of capitalism was bolstered by the election of Ronald Reagan as US President in 1981, marking the beginning of a sustained shift away from welfare policies to macroeconomic market-based policies focusing on reducing inflation and the promotion of business interests.[371] The neoliberal policies of Reaganism were matched in the UK by those of Margaret Thatcher, elected as prime minister in 1979. Similar, if less extreme, policies were also adopted in nations, such as Canada, New

[368] Nitsan Chorev, 'On the origins of Neoliberalism: Political Shifts and Analytical Challenges', in Kevin T Leicht, J Craig Jenkins (eds), *Handbook of Politics: State and Society in Global Perspective* (Springer 2010) 127, 128.
[369] Patrick J Akard, 'Corporate Mobilization and Political Power: The Transformation of US Economic Policy in the 1970s' (1992) 57 *American Sociological Review* 597.
[370] *Ibid*.
[371] David Jacobs, Lindsey Myers, 'Union Strength, Neoliberalism and Inequality: Contingent Political Analyses of US Income Differences since 1950' (2014) 70 *American Sociological Review* 752, 754-756.

Zealand, France and Germany, traditionally used to a more social politics. Under the banner of the Washington Consensus,[372] and through the mechanism of fiscal control implemented by bodies such as the World bank and the International Monetary Fund, neoliberal policies were propagated transnationally. Thus, Brenner and Theodore comment that:

> By the mid-1980s, in the wake of this dramatic U-turn of policy agendas throughout the world, neoliberalism had become the dominant political and ideological form of capitalist globalization.[373]

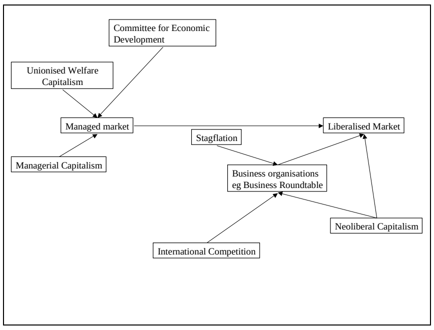

Figure 5: The Neoliberalisation of the US Market in the 1970s

[372] Williamson, the originator of the Washington Consensus, has claimed that it was not intended as a document of neoliberal propoganda and that it subsequently came to be used in a manner quite different from his own motivations, which were that the document should be a tool for debt relief in South American countries: John Williamson, 'A Short History of the Washington Consensus', in Narcis Serra, Joseph E Stiglitz (eds), *The Washington Consensus Reconsidered: Towards a New Global Governance* (Oxford University Press 2008), 14.

[373] Neil Brenner, Nik Theodore, 'Cities and the Geographies of "Actually Existing Neoliberalism"' (2002) 34 *Antipode* 349, 350.

The process of institutionalising neoliberal capitalism was, as Susan George explained, well-orchestrated, highly organised and generously funded. Building on the economic philosophy of Von Hayek and Friedman of the University of Chicago, they 'created a huge international network ... to develop, package and push their ideas and doctrine relentlessly' to create a 'cultural hegemony' that 'made neo-liberalism seem as if it were a natural and normal condition of humankind'.[374] Through this process, the norms and behavioural scripts of neoliberal capitalism rapidly acquired the characteristics of an institution, influencing the minds and guiding the actions of agents who unquestioningly incorporated the doctrine's tenets into their own beliefs.

Facilitated by the increasing professionalisation of financial services with the 'new professionals ... [acting as] important emissaries of the emergent market logic',[375] the institutionalisation of neoliberal capitalism impacted on financial systems throughout the world of conventional finance. It is traditional practice to characterise financial systems as either bank-based or market-based. The isomorphic effect of the new neoliberal norms and behavioural scripts have, since the 1990s, resulted in a blurring of the distinctions with commercial banks taking on more investment roles and mixed systems becoming increasingly apparent.[376] Writing in 2003, some four years before the global financial crisis of 2007, Amable explained:

> There are no signs of a complete conversion of Continental financial systems to a market-based system, but there are signs that the systems are changing ... [possibly] towards a hybrid system ...

[374] Susan George, 'A Short History of Neoliberalism' (Conference on Economic Sovereignty in a Globalising World, Bangkok March 1999).
[375] Michael Lounsbury, 'Institutional Transformation of Status Mobility: The Professionalization of the Field of Finance' (2002) 45 *Academy of Management Journal* 255, 264.
[376] Bruno Amable, *The Diversity of Modern Capitalism* (Oxford University Press 2003), 143.

> [with] a general trend towards securitization ... changes in the regulative frameworks of the banking industry and the soar of financial markets.[377]

In part, at least, this may be a result of the globalisation agenda that accompanied neoliberalism and extended the presence of global commodities, capital and currency markets.[378] It appears, therefore, that, through the processes of competitive and institutional isomorphism, the recent development of conventional finance has been shaped by neoliberal capitalism. As an institutionalised discourse, neoliberal capitalism remains the dominant institutional influence on conventional finance.

2.2.1.3 Capitalism and money

Before considering the impact of neoliberal capitalism on shadow banking and the innovative development of the financial system, the capitalist conception of money will be briefly discussed. This is important because the conception of money is integral to the norms and behavioural scripts constitutive of the institution of capitalism and its neoliberal child. The way in which we perceive money reflects the way in which we see ourselves and our relation to others and society more widely.[379] This, in turn, is influenced by the norms and behavioural scripts of the institutions that provide the cultural context for our lives.

A traditional, but limited, view of money is to see it simply as a relatively insignificant medium of exchange in a complex system of barter embodied by the

[377] *Ibid*, 254 (focus on France and Germany).
[378] Neil Brenner, Nik Theodore, 'Cities and the Geographies of "Actually Existing Neoliberalism"' (2002) 34 *Antipode* 349, 364,
[379] See: Robert Perinbanayagam, 'The Coinage of the Self: Money, Signs and the Social Self', in Norman K Denzin (ed) *Blue Ribbon Papers: Interactionism: The Emerging Landscape* (Emerald Books 2011) 107, 127-128.

market.[380] Thus, Keynes states that '[m]oney is only important for what it will procure'.[381] This thin view of money is reflected in the 'old saying that everyone knows what money is except economists'.[382] As Baker and Jimerson explain: '[money] is not as colorless, neutral, fungible and objective as economists contend. Money is shaped by objective social relations (social structure) and cognitive classifications and evocative meanings (culture)'.[383] For capitalists, and neoliberal capitalists in particular, money is a 'special form of private property' that dominates the capitalist economy providing the raison d'être for the production of goods, 'subordinat[ing]' any community benefit to an incidental value.[384] Money constitutes far more than a neutral token and is as ideologically laden as the system that provides the institutional framework for its production and use.[385]

Rather than simply representing the value of things, money in a capitalist system 'is a means by which value is established'.[386] Furthermore, as Ingham explains, the banking system's creation of money as credit goes beyond storing and transferring value and provides a means of creating value.[387] In so doing, money establishes, maintains, and transforms social relations of trust and confidence allowing economic actors to engage in de-personalised speculative activity that, in the absence of ready

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[380] Jeffrey YF Lau, John Smithin, 'The Role of Money in Capitalism' (2002) 32 *International Journal of Political Economy* 5, 6.
[381] John Maynard Keynes, *A Tract on Monetary Reform* (MacMillan & Co Ltd 1924), 1.
[382] Dudley Dillard, 'Money as an Institution of Capitalism' (1987) 21 *Journal of Economic Issues* 1623.
[383] Wayne E Baker, Jason B Jimerson, 'The Sociology of Money' (1992) 35 *American Behavioral Scientist* 678, 680.
[384] Dudley Dillard, 'Money as an Institution of Capitalism' (1987) 21 *Journal of Economic Issues* 1623, 1627.
[385] See Furnham et al's study, in which they found that 'the emotional underpinnings of money are linked to moral and political issues': Adrian Furnham, Emma Wilson, Kate Telford, 'The meaning of money: The validation of short money-types measure' (2012) 52 *Personal and Individual Differences* 707, 711. See also: Terence R Mitchell, Amy E Mickel, 'The Meaning of Money: An Individual-Difference Perspective' (1999) 24 *Academy of Management Review* 568.
[386] Geoffrey Ingham, 'Capitalism, money and banking: a critique of recent historical sociology' (1999) 50 *British Journal of Sociology* 76, 80.
[387] *Ibid*.

credit-money, would not be available to them.[388] Money, as a capitalist conception, transcends the absence of any intrinsic value in the paper (or metal) token. Rather than simply representing the value of a promise-to-pay, money is an independent source of power,[389] which explains the value intrinsic to the concept of money and creates an illusion of intrinsic value in tokens of money. Although the true value of money is instrumental and lies in the social relationships of power that it enables,[390] the illusion of intrinsic value enables the attitude that money is an end in itself.

For Lau and Smithin, money is crucial to both the substantive and formal rationality of capitalism. Substantively, capitalism is embodied by a 'relentless drive for profit'.[391] As Keynes comments: '[t]he firm ... has no object in the world except to end up with more money than it started with'.[392] This motivation, to the exclusion of all others, is emphasised by Milton Friedman, one of the fathers of neoliberal capitalism, who stated that:

> there is one and only one social responsibility of business ... to increase its profits ... in open and free competition.[393]

Formally, the success or failure of capitalist endeavours is measured in monetary terms. It is this drive for profit combined with an exclusively monetary valuation that imbues money with the illusion of intrinsic value. In the institution of capitalism,

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[388] *Ibid*, 81.
[389] Wayne E Baker, Jason B Jimerson, 'The Sociology of Money' (1992) 35 *American Behavioral Scientist* 678, 680. See also, Heiner Ganssmann, 'Money - a symbolically generalized medium of communication? On the concept of money in recent sociology' (1988) 17 *Economy and Society* 285.
[390] Jeffrey YF Lau, John Smithin, 'The Role of Money in Capitalism' (2002) 32 *International Journal of Political Economy* 5, 6.
[391] *Ibid*, 12. See also Dillard, who notes the formal recognition given to Capitalism's profit motive in the work of John Maynard Keynes: Dudley Dillard, 'Money as an Institution of Capitalism' (1987) 21 *Journal of Economic Issues* 1623, 1631.
[392] John Maynard Keynes, D Moggridge (ed), *The Collected Writings of John Maynard Keynes*, vol 29, (MacMillan 1979), 89.
[393] Quoting from his own book, Capitalism and freedom: Milton Friedman, 'The Social Responsibility of Business to Increase its Profits' (13 September 1970) *The New York Times Magazine* 32-33, 122-124.

money is synonymous with success. Indeed, the success of neoliberal capitalism as an institution is illustrated by the rise, from 49.9% in 1971 to 74.7% in 1991, in the proportion of new US university students who indicated that money was the primary reason for entering higher education.[394] As Dillard notes: 'Money is unlike any other asset because it is the socially recognised form of private wealth'.[395] If being successful is a goal, or intrinsically valuable end, then so too is money. This is exemplified by the whole concept of a rate of interest and the consequential existence of an "investing class",[396] whose role is to make money out of money, rather than from labour and the provision of goods or services. The explication of conventional finance turns now to consider the development of shadow banking.

2.2.1.4 Shadow Banking

The shadow banking system,[397] which had its origins in US government sponsored enterprises such as the Federal Home Loan Bank System (1932), Fannie Mae (1938) and Freddie Mac (1970), has grown substantially over the past 30 years.[398] This has been facilitated by the financial deregulation consistent with the neoliberal capitalist ideology that drove government financial policy in most Western countries, but particularly the US,[399] and the UK. Weiss explains:

> Even more than the historical record effectively demonstrates, the global financial meltdown is itself a textbook story of the state's

[394] Alexander W Astin, 'The changing American college student: Thirty-year trends, 1966-1996' (1998) 21 *Review of Higher Education* 115, 125.
[395] Dudley Dillard, 'Money as an Institution of Capitalism' (1987) 21 *Journal of Economic Issues* 1623, 1627, 1633.
[396] John Maynard Keynes, *A Tract on Monetary Reform* (MacMillan & Co Ltd 1924), 5.
[397] The discussion is focused on the US, but there were similar developments in Europe that followed mimetically the early success of the US shadow banking system: see, Elias Bengtsson, 'Shadow banking and financial stability: European money market funds in the global financial crisis' (2013) 32 *Journal of International Money and Finance* 579. Unless otherwise indicated, the definitions are taken from Investopedia <http://www.investopedia.com/> accessed 05 September 2016.
[398] Zoltan Pozsar, Tobias Adrian, Adam Ashcraft, Hayley Boesky, 'Shadow Banking' (2010) Federal Reserve Bank of New York Staff Report No 458, 20.
[399] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (2011), 35, 52-56.

> disentwinement from financial regulation ... the United States "threw away a critical core of the regulatory rule book" - effectively disentwining itself from the financial market and in the process fostering a giant shadow banking sector.[400]

She attributes this process to three deregulatory acts: The 1999 repeal of the Glass-Steagall Act, legitimising the concept of financial holding companies,[401] and removing the separation between commercial and investment banks, so opening access to deposit savings for risky investments; legislation in 2000 that '*exempted derivatives from regulation*';[402] and, in 2004, the informal removal of 'the prudential requirement for investment banks originating mortgages to maintain adequate capital reserves'.[403]

Interestingly, Weiss, who seeks to argue against the existence of a neoliberal state, goes on to claim that: 'according to the more astute observers, this was no "neoliberal experiment" gone haywire'. In support of this, she points to the words of Simon Johnson, 'former chief economist at the IMF and one of the most respected analysts of the crisis'. She states that he 'has noted that the deregulatory motives were anything but ideological'. It was not about market fundamentalism, but, in Johnson's words, about '"[a] whole generation of policy makers ... mesmerised by Wall Street

[400] Linda Weiss, 'The Myth of the Neoliberal State', in Chang Kyung-Sup, Ben Fine, Linda Weiss (eds) *Developmental Politics in Transition: The Neoliberal Era and Beyond* (Palgrave-MacMillan 2012) 27, 36.
[401] Zoltan Pozsar, Tobias Adrian, Adam Ashcraft, Hayley Boesky, 'Shadow Banking' (2010) Federal Reserve Bank of New York Staff Report No 458, 24. A financial holding company engages in a variety of financial services. The Gramm-Leach-Bliley Act 1999 allowed bank holding companies to declare themselves financial holding companies and engage in a wider range of investment activities.
[402] The Commodity Futures Modernization Act 2000. See, the President's Working Group on Financial Markets, *Over -the-Counter Derivatives Markets and the Commodity Exchange Act* (Report, November 1999).
[403] Linda Weiss, 'The Myth of the Neoliberal State', in Chang Kyung-Sup, Ben Fine, Linda Weiss (eds) *Developmental Politics in Transition: The Neoliberal Era and Beyond* (Palgrave-MacMillan 2012) 27, 36.

... Washington insiders already believed that large financial institutions and free-flowing capital markets were crucial to America's position in the world'".[404] This argument is disingenuous. Policy is inevitably ideological and simply claiming it was not ideologically driven does not make it so. Even the quote included here demonstrates the ideology of neoliberal capitalism in the belief in the power and value of 'free-flowing capital markets'. This is not to say that Weiss is wrong to argue that there has never been a neoliberal state, but that is not the point here. The point here is the more limited claim that the financial policies allowing the emergence of shadow banking were neoliberal in origin.

It should also be noted that the institutionalised form of any ideology is unlikely to be academically pure. Rather, it will involve a complex mix of norms and policies, not all of which will appear to be consistent. As such, neoliberal financial policies can coexist in practice alongside more interventionist neoconservative policies.[405] Harvey, for example, accepts the pragmatics of ideologies in practical politics when he explains what he takes neoliberalism to mean:

> My view is that it refers to a class project that coalesced in the crisis of the 1970s. Masked by a lot of rhetoric about individual freedom ... and the virtues of privatisation, the free market and free trade, it legitimised draconian policies designed to restore and consolidate capitalist class power ...
>
> One of the basic pragmatic principles that emerged in the 1980s ... was that state power should protect financial institutions at all

[404] Linda Weiss, 'The Myth of the Neoliberal State', in Chang Kyung-Sup, Ben Fine, Linda Weiss (eds) *Developmental Politics in Transition: The Neoliberal Era and Beyond* (Palgrave-MacMillan 2012) 27, 36-37.
[405] Jamie Peck, Nik Theodore, Neil Brenner, 'Neoliberalism Resurgent? Market Rule after the Great Recession' (2012) 111 *The South Atlantic Quarterly* 265, 269-273.

> costs. This ... flew in the face of the non-interventionism that neoliberal theory prescribed ... Put crudely, the policy was privatise profits and socialise risks.[406]

In other words, the neoliberal capitalism institutionalised in practice is not the simple application of pure neoliberal principles. Markets should be deregulated to permit the pursuit of profit, but the crucial importance of the financial system to the well-being of the state meant that the state would always be prepared to step in.

As a consequence of the relentless pursuit of profit, a central institutional norm of neoliberalism:

> Strange new markets arose, pioneered within what became known as the "shadow banking" system, permitting investment in credit swaps, currency derivatives, and the like. The futures market embraced everything from trading in pollution rights to betting on the weather.[407]

The problem created by shadow banking is the increased threat to financial stability created by a system that exists outside the regulation of the standard financial system. It was this shadow banking system (which is subject to limited regulation) that, as a now well-recognised source of systemic risk, is at least partially to blame for the 2007 financial crisis.[408] Indeed the term itself only came in to widespread use with the onset of the crisis itself.[409]

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[406] David Harvey, *The Enigma of Capital: and the Crises of Capitalism* (Profile Books 2010), 10.
[407] *Ibid*, 21.
[408] Elias Bengtsson, 'Shadow banking and financial stability: European money market funds in the global financial crisis' (2013) 32 *Journal of International Money and Finance* 579, 580; Oliver Kessler, Benjamin Wilhelm, 'Financialization and the Three Utopias of Shadow Banking' (2013) 17 *Competition and Change* 248.
[409] FSB, *Shadow Banking: Strengthening Oversight and Regulation* (FSB 2011), 1.

Bakk-Simon et al explain that defining the concept of shadow banking 'is not straightforward'. It involves activities 'undertaken in the less regulated segment of the financial system', which has two main dangers: a reliance on short-term, uninsured funds 'makes it susceptible to modern-type "bank runs" and the related liquidity risks without the safety nets available to regulated banking systems'; and regulatory arbitrage.[410] Both of these can negatively impact on the fragility of the regulated sector through contagion or because of the connections between the organisations in the two sectors. They settle on a functional definition of shadow banking as:

> activities related to credit intermediation, liquidity and maturity transformation that takes place outside the regulated banking system.[411]

The Financial Stability Board (FSB), an international body established in 2009 and endorsed by the G20 governments to 'monitor and make recommendations about the global financial system',[412] similarly defines shadow banking as:

> credit intermediation involving entities and activities outside the regular banking system.[413]

It then explained a two-stage, policy-motivated, functional approach that initially includes all non-bank credit intermediation. This is then narrowed to those intermediaries: (i) who show indications of regulatory arbitrage; or (ii) that, through

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[410] Regulatory arbitrage occurs where participants exploit regulatory differences between sectors and countries for financial gain. Klara Bakk-Simon, Stefano Borgioli, Celestino Giron, Hannah Hempell, Angela Maddaloni, Fabio Recine, Simonetta Rosati, *Shadow Banking the Euro Area: An Overview* (2012) ECB Occasional Paper No 133, 8.

[411] Klara Bakk-Simon, Stefano Borgioli, Celestino Giron, Hannah Hempell, Angela Maddaloni, Fabio Recine, Simonetta Rosati, *Shadow Banking the Euro Area: An Overview* (2012) ECB Occasional Paper No 133, 8.

[412] FSB, About the FSB <http://www.financialstabilityboard.org/about/> ; Our History <http://www.financialstabilityboard.org/about/history/> accessed 05 September 2016.

[413] FSB, *Shadow Banking: Strengthening Oversight and Regulation* (FSB 2011), 1.

their activities, pose an increased systemic risk.[414] For Pozsar et al, the key is that: '[s]hadow banks are financial intermediaries that conduct maturity, credit, and liquidity transformation without access to central bank liquidity or public sector credit guarantees'.[415]

These broad definitions include finance companies, money market funds (MMF),[416] the repo markets,[417] some hedge funds, and special-purpose vehicles within the shadow finance sector. The activities typically involve maturity transformation, in which short-term liabilities are used to fund long-term assets. Within the shadow banking system, financial intermediation often involves a chain of intermediation between the investor and the final borrower.[418] This chain may begin with the pooling and structuring of loans into asset-backed securities (ABS).[419] These may be further pooled into collateralised debt obligations (CDOs).[420] Both of these financial instruments are created by broker-dealers' ABS syndicate desks, while intermediation is performed by limited purpose finance companies, structured investment vehicles, conduits and credit hedge funds. These may be funded by, *inter alia*, repo agreements, asset backed commercial paper (ABCP)[421] bonds[422] and medium term

[414] *Ibid*, 3.
[415] Zoltan Pozsar, Tobias Adrian, Adam Ashcraft, Hayley Boesky, 'Shadow Banking' (2010) Federal Reserve Bank of New York Staff Report No 458.
[416] Money market funds are low risk, short term liquid investments in which the intention is for the price of the shares to remain constant and provide a fixed income, interest based yield for the investor.
[417] Markets for the sale and repurchase of financial assets such as Treasury securities.
[418] Klara Bakk-Simon, Stefano Borgioli, Celestino Giron, Hannah Hempell, Angela Maddaloni, Fabio Recine, Simonetta Rosati, *Shadow Banking the Euro Area: An Overview* (2012) ECB Occasional Paper No 133, 9.
[419] An ABS is a bond backed by the collateral of a financial asset other than a mortgage, such as: loans, credit card debt, company receivables or royalties: see, Financial Times Lexicon <http://lexicon.ft.com/Term?term=asset_backed-securities--ABS> accessed 8 December 2014.
[420] CDOs repackage a pool of debt based assets, including ABS and mortgage backed securities, into a number of tranches distinguished by the risk and associated rate of return
[421] ABCP is a short-term investment vehicle backed by assets such as trade receivables (money owed to the company by customers).
[422] Bonds are debt investment securities, with a fixed interest rate and finite maturity, issued by companies and governments.

notes.[423] These activities, in turn, are funded by wholesale funding markets through money market intermediaries whether subject to intense or limited regulation.[424] The aim is to repackage illiquid loans into money-like financial instruments that serve to increase the liquidity and transform ('polish') the credit rating of the original loans. As a general rule, the poorer the credit quality of the originating loans, the longer the chain of intermediation required to repackage them.[425] Through this chain, shadow banking uses a model of loan financing referred to as 'originate-to-distribute', rather than the traditional model of 'originate-to-hold'.

Shadow banking grew out of the competition within the regulated banking system and between banks and non-banks. In order to remain competitive and profitable, banks sought to avoid both the impact of 'interest rate ceilings on demand deposits',[426] and the effect of deposit insurance caps on their ability to provide safe, short term high value investments. They also turned to shadow banking to create 'off-balance-sheet entities to host some of the banks' assets and, thereby, reduce their regulatory capital requirements' (see figure 6).[427] As McCulley explains:

> The allure of shadow banking ... is unambiguous: There is no better way for bankers to maximally leverage the inherent banking model

[423] A medium term note is a debt security with a maturity of over 1 year, usually 5-10 years, but longer is possible.
[424] Klara Bakk-Simon, Stefano Borgioli, Celestino Giron, Hannah Hempell, Angela Maddaloni, Fabio Recine, Simonetta Rosati, *Shadow Banking the Euro Area: An Overview* (2012) ECB Occasional Paper No 133, 9.
[425] Zoltan Pozsar, Tobias Adrian, Adam Ashcraft, Hayley Boesky, 'Shadow Banking' (2010) Federal Reserve Bank of New York Staff Report No 458, 14.
[426] Gary Gorton, Andrew Metrick, 'Regulating the Shadow Banking System' (2010) *Brookings Papers on Economic Activity* 261, 269.
[427] Bryan J Noeth, Rajdeep Sengupta, 'Is Shadow Banking Really Banking?' (October 2011) *The Regional Economist* 8, 9.

(of borrowing cheap and lending rich) than by becoming ... shadow bankers. And they did this in droves ...[428]

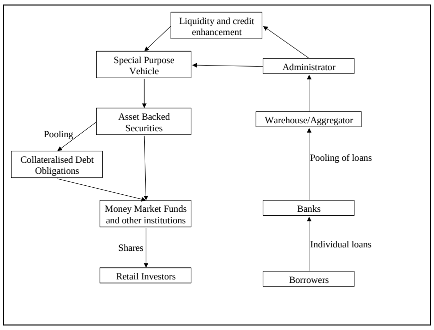

Figure 6 The Relationship Between Shadow Banking and Regulated Banking

In other words, shadow banking grew out of the isomorphic drive to squeeze every last drop of profit from available funding. While the emergency credit provided by deposit insurance and central banks as lenders of last resort provided a safety net for regulated banks, it was at least partly the need to avoid the associated prudential regulations aimed at reducing the moral hazard accompanying the use of such a safety net that led to the growth of shadow banking as a profit-making machine. Such was its success that, at its peak, the shadow banking system had gross liabilities of about $20 trillion, an amount far larger than the liabilities of regulated banking.[429]

[428] Paul McCulley, 'The Shadow Banking System and Hyman Minsky's Economic Journey', in Laurence B Siegel (ed) *Insights into the Global Financial Crisis* (Research Foundation of CFI Institute 2009) 257.
[429] Zoltan Pozsar, Tobias Adrian, Adam Ashcraft, Hayley Boesky, 'Shadow Banking' (2010) Federal Reserve Bank of New York Staff Report No 458, 4.

The push to maximise profits is driven by the behavioural scripts and norms of capitalism and facilitated by the *laissez-faire* culture indicative of the neoliberal capitalist approach to free market enterprise. If left unchecked by regulatory oversight, such a competitive drive will inevitably lead to a spiral of increasingly creative and risky investment practices in order to maintain an advantage and profit margins over one's competitors. Successful risk-taking, coupled with a confidence in the persistence of existing economic stability,[430] mimetically spreads risk-taking investment behaviour, particular when the real risk is underestimated. While confidence remains intact, the reward of risk-taking reinforces the behaviour, encouraging ever riskier behaviour.[431] The danger of this comes from the equally inevitable loss of confidence that triggers a run on deposits (see below).[432]

This process was identified with capitalist economies by Minsky as part of his financial instability hypothesis. Bankers, he noted, are profit-seeking entrepreneurs driven to innovate in order to maximise financial returns. During periods of success and high profitability, investment behaviour moves, in search of ever increasing profits, from more stable investments to less stable speculative investments.[433] Over time, speculative investments become Ponzi investments, which in turn lose value resulting in shortfalls of liquidity and the pressure to sell assets. This cyclical

[430] Elias Bengtsson, 'Shadow banking and financial stability: European money market funds in the global financial crisis' (2013) 32 *Journal of International Money and Finance* 579, 582-583.
[431] Paul McCulley, 'The Shadow Banking System and Hyman Minsky's Economic Journey', in Laurence B Siegel (ed) *Insights into the Global Financial Crisis* (Research Foundation of CFI Institute 2009) 257, 261.
[432] Zoltan Pozsar, Tobias Adrian, Adam Ashcraft, Hayley Boesky, 'Shadow Banking' (2010) Federal Reserve Bank of New York Staff Report No 458, 2.
[433] Speculative investments are those where income is sufficient to meet the interest but not the principle, requiring the liabilities to be rolled over on maturity. Ponzi investments are those where neither the principle nor the interest can be met by income, requiring further borrowing or the sale of assets.

behaviour is inherent to a capitalist system and requires a prudent framework of regulation and intervention to maintain overall stability.[434]

As noted above, the shadow banking system uses short term financial instruments (e.g. Repo and ABCP) to provide the funding necessary for managing the securities issued on the back of long term loans, and so perform a similar role to regulated banks by transforming short term liquid funding into longer term illiquid loans. As with the regulated banking system, this creates a system made fragile by the risk of bank runs as depositors seek to reclaim their funds (especially Repo and ABCP markets). Unlike the regulated system, shadow banking lacks access to emergency funding to meet liquidity demands leaving their fragility exposed. As predicted by Minsky's financial instability hypothesis, the ultimate consequence is that, in order to meet the demand for money, shadow banking firms can only respond by selling off assets. This can create a crisis of funding for the shadow banking system as occurred during the 2007 crisis.[435]

2.2.2 The financial crisis of 2007 and the aftermath

(see figure 7 for a simplified overview)

The growth and spread of neoliberal capitalism arguably peaked with the events that culminated in the 2007 financial crisis.[436] As noted earlier, the influence of this form of capitalism may be seen in the shift from bank-based to more market-based or hybrid models, It can also be seen in the change in banking practices. Historically, banks have been 'the main deposit-taking institutions and principal suppliers of loans

[434] Hyman P Minsky, 'The Financial Instability Hypothesis' (1992) Working Paper No 74, 6-8.
[435] Bryan J Noeth, Rajdeep Sengupta, 'Is Shadow Banking Really Banking?' (October 2011) *The Regional Economist* 8, 11, 13.
[436] David M Kotz. 'The Financial and Economic Crisis of 2008: A Systemic Crisis of Neoliberal Capitalism' (2009) 41 *Review of Radical Political Economics* 305; Kevin Rudd, 'The Global Financial Crisis'. (2009) February, *The Monthly* 20, 22.

in the economy'.[437] In the years leading up to the 2007 global financial crisis, however, 'the banking model ... evolved, becoming increasingly dominated by wholesale markets and in particular derivatives, to the detriment of the more traditional deposit-taking and lending activities'.[438]

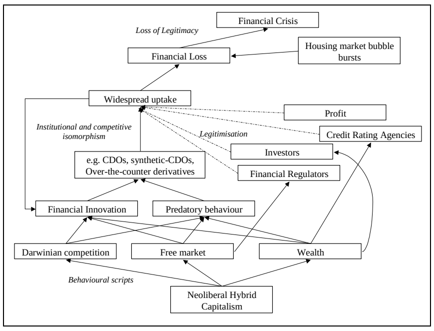

Figure 7: Neoliberalism, Isomorphism and the Financial crisis

The institutionalisation of the neoliberal capitalist discourse facilitated the development of a high risk 'aggressive investment-oriented culture' that was savings averse, but accepting of high debt and large mortgages.[439] The early success of such an approach, initially in the US and UK, influenced first other Western countries and then emerging markets and transition countries to adopt similar strategies.[440] Over time, however, financial pressure grew on the ordinary consumer and the financial

[437] AD Bain, *The Economics of the Financial System*, 2nd ed (Blackwell Publishers 1992), 179.
[438] OECD, *The Role of Banks, Equity Markets and Institutional Investors in Long-Term Financing for Growth and Development: Report for G20 Leaders* (OECD 2013), 4.
[439] Suhaib Riaz, 'The global financial crisis: an institutional theory analysis' (2009) 5 *Critical Perspectives on International Business* 26, 27.
[440] *Ibid*, 30.

system became increasingly fragile as organisations adopted riskier strategies and chased ever increasing profits.[441] Eventually the bubble burst in August 2007 when the subprime mortgage market collapsed, following a 'shock' to house prices.[442] The ABSs built on these mortgages plummeted in value triggering a contagious lack of confidence in other financial instruments and markets,[443] including the ABCP market used by MMFs. This initial stress on the system was compounded by the collapse of the Lehman Brothers in September 2008. The consequent default on ABCPs triggered a run on MMFs, only stemmed by the intervention of the US Treasury.[444] The damage, however, was done and the crisis of legitimacy that originated in the shadow banking system spread contagiously by association to the regulated system.[445] As McCulley noted:

> The rise of [shadow banking] ... drove one of the biggest lending booms in history, and its collapse resulted in one of the most crushing financial crises we have ever seen.[446]

The origins of the subprime mortgage collapse can be traced back to the Roosevelt administration's policy of private home ownership enabled by the New Deal which was put into effect over the course of the 1930s in response to the Great

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[441] David M Kotz. 'The Financial and Economic Crisis of 2008: A Systemic Crisis of Neoliberal Capitalism' (2009) 41 *Review of Radical Political Economics* 305, 314.
[442] Gary Gorton, Andrew Metrick, 'Regulating the Shadow Banking System' (2010) *Brookings Papers on Economic Activity* 261, 279.
[443] This loss of confidence causes a contagious demand for and lack of liquidity: see, Francis A Longstaff, 'The subprime credit crisis and contagion in financial markets' (2010) 97 *Journal of Financial Economics* 436.
[444] Bryan J Noeth, Rajdeep Sengupta, 'Is Shadow Banking Really Banking?' (October 2011) *The Regional Economist* 8, 13.
[445] Suhaib Riaz, 'The global financial crisis: an institutional theory analysis' (2009) 5 *Critical Perspectives on International Business*, 26, 32.
[446] Paul McCulley, 'The Shadow Banking System and Hyman Minsky's Economic Journey', in Laurence B Siegel (ed) *Insights into the Global Financial Crisis* (Research Foundation of CFI Institute 2009) 257.

Depression.[447] As part of this approach, federal deposit insurance was introduced to reassure savers that they would be compensated for losses caused by defaulting borrowers. The Federal Housing Administration encouraged long term mortgages and in 1938 the Federal National Mortgage Association (Fannie Mae) was established to issue bonds that would fund the purchase of mortgages from the privately owned and heavily regulated local Savings and Loans. These changes meant that 'the US government was effectively underwriting the mortgage market' causing a 20% increase in home ownership (up to 60% by 1960), and an associated rise in mortgage debt.[448]

The process of extending private home ownership continued and was extended to include African-Americans with the growth of civil rights in the 1960s. In 1968, Fannie Mae was divided in two and privatised as a government sponsored enterprise (GSE). This created organisations with political influence, but a conflicting dual mission with the public policy goals of affordable housing losing out to the risky strategies required to maximise profits for shareholders, a strategy that would ultimately prove the undoing of the GSE and require it to be bailed out and taken into government conservatorship before the crisis had fully unfolded.[449] A new Government National Mortgage Association (Ginnie Mae) was created to provide mortgages for poor borrowers, while Fannie Mae was allowed to buy both conventional and government sponsored mortgages. In 1970, the Federal Home Loan

[447] In the UK, the policy of private home ownership arrived with a vengeance in the 1980s as part of Margaret Thatcher's neoliberal agenda.
[448] Niall Ferguson, *The Ascent of Money: A Financial History of the World* (Allen Lane 2008), 246-249.
[449] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (2011), 41, 178-187, 309*ff*.

Mortgage Corporation (Freddie Mac) was established to inject competition into the market with the aim of lowering mortgages and widening access.[450]

While house prices outgrew inflation, the policy was successful. This all changed in the late 1970s and early 1980s as stagflation hit home. The Savings and Loans companies, which were the backbone of private mortgages, were hit hard by this inflation, exacerbated by the deposit cap of Regulation Q that pushed investors to the more lucrative MMFs. The US government neoliberal response was tax breaks and deregulation, freeing the Savings and Loans companies to utilise a wider range of investment and funding opportunities, while retaining the security of deposit insurance. This created a moral hazard and encouraged both excessive risk taking and misfeance resulting in a prolonged crisis for the Savings and Loans companies, which had to sell-off their mortgages to remain solvent. They were bought up by ambitious traders such as Lewis Ranieri at Salomon Brothers, and repackaged in large bundles as collateral for new securities known as collateralised mortgage obligations. This was, as Ferguson comments, 'the dawn of a new era in American finance'.[451]

The advantage of these securities were that many of the mortgages were backed by government insurance, which gave them a higher credit rating and encouraged a growth in the use of these securities such that by 2007 about 56% of the US home mortgage market was securitised. The success of private home ownership, and the money that could be made from mortgages, together with the pressure to remain competitive and continue to increase profits led to the mortgage market expanding to

[450] Niall Ferguson, *The Ascent of Money: A Financial History of the World* (Allen Lane 2008), 250-252.
[451] *Ibid*, 260.

include borrowers who previously would have been considered too high a credit risk. Facilitated by the American Dream Downpayment Act 2003, which made it easier for low-income families to buy a house, the subprime mortgage market blossomed. With variable interest rates and a fragile reliance on job security, these mortgages were effectively a ticking time-bomb, that would ultimately explode in August 2007.

The overconfidence gained from a prolonged period of economic stability, fuelled by a facilitatory monetary policy, resulted in widespread use of aggressively profit-motivated predatory practices (including fraud) and products, such as inflated appraisals, opaque charges, high loan-to-value mortgages, low-documentation loans, mortgages with teaser rates and "ninja" loans.[452] With these mortgages sold on, bundled together into securities and repackaged as CDOs, risky loans were transformed into apparently risk free investments backed by the profit-motivated credit agencies who were only too ready to legitimise these products by awarding triple-A ratings.[453] Many of the CDOs were overpriced and, when coupled with a reversal of monetary policy and gradually increasing interest rates,[454] the end of low-interest teaser periods, job redundancies and falling house prices,[455] the result was the collapse of the subprime mortgage market, which, domino-like, triggered the financial crisis.[456]

[452] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (2011), 88-93, 109-110, 160*ff*. Josef Ackermann, 'The subprime crisis and its consequences' (2008) 4 *Journal of Financial Stability* 329, 330. Teaser rates are discounted interest rates the induce a borrower to take out a mortgage, but revert to a standard interest rate at the end of the discounted period. Ninja mortgages are offered to those with "no income, no job, no assets".
[453] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (2011), xxv.
[454] Josef Ackermann, 'The subprime crisis and its consequences' (2008) 4 *Journal of Financial Stability 329, 330*.
[455] Anthony Sanders, 'The subprime crisis and its role in the financial crisis' (2008) 17 *Journal of Housing Economics* 254, 257-260.
[456] Niall Ferguson, *The Ascent of Money: A Financial History of the World* (Allen Lane 2008), 260-271.

2.2.2.1 Institutional isomorphism and the financial crisis

The impact of the subprime mortgage crash was compounded by the practices of large financial conglomerates and universal banks who packaged, repackaged, and retained CDOs in off-balance conduits and warehouses. Rather than distributing the risk, they effectively 'pursued an "originate to not really distribute" strategy, due to their overwhelming desire to complete more transactions and earn more fees'.[457] This was compounded by the creation of 'synthetic CDOs - composed not of real mortgage securities but just of bets on other products'.[458] Synthetic CDOs are perhaps the ultimate neoliberal capitalist financial instrument. Investors taking a short position are betting that the market will fail. This is the ultimate expression of self-interested individual financial gain, with little if any concern for the stability of the financial system and the consequential well-being of the community. It is the paradigm expression of the capitalist profit motive unchecked by the ethical scripts of other institutions such as regulation or religion.

The initial success of products like mortgage backed securities, CDOs, and over-the-counter derivatives, and the belief that risk could be distributed so efficiently that they became effectively risk free, became embedded in the institutional scripts of the financial system. These scripts were legitimised by the 'public endorsement' of the investors and the equally profit hungry credit rating agencies. The widespread and increasing use of these financial products by banks and other financial organisations reflected a process of isomorphism (see figure 8) that, along with the short term profit to be made from giving favourable ratings, appeared to have a significant

[457] Arthur E Wilmarth Jr, 'The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis' (2009) 41 *Connecticut Law Review* 963, 970-971.
[458] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (2011), 8.

impact on securing the endorsement that came from the credit rating agencies.[459] This endorsement in turn legitimised the products facilitating the isomorphism as other firms were encouraged to follow suit. This cycle of isomorphism and legitimisation was reinforced by 'regulatory endorsement' signalled by the default acquiescence of the regulators, who did little to curb the predatory behaviour even when there was evidence of misfeasance.[460]

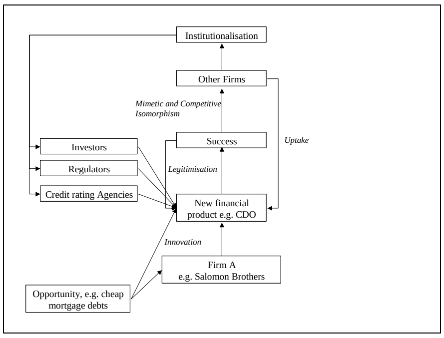

Figure 8: Financial Innovation and Isomorphism

The apparently unlimited wealth to be made resulted in a spiral of mimetic and competitive isomorphism that iteratively reinforced risky behaviour and saw

[459] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (2011), 118*ff*, 149, *206ff*. The downgrading of credit ratings from July 2007 onwards had the opposite effect on legitimacy (242*ff*).
[460] For a study demonstrating the connection between legitimisation and isomorphism see: David L Deephouse, 'Does Isomorphism Legitimate?' (1996) 39 *The Academy of Management Journal* 1024.

corporate governance concerns brushed aside.[461] Belief in these products became so unquestioning that their use continued to grow even after the housing market had begun its slump.[462] As the Financial Crisis Inquiry Commission noted: '[t]he CDO machine had become self-fueling'.[463] Then, when the housing bubble burst, just as success had legitimised products and practices, so the failure of sub-prime mortgages and the CDOs based on them resulted in a contagion of illegitimacy that spread across markets and countries. In sum, the neoliberal capitalist norms of a free market, coupled with the behavioural script of competitive profit seeking were at least significant causal factors in the financial bubble that subsequently burst, resulting in the 2007 crisis and its consequences.

2.2.2.2 The aftermath of the financial crisis

In the US, the Financial Crisis Inquiry Commission conducted a formal examination of the crisis. The Commission summarised its findings, focusing primarily on the immediate cause:

> it was the collapse of the housing bubble - fueled by low interest rates, easy and available credit, scant regulation, and toxic mortgages - that was the spark that ignited a string of events, which led to a full-blown crisis in the fall of 2008. Trillions of dollars in risky mortgages has become embedded throughout the financial system, as mortgage-related securities were packaged, repackaged, and sold to investors around the world. When the bubble burst, hundreds of billions of dollars in losses in mortgages and mortgage-related securities shook markets as well as financial

[461] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (2011), 11-22, 157.
[462] See the recounting of the events in: Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (2011), especially chapters 9 and 10.
[463] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (2011), 188.

> institutions that had significant exposures to those mortgages and had borrowed heavily against them. This happened not just in the United States but around the world.[464]

Tellingly, they also noted that: 'the vulnerabilities that created the potential for crisis were years in the making'. These vulnerabilities, as discussed above, were the result of the neoliberal capitalist policies of encouraging private home ownership with the consequential change in culture that saw houses as investments rather than homes,[465] rewarding aggressively competitive profit seeking and growth of the financial sector, deregulation and the belief in the power and efficiency of a relatively unfettered market.[466] As the Commission noted, the failings could not be laid solely at the door of individual greed, but were essentially the responsibility of public leaders and the collectively embraced national policies that facilitated the behaviour resulting in the crisis.[467]

The 2007 crisis has highlighted the dangers of the neoliberal approach to the financial system and required significant government intervention, including the effective nationalisation - if temporary - of the banks most critically affected (such as the Royal Bank of Scotland in the UK). US, UK and European governments and central banks provided nearly $9 trillion of financial support for the financial system through emergency liquidity, capital, asset purchase and guarantees.[468] Even Alan Greenspan, the former chairman of the US Federal Reserve Bank, admitted that the

[464] *Ibid*, xvi.
[465] *Ibid*, 5-6.
[466] See, eg, the Riegle-Neal Interstate Banking and Branching Efficiency Act 1994; the Economic Growth and Regulatory Paperwork Reduction Act 1996; the Gramm-Leach-Bliley Act 1999; the absence of regulation for over-the-counter derivatives.
[467] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (2011), xxiii.
[468] Arthur E Wilmarth Jr, 'The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis' (2009) 41 *Connecticut Law Review* 963, 968.

crisis exposed flaws in the neoliberal free market approach.[469] The consequences of the crisis has prompted calls for a change in ideology, and while the institutionalised discourse will remain a variety of capitalism it is likely to move towards a more social or managerial version.[470] This will involve greater, and more strictly applied, regulation[471] and a change to the organisational structure of the financial system so that the market investment practices undertaken by banks are separated from the deposit, loans and payment services.[472] Of course, how far we pull back from neoliberalism will vary from country to country and remains to be seen. It also remains to be seen how long such changes will last before a more liberal approach creeps back in.

Regardless of how the system develops, as a fundamentally capitalist institution it will remain essentially motivated by profit and dependent on debt, interest, risk taking, innovation. Money will continue to be perceived as intrinsically valuable and success measured by wealth with a more or less individualistic conception of the autonomous agent living in an aggressively competitive Darwinian society.[473] This is evidenced in the acceptance of the value of the originate-to-distribute model of finance, along with the endorsement of the efficiency of the shadow banking system, albeit in a more regulated environment with restricted opportunity for regulatory

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[469] Andrew Clark, Jill Treanor, 'Greenspan - I was wrong about the economy. Sort of' (24 October 2008) *The Guardian*, available at <http://www.theguardian.com/business/2008/oct/24/economics-creditcrunch-federal-reserve-greenspan> accessed 11 December 2014.
[470] Kevin Rudd, 'The Global Financial Crisis'. (2009) February, *The Monthly* 20, 26.
[471] See, for example Basel III. The collection of documents that set out the Basel III requirements are available at: <http://www.bis.org/bcbs/basel3.htm>, accessed 30 July 2014.
[472] See, for example, the Financial Services (Banking Reform) Act 2013, ch 33.
[473] Roger Friedland, Robert R Alford, 'Bringing Society Back In: Symbols, Practices, and Institutional Contradictions', in Powell WW, DiMaggio PJ (eds), *The New Institutionalism in Organizational Analysis* (University of Chicago Press 1991) 232, 240.

arbitrage and access to emergency liquidity.[474] Imposing structural changes and more stringent regulation will influence behaviour by altering the cultural rules and the scripts reflecting what is considered acceptable. Reconceiving the discourse associated with the institution of capitalism may also contribute to this influence and change behaviour to reduce the risk of future crises. An institutional change of this nature, involving a 'reinterpretation' of capitalism will depend on a number of actors, including government, the regulatory institution and the firms that operate within the financial system.[475]

Such a change may arise in the form of 'shared' or 'inclusive' capitalism. Shared capitalism refers to 'a diverse set of compensation practices through which worker pay or wealth depends on the performance of the firm or work group'.[476] Although shared capitalism is not a new concept, the failure of neoliberal capitalism may give it a new impetus. Shared capitalism, which is sometimes also referred to as inclusive capitalism, is not about wealth redistribution but about increasing productivity and wealth production.[477] As such it does not affect the cultural attitudes to debt, interest and profit, but it does encourage a more cooperative shared decision making approach[478] that may constrain the worst excesses of risky innovation.

[474] Zoltan Pozsar, Tobias Adrian, Adam Ashcraft, Hayley Boesky, 'Shadow Banking' (2010) Federal Reserve Bank of New York Staff Report No 458, 5-6.
[475] Peter A Hall, Katheleen Thelen, 'Institutional change in varieties of capitalism' (2009) 7 *Socio-Economic Review* 7, 16, 19.
[476] Richard B Freeman, Joseph R Blasi, Douglas L Kruse, 'Introduction', in Kruse DL, Freeman RB, Blasi JR (eds), *Shared Capitalism at Work: Employee Ownership, Profit and Gain Sharing, and Broad-based Stock Options* (University of Chicago Press 2010) 1, 4.
[477] David Madland, Karla Walter, *Growing the Wealth: How Government Encourages Broad-Based Inclusive Capitalism* (Center for American Progress 2013), 2.
[478] David Madland, Karla Walter, *Growing the Wealth: How Government Encourages Broad-Based Inclusive Capitalism* (Center for American Progress 2013) 37; Richard B Freeman, Joseph R Blasi, Douglas L Kruse, 'Introduction', in Kruse DL, Freeman RB, Blasi JR (eds), *Shared Capitalism at Work: Employee Ownership, Profit and Gain Sharing, and Broad-based Stock Options* (University of Chicago Press 2010) 1.

Inclusive capitalism has also been adopted as the term to refer to an approach quite distinct from shared capitalism. It has been described as: 'a basic social contract comprised of relative equality of outcomes; equality of opportunity; and fairness across generation'.[479] The values behind this form of capitalism include trust, fairness and a respect for others reflected in a 'sense of society'. For Mark Carney, the governor of the Bank of England:

> unchecked market fundamentalism can devour the social capital essential for the long-term dynamism of capitalism itself. To counteract this tendency, individuals and their firms must have a sense of their responsibilities for the broader system.[480]

The need for this was the unchecked market fundamentalism, characterised by light regulation and a belief in the invisible hand mechanism of competitive free markets. Again, this form of capitalism will still be characterised by profit, debt, risk taking and high rewards for success. However, the risks associated with neoliberal capitalism would be tempered by developing a new set of cultural rules and behavioural scripts designed to increase 'social capital' by, *inter alia*, stricter regulation, reformed compensation[481] and a greater emphasis on professionalism and societal obligations.[482]

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[479] Mark Carney (Governor of the Bank of England), 'Inclusive Capitalism: creating a sense of the systemic', Speech given at the Conference on Inclusive Capitalism, London, 27 May 2014 <www.bankofengland.co.uk/publications/Pages/speeches/default.aspx>, accessed 30 July 2014.
[480] Mark Carney (Governor of the Bank of England), 'Inclusive Capitalism: creating a sense of the systemic', Speech given at the Conference on Inclusive Capitalism, London, 27 May 2014.
[481] It has, for example, been announced that the Bank of England plans to extend the time limit to 7 years on requiring repayment of bank bonus payments: BBC News, 'New banker rules "could hurt London as financial centre', 30 July 2014 <http://www.bbc.co.uk/news/business-28556906>, accessed 31 July 2014. The UK Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) have also initiated a consultation: PRA & FCA, *Strengthening accountability in banking: a new regulatory framework for individuals* (2014), FCA CP14/13PRA CP14/14.
[482] Mark Carney (Governor of the Bank of England), 'Inclusive Capitalism: creating a sense of the systemic', Speech given at the Conference on Inclusive Capitalism, London, 27 May 2014.

The legislative, policy and regulatory changes that are gradually being implemented following the crisis are aimed at managing the institutional discourse of capitalism and its influence on behaviour within the financial system and the banking sector in particular.[483] In the UK, for example, the Parliamentary Commission on Banking Standards recommended a five themed approach to: improve individual responsibility; reform governance in the banking system; create more diverse banking markets with higher standards; to reinforce the responsibility of regulators; and to specify governmental responsibilities.[484] How far such policies will affect the financial system, and the long term implications of any changes, will take time to become apparent. Regardless of these changes, the importance of profit, debt and interest remain. Indeed, although recommending changes to improve the regulation of banking in the UK, the Parliamentary Commission on Banking nevertheless emphasised that: '[t]he UK should do what is necessary to secure London's position as a pre-eminent and well-regulated financial centre'. The importance of competitiveness remains, but there is a shift towards a longer term view of success coupled with the message that effective regulation will attract new business.[485] As such, the innovation and risk taking necessary to sustain economic growth are likely to be constrained, but will still be an important part of the culture associated with capitalism. The worst excesses of neoliberal capitalism are being countered, but the essential institution of capitalism will be preserved and continue to exert isomorphic

[483] For example, the increased capital requirements of Basel III and, in the US the Credit Rating Agency Reform Act 2006, the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010. For a discussion of the latter US Act see, Anne M Khademian, 'The Financial Crisis: a Retrospective (November/December 2011) *Public Administration Review* 841.

[484] Parliamentary Commission on Banking Standards, *Changing banking for good, Volume 1: Summary, and Conclusions and recommendations* (Report, HL Paper 27-1, HC 175-1, 2013), 8. This is to build on the changes already begun, such as the creation, under the Financial Services Act 2012, of the Financial Conduct Authority and the Prudential Regulation Authority as replacements for the Financial Services Authority.

[485] Parliamentary Commission on Banking Standards, *Changing banking for good, Volume 1: Summary, and Conclusions and recommendations* (Report, HL Paper 27-1, HC 175-1, 2013), 21-22.

pressure on conventional financial systems. Indeed, some commentators argue that neoliberalism will survive as part of a hybrid form of capitalism.[486]

2.2.3 Other institutional influences

Before bringing this chapter to a close, two further institutional influences should, at least, be mentioned. The first of these is regulation, which acts to both facilitate and constrain the influence of the other institutional influences. Consideration of this institution will be left until chapter four, where the issue of *Sharia* governance is examined. The second is the institution of a traditional religion, which may act to counter the unethical pursuit of money.[487] It is arguable that one of the problems of contemporary secular western society is that traditional religion, as in institution, has declined in influence and no longer provides an effective counter to the institution of capitalism and the values of consumerism. Loy goes so far as to argue that, from the functionalist perspective of 'teaching us what the world is, and what our role in the world is', that the market is a religion, with economics its theology.[488] Because traditional religion, as an institution, is explicitly more central to Islamic finance, its relevance will be explored in detail in chapter three.

2.3 Conclusion

The aims of this chapter were to provide a context and contrast for Islamic finance. These have been achieved by: first, explicating the concept of a financial system; and second, by examining conventional financial systems from the 1970s through to the

486 Jamie Peck, Nik Theodore, Neil Brenner, 'Neoliberalism Resurgent? Market Rule after the Great Recession' (2012) 111 *The South Atlantic Quarterly* 265, 274.
487 Thomas Li-Ping Tang, 'Theory of Monetary Intelligence: Money Attitudes - Religious Values, Making Money, Making Ethical Decisions, and Making the Grade' (2014) *Journal of Business Ethics*, published online, DOI 10.1007/s10551-014-2411-5.
488 David R Loy, 'The Religion of the Market' (1997) 65 *Journal of the American Academy of Religion* 275.

2007 global financial crisis and its aftermath. Following the approach of a number of commentators, it was suggested that the underlying theory of the concept explains a financial system as:

> *A complex socio-cultural system comprising a relational network of interdependent roles coordinated to facilitate the flow of money within the community served by that system.*

This system, which involves both markets and financial intermediaries, provides for a number of functions, such as deposit-holding, payment processing, loans, trading, risk management, information provision and financial innovation. As a subset, conventional financial systems are shaped by the institutional norms and behavioural scripts of capitalism.

Since the problems caused by "stagflation" in the 1970s, neoliberal capitalist economic policies have become institutionalised, particularly in the US and the UK. With the emphasis on private home ownership, deregulation of the market, increased competitiveness and the aggressive pursuit of profit, financial innovation flourished and the markets grew. New financial products - such as subprime mortgages bundled into CDOs, over-the-counter derivatives, and synthetic-CDOs - proliferated, accompanied by the growth of the shadow banking system which is subject to limited regulation. Early successes saw the products and processes spread through mimetic and competitive isomorphism, legitimised by the acquiescent inaction of regulators, profit hungry investors and the equally profit hungry credit rating agencies. The bubble burst in 2007, spread contagiously throughout the world, and required massive government intervention to limit its impact.

Although the response to the crisis should temper the worst excesses of neoliberal capitalism, conventional financial systems remain driven by competition between autonomous individuals with profit and wealth the primary goals. Because of its power to shape social relationships, money is treated as if it is intrinsically valuable and an end in itself. Other goals are valuable only insofar as they are necessary to support the financial system in its pursuit of profit. It is the institution of capitalism, and the conventional financial system it shapes, that provides the contrast necessary to fully understand the distinctiveness of Islamic finance. Since it must often coexist alongside, and perhaps in competition with, conventional finance, capitalism also provides a context for Islamic finance. As explained in chapter one, the growth of Islamic finance really began in the mid-1970s, at a time when neoliberal capitalism was on the rise. Islamic finance has matured in a global capitalist environment comprised of aggressive and competitive, profit-chasing financial practices that came crashing down in 2007 with the global financial crisis. Given this context, the question is how the neoliberal capitalist scripts and norms have affected Islamic finance. This question, and the broader issue of the nature of Islamic finance, will be considered in the next chapter.

Chapter Three: Islamic Finance: its Nature and Institutional Context

Chapter two examined the concept of a financial system and considered the nature and institutional influences of conventional finance. In particular the impact of capitalism as the dominant institution shaping the development of conventional financial systems was explored. Although there are different conceptions of capitalism, neoliberal capitalism has been the most influential form over the 30 years leading up to the global financial crisis of 2007. While this version of capitalism may not have existed in its purest form, it nevertheless represents an extreme view of capitalism, reliant on a free market unencumbered by regulation. Driven by efficiency through competition, with profit as the prime motive and wealth as the dominant value, the experience of neoliberal capitalism was one of a vicious spiral of profit-chasing, risk-taking behaviour that eventually resulted in the sub-prime mortgage crisis, and the subsequent global economic crisis.

This recent chapter in financial history began in the 1970s, and provided the global context for the development of Islamic finance, which, as noted in chapter one, really took off in the mid 1970s. It is the nature of Islamic finance, and its dominant institutional influence of Islam, that forms the focus of this chapter. The aim is to provide a general explanation of the concept of Islamic finance and the shaping influence of Islam situated within the competitive context of capitalist driven conventional finance. This explication will then provide the background for subsequent chapters and a more specific focus on *Sharia* non-compliance, *Sharia* governance and regulation.

3.1 Islamic finance as a type of financial system

As noted in chapter one, the term "Islamic finance" may be applied to any financial transaction intended to be *Sharia* compliant or *halal*, meaning permissible. For the purposes of this thesis, however, the term will be used to refer to the modern organised services offering *Sharia* compliant products that began to develop in the 1940s, but experienced a huge impetus in the 1970s with the establishment of the IDB, the Dubai Islamic Bank and the Faisal Islamic Banks. These Islamic banks 'go beyond pure financial intermediation of the traditional sort, and have direct participation in business and investments with profit-and-loss-sharing along equity lines'.[489] The profit-and-loss sharing (PLS) principle, which forms part of the foundation of Islamic finance,[490] is not explicit in the *Qur'an*. Rather it is developed through the *Sharia* as an interpretation of the distinction between trade or business, which is acceptable, and usury or *riba*, which is not.

The concept of *riba* will be considered in more detail in section 3.3.1. For now it is sufficient to note that *riba*, which may be broadly equated with interest, is forbidden by the *Qur'an* and hence by *Sharia*. For example, in chapter two, verse 275 of the *Qur'an* it states:

> Those who swallow usury cannot arise except as he arises whom the devil prostrates by (his) touch. That is because they say, Trading is only like usury. And Allah has allowed trading and forbidden usury.[491]

[489] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 76.
[490] *Ibid*, 1.
[491] English translation of the *Qu'ran* by Maulana Muhammad Ali (2002) <http://www.muslim.org/english-quran/quran.htm>, accessed 07 September 2016. The word usury is the given translation of the Arabic word *riba*, and is commonly interpreted as including all interest: see the discussion of *riba* later in the chapter.

This prohibition of *riba* lies at the heart of Islamic finance. It is required by the obligation to comply with the *Qur'an* and the *Sharia*, which is primarily expressed through the requirement for Sharia-compliant certification by a *Sharia* board.[492] It provides an overt characteristic, or attribute, of Islamic finance distinguishing it from conventional finance, which relies on interest as an incentive for investment.

While the prohibition of *riba* is a central characteristic of Islamic finance, it is really the fundamental need to comply with the tenets of Islam and *Sharia* that identifies Islamic finance as distinct from conventional finance.[493] Applying the theory-based approach to concepts, as discussed in chapter two, the role of Islam forms part of the theory underlying the concept of Islamic finance and explaining its attributes. In chapter two, the theory underlying the concept of a financial system was set out. Relying on that, the basic theory of Islamic finance is (see figure 9):

> *A complex socio-cultural system comprising a relational network of interdependent roles, guided by the tenets of Islam and coordinated to facilitate the flow of money in a way that is consistent with Sharia.*

[492] Mahmoud A El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006), 7-8.
[493] See, Zamir Iqbal, Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice*, (2nd edition, e-book, John Wiley & Sons 2011), chapter one.

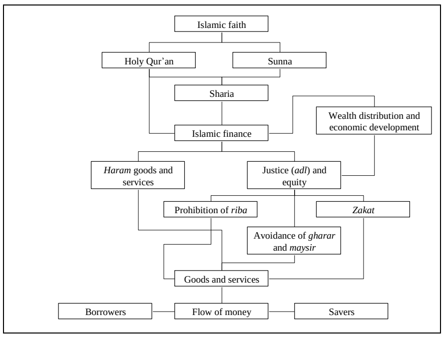

Figure 9: Islamic Finance

The prohibition of *riba* is one of the main pillars of Islamic finance. However, despite its importance, it is Islam and *Sharia* more broadly, rather than *riba per se*, that are crucial to the existence of Islamic finance and its identity as distinct from other forms of finance. Instead of contributing to the explanatory theory of Islamic finance, the prohibition of *riba* is an expression of that theory. The prohibition of *riba* is merely an attribute of Islamic finance, albeit a core attribute. Although Islamic finance may sometimes be equated with the prohibition of *riba*, a financial system is not Islamic because *riba* is prohibited, rather *riba* is prohibited because the financial system is Islamic.

Consistent with this, the prohibition of *riba* is not the sole *Sharia* principle influencing Islamic finance. Other important attributes include the prohibition of investment in forbidden (*haram*) goods and services, the avoidance of gambling (*maysir*) and uncertainty (*gharar)*.[494] Islamic finance is also concerned with promoting economic development and adopts an equitable approach based on the Islamic conception of justice (*adl*) that requires a fair distribution of wealth and opportunity,[495] including the opportunity to participate in the economy. This equitable approach is consistent with the prohibition of *riba*, particularly the more exploitative form of interest that constitutes usury. It grounds the PLS mechanism that allows financial services to be characterised as trade rather than *riba*. It is also expressed through *zakat*, which is an obligation to contribute a proportion of one's profit to charity. It is, however, the prohibition of *riba* that is the most visible *Sharia* principle defining a financial service as Islamic.

The prohibition of *riba* does not preclude a return on investments. It does, however, prevent a rate of return that is guaranteed regardless of the success or failure of the venture in which the money has been invested. Profit is acceptable, but only where it is associated with the possibility or risk of loss. Islam encourages such entrepreneurship, provided it is honest and fair.[496] In chapter 45, verse 12, for example, the *Qur'an* tells us that Allah gave us the sea so that we could sail in ships to 'seek of his bounty'. Similarly, in chapter 15, verses 19-21, the *Qur'an* explains that Allah provided the earth as a 'means of subsistence'.[497]

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[494] See sections 3.3.2.-3.3.4.
[495] See, Sayd Farook, 'On Corporate Social Responsibility of Islamic Financial Institutions' (2007) 15 *Islamic Economic Studies* 31, 32; Muhammad Ayub, *Understanding Islamic Finance*, (John Wiley 2007), 9; Zamir Iqbal, Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice*, (2nd edition, e-book, John Wiley & Sons 2011), chapter one.
[496] Solahuddin Abdul Hamid, Che Zarrina Sa'ari, 'Reconstructing Entrepreneur's Development Based on al-*Qur'an* and al-Hadith' (2011) 2 *International journal of Business and Social Science* 110.
[497] English translation of the *Qu'ran* by Maulana Muhammad Ali (2002).

Tellingly, in chapter 53, verses 39-41, the *Qur'an* states:[498]

> And that man can have nothing but what he strives for: And that his striving will soon be seen. Then he will be rewarded for it with the fullest reward.

This passage clearly emphasises that things must be worked for, which hints at Allah's condemnation of *riba* as an undeserved gain not obtained through fair and honest endeavour. It is fair to earn a profit if one works for it, or if one invests in another person's work while bearing a liability for loss. Thus, Algaoud and Lewis quote the Hanafi jurist, Al-Kasani, who stated: 'The rule, in our view, is that entitlement to profit is either due to wealth (*mal*) or work (*'amal*) or by bearing a liability for loss (*daman*)'.[499] These are not three independent mechanisms, however, as Al Kasani goes on to explain that 'profit is an increase in wealth', and such an increase is only *halal* where it has grown through investment that carries a liability for loss. In other words, wealth must be combined with entrepreneurship in a way that allows profit to be gained either from work or from the liability for loss, or some combination of the two.[500] In such schemes the investor of capital risks financial loss, the investor of labour risks losing the value of the work invested.[501]

If capitalism is the core institution of conventional finance (see chapter two), then Islam, embodied in the *Qur'an*, the *sunna* and the *Sharia*, is the core institution of Islamic finance. Just as capitalism provides the structure, symbolism, normative guide and behavioural scripts for conventional finance, so Islam provides the

[498] *Ibid*.
[499] Latifa M Algaoud, Mervyn K Lewis, 'Islamic critique of conventional financing', in M Kabir Hassan, Mervyn K Lewis (eds), (Edward Elgar 2997) *Handbook of Islamic Banking* 38, 46.
[500] Muhammad Junaid Sharif, Muhammad Ijaz, 'Classical Jurists Perspective of Entitlement of Profit in Mudarabah: how and Who Really Deserves?' (2013)18 *Al-Qalam* 58, 59.
[501] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 40.

structure, symbolism, normative rules and behavioural scripts for Islamic Finance. These are, of course, not the sole institutional influences and the relevance of professionalism was noted earlier. Further to this, Friedland and Alford, for example, identify the 'central institutions of the contemporary capitalist West [as the] capitalist market, [the] bureaucratic state, democracy, nuclear family, and Christian religion'.[502] These institutions provide alternative, and possibly contradictory, institutional logics[503] that may be exploited by '[i]ndividuals and organizations [to] transform the institutional relations of society'.[504] For Islamic finance, however, particularly in a Muslim country, the institution of Islam provides a pervasive and ubiquitous influence that should operate to limit the potential for institutional contradictions that are perhaps more prevalent in the organisational field of conventional finance.

The relative purity of the institutional influence within a Muslim country makes it important to understand the *Sharia* principles that govern the provision of Islamic finance. The *Sharia* is, as noted above, the defining influence in Islamic finance whether the service is situated in a Muslim or non-Muslim country. In non-Muslim countries, however, the provision of Islamic finance will inevitably be subject to competing institutional logics, including the bureaucratic state, democracy and the competitive influences of capitalism. Even organisations primarily based in a Muslim

[502] Roger Friedland, Robert R Alford, 'Bringing Society Back In: Symbols, Practices, and Institutional Contradictions', in Powell WW, DiMaggio PJ (eds), *The New Institutionalism in Organizational Analysis* (University of Chicago Press 1991) 232.
[503] Institutional logics may be defined as: 'the socially constructed, historical patterns of material practices, assumptions, values, beliefs and rules' through which institutions influence individuals and organisations. They are comprised of symbolic, normative and structural elements: see, Patricia H Thornton, William Ocasio, 'Institutional Logics', in Greenwood R, Oliver C, Suddaby R, Sahlin-Andersson K (eds), *The Sage Handbook of Organizational Institutionalism* (Sage Publications Ltd 2008) 99, 101.
[504] Roger Friedland, Robert R Alford, 'Bringing Society Back In: Symbols, Practices, and Institutional Contradictions' in Powell, WW, DiMaggio PJ (eds) *The New Institutionalism in Organizational Analysis* (University of Chicago Press 1991) 232.

country, will be subject to these conflicting logics if they engage with the global market. This issue of conflicting institutional logics may be further magnified by the 'structural overlap' of competing logics[505] found in the case of Islamic financial services provided by a conventional bank, which will be more familiar with the capitalist western institutions than with the institutional logics of Islam.

Islamic finance may be provided in a number of different contexts, which embody distinct combinations of institutional logics that, when combined with alternative forms of rationality,[506] may result in different interpretations of the institutional symbols and practices.[507] This, in turn, may affect the way in which *Sharia* is interpreted and applied to the development of new financial products or services. In chapter one a number of distinct contexts were identified, including: Muslim countries with a fully Islamic financial system; Muslim countries where Islamic finance operates alongside conventional finance; non-Muslim countries with a predominantly Muslim population; non-Muslim countries with a minority Muslim population; and the global market. As noted above, it is also important to appreciate that Islamic finance may be provided by Islamic or conventional organisations. Finally, a distinction may be made between those banks that are *halal*, offering financial products technically within the letter of *Sharia* law, and those organisations that accept 'an explicit socio-economic responsibility' reflecting the true spirit of the *Qur'an*.[508]

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[505] Patricia H Thornton, William Ocasio, 'Institutional Logics' in Greenwood, R, Oliver, C, Suddaby, R, Sahlin-Andersson, K (eds) *The Sage Handbook of Organizational Institutionalism* (Sage Publications Ltd 2008) 99, 116.
[506] Barbara Townley, 'The Role of Competing Rationalities in Institutional Change' (2002) 45 *Academy of Management Journal* 163, 175-177.
[507] Roger Friedland, Robert R Alford, 'Bringing Society Back In: Symbols, Practices, and Institutional Contradictions', in Powell WW, DiMaggio PJ (eds), *The New Institutionalism in Organizational Analysis* (University of Chicago Press 1991) 232, 254.
[508] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 91.

In all of these contexts, Islam provides the central institutional influence for the Islamic financial system, although it will, as discussed, be subject to context-dependent competing logics. Because it is such a fundamental influence, a deep understanding of Islamic finance requires at least some familiarity with Islam, *Sharia* and what it means to be a Muslim. This will be discussed in the next section, followed by a more detailed examination of the *Sharia* principles relevant to Islamic finance. After considering the relevant *Sharia* principles, an introduction to Islamic banks and Islamic financial products will be provided. As part of this discussion, the impact of the competing influences, as adverted to above, will also be analysed. In particular, the influence of capitalism on the development of Islamic finance and the obligation to comply with *Sharia* will be examined. The issue is whether the need to coexist with conventional finance in the context of a competitive capitalist economy influences Islamic financial innovation and contributes to the risk of *Sharia* non-compliance.

3.2 Islam and being a Muslim

This section will consider what it means to be Muslim. This is not a discussion that generalises the experiences of real Muslims. Nor is it an examination of life as a Muslim for specific individuals. Rather, this explication of being a Muslim is intended to reflect the institutional discourse of Islam. It is, in other words, the idealisation of Islam that provides the normative rules and behavioural scripts that should form the aspirational influence guiding the faithful Muslim.

3.2.1 Islamic epistemology and ontology

As an institution, Islam instils a characteristic epistemology and ontology that define the way in which Muslims understand the world and their place in it (figure 10).[509] Islamic epistemology is constituted by revealed knowledge and acquired knowledge. Allah is the ultimate source of all knowledge, with revealed knowledge representing the most direct and immediate word of God, as found in the *Qur'an* and the *sunna* (see below). Acquired knowledge derives from the interaction between the environment and human understanding. Islamic ontology recognises both those things that can be perceived by human senses and those things that are hidden from humans and understood solely through revealed knowledge.[510] Ultimately, Allah created all things, both the seen and the unseen, and Allah is the source of all knowledge (*Tawhid*). Allah is the only truth,[511] in its pure objective sense.[512] As stated in the *Qur'an*:[513]

> He is Allah and there is no God beside him, the Knower of the unseen and the seen ...
>
> He is Allah, the Creator, the Maker, the Fashioner.
>
> The Knower of the unseen, so He makes his secrets known to none, except a messenger whom he chooses.
>
> That is because Allah, He is the Truth ...

---

[509] Islamic ontology and epistemology are presented as clearly distinct concepts, although it may be argued that the 'separation between reality and knowledge is a peculiarly Western binary': Ali Raza Mir, 'Multiplicity of Knowledge Forms: Lessons from Islamic Epistemology' (1999) 16 *The American Journal of Islamic Social Sciences* 99, 105.

[510] Abdullahi Barise 'Social Work with Muslims: Insights from the Teachings of Islam' (2005) 6 *Critical Social Work*, <http://www1.uwindsor.ca/criticalsocialwork/social-work-with-muslims-insights-from-the-teachings-of-islam> accessed 26 January 2015.

[511] The Holy *Qur'an*, chapter 4, verses 105; chapter 6, verses 114-115, English translation of the *Qu'ran* by Maulana Muhammad Ali (2002).

[512] Naail Mohammed Kamil, 'Ontology and Epistemology in Management Research: An Islamic Perspective' (2011) 7 *Postmodern Openings* 67, 69.

[513] The Holy *Qur'an*, chapter 59, verses 22, 24; chapter 72, verses 26-27; chapter 22, verse 6, English translation of the *Qu'ran* by Maulana Muhammad Ali (2002).

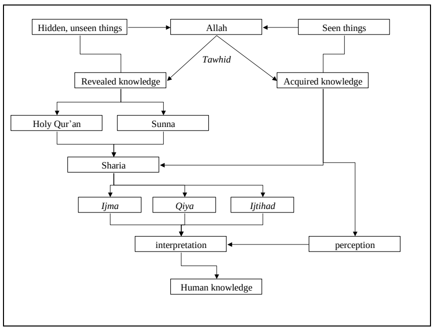

Figure 10: Islamic Epistemology and Ontology

While, in this part of the thesis, Islam will be considered in an idealised form, it should be noted that Islamic epistemology and ontology will be affected by the situational context of the particular community so that, in practice, there will be many variations of the idealised form. This will be particularly so with regard to acquired knowledge. Acquired knowledge allows for a subjective epistemology, which is formalised within the institution of Islam through the recognised methods of interpretation such as *Ijma* (consensus), *Qiya* (analogy), and *Ijtihad* (personal reflection and reasoning) (see below).[514] This subjective epistemology, however, is constrained by the objective epistemology of revealed knowledge. Thus, Islam is centred on a critical realist ontology that posits the existence of things independent of

[514] Naail Mohammed Kamil, 'Ontology and Epistemology in Management Research: An Islamic Perspective' (2011) 7 *Postmodern Openings* 67, 70.

human cognition, but recognises the subjective nature of human experience that constructs a perceived and interpreted version.[515]

3.2.2 The nature of Islam

A good starting point for this brief exposition is with the literal meaning of Islam, which may be defined as "submission" or "surrender" to God.[516] This submission or surrender should be total. As Mawdudi states:

> The main characteristic of Islamic ideology is that it does not acknowledge a conflict; not even a slight separation between spiritual and mundane life. It does not confine itself merely to purifying the spiritual and the moral life of man in the limited sense of the word. Its scope extends to the entire aspects of life.[517]

Similarly, Haneef explains that:

> Islam is not a mere belief system, an ideology or a religion in the usual sense in which these words are understood. Rather it is a total way of life, a complete system governing all aspects of man's existence, both individual and collective.[518]

A Muslim's life may not be compartmentalised into religious or secular activity. Rather, Islamic values should pervade all of his or her activities, whether in the context of the family, the community or the commercial.

[515] Naail Mohammed Kamil, 'Ontology and Epistemology in Management Research: An Islamic Perspective' (2011) 7 *Postmodern Openings* 67, 71.
[516] Suzanne Haneef, *What Everyone Should Know About Islam and Muslims* (14th ed, Library of Islam 1996), viii.
[517] AA Mawdudi, *Islamic Way of Life* (Scribe Digital 2012), 3. Mawdudi may also be spelt as Maududi.
[518] Suzanne Haneef, *What Everyone Should Know About Islam and Muslims* (14th ed, Library of Islam 1996), 3-5. See also, Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 16.

At the centre of the Islamic faith is the belief in the sole, omnipotent deity of Allah, whose word was communicated through his Prophet Muhammad (pbuh) and made explicit in the *Qur'an*.[519] It is through the Prophet Muhammad (pbuh) and the *Qur'an* that Allah set down the rules that govern Muslim life. The *Qur'an* is the purest form of revealed knowledge, literally representing God's word as the immediate inspiration for Sharia, both as a way of life and as law. The *Qur'an*, then, is the most fundamental source of Islam, specifying 'the moral, philosophical, social, political and economic basis' for any Islamic community.[520] The second main source is the *sunna*, which literally means 'ancestral precedent' or 'custom of the tribe' and derives from 'the teachings and traditions of the Prophet Muhammad (pbuh) ... as transmitted by the relators of authentic tradition'.[521] As Rahman notes, however, *sunna* is not simply behaviour, practice or custom, but includes only such behaviour that is essentially morally normative.[522] The Prophet Muhammad (pbuh), while not a divine being, is nevertheless so unique and worthy of reverence as Allah's chosen messenger, that his life, his actions and his words, as represented in the *sunna*, are an example for all Muslims to follow. Thus, in chapter 33, verse 21, the *Qur'an* states: '[c]ertainly you have in the Messenger of Allah an excellent exemplar for him who hopes in Allah ...'.[523] In following the example of the prophet, Islam requires Muslims to embody the principles of Islam and the *Sharia* in all elements of their lives. Thus, the principles of Islam and the *Sharia* create an isomorphic pressure shaping the behaviour of devout Muslims.

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519 Suzanne Haneef, *What Everyone Should Know About Islam and Muslims* (14th ed, Library of Islam 1996), viii.
520 Farhad Nomani, Ali Rahnema, *Islamic Economic Systems* (Zed Books Ltd 1994), 2.
521 Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 3.
522 Fazlur Rahman, *Islamic Methodology in History* (3rd reprint, Islamic Research Institute 1995), 1.
523 English translation of the *Qu'ran* by Maulana Muhammad Ali (2002).

The law and moral code used to govern and comprehensively guide the life of Muslims is known as the *Sharia*, which means, "the path to follow". It is distilled primarily from the *Qur'an* and the *sunna*, as collected in the *hadith* (the 'authentic tradition'), and representing the words and acts of the Prophet Muhammad (pbuh). It goes further than a conventional legal system and provides not just obligatory rules, but also indicates the aspirational, the permissible (*halal*) and the forbidden (haram). It reflects Allah's will as revealed through the Prophet Muhammad (pbuh) and covers social, ethical, civil and criminal aspects of life.[524]

Apart from the *Qur'an* and the *sunna*, there are three techniques of analysis and interpretation that guide the deduction and application of *Sharia* in practice. These methods, which comprise a significant source of Islamic jurisprudence, are used to determine the proper way of dealing with those things not directly covered in the *Qur'an* or *sunna*.[525] They are: the *Ijma* or consensus opinion (*ijtihad*) of Islamic scholars; *qiyas* or reasoning by analogy,[526] which 'constitutes a *speculative* proof ... based on fallible human reasoning';[527] and *ijtihad* or interpretation through private reflection and reasoning,[528] which may be literal or purposive.[529] Currently, three types of *ijtihad* are utilised: classical *ijtihad*, which relies on literal reading and strict application of *usul-al-fiqh* (jurisprudential principles); 'eclectic' *ijtihad*, which is

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[524] Ahmed, Zaki Yamani, 'The Eternal Shari'a' (1979) 12 *International Law and Politics* 205; Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 16, 20-25.
[525] Irshad Abdal-Haqq, 'Islamic Law: an Overview of Its Origin and Elements' (1996) 1 *Journal of Islamic Law* 1, 9.
[526] J Mark Halstead, 'Islamic values: a distinctive framework for moral education?' (2007) 36 *Journal of Moral Education* 283, 285.
[527] Mohammad Omar Farooq, 'Analogical Reasoning (Qiyas) and the Commodification of Women: Applying Commercial Concepts to the Marital Relationship in Islamic Law' (2011) 3 *Islam and Civilisational Renewal* 155, 160.
[528] Samiul Hasan, 'Islamic Jurisprudence: Sources and Traditions Creating Diversity in Human Relationships' in Samiul Hasan (ed) *The Muslin World in the 21st Century* (Springer 2012) 23, 26.
[529] Nazeem M I Goolam, '*Ijtihad* and its Significance for Islamic Legal Interpretation' (2006) *Michigan State Law Review* 1443, 1450.

problematically idiosyncratic and used to justify an individual scholar's opinion; and 'context-based' *itjihad*, which is a relatively modern approach to understanding issues taking into account the situational context.[530] These methods of producing acquired knowledge admit further opportunity for diversity through the role of *istihsan* and *maslahah* (justifying one solution over another on the grounds of public interest)[531] and the incorporation of local customs (*urf*) and customary laws (*adat*). These variations are always subject to the constraints of the revealed knowledge and *tawhid*.[532]

Central to the behavioural scripts of the Islamic institution is its conception of what it is to be human. The Muslim person, as created by Allah, is a complex being with a physical body, emotions, free will, and an immortal soul that survives the death of the physical being. Each constituent element has needs to be satisfied and these needs, and hence the elements of the person, are harmonised by living according to Allah's law.[533] A faithful life that follows the *Qur'an* and complies with *Sharia* will be one of balance and contentment and will carry that person through to their deserved place in the Hereafter. After death, the good and faithful will be rewarded and abide in 'Gardens of perpetuity'.[534] The guilty and unfaithful, however, will 'despair' in the 'chastisement of hell'.[535]

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[530] A Saeed, O Salah, 'Development of sukuk: pragmatic and idealistic approaches to sukuk structure' (2014) 29 *Journal of International Banking Law and Regulation* 41, 42.
[531] Irshad Abdal-Haqq, 'Islamic Law: an Overview of Its Origin and Elements' (1996) 1 *Journal of Islamic Law* 1, 33; Nazeem MI Goolam, '*Ijtihad* and its Significance for Islamic Legal Interpretation' (2006) *Michigan State Law Review* 1443, 1444.
[532] Samiul Hasan, 'Islamic Jurisprudence: Sources and Traditions Creating Diversity in Human Relationships' in Samiul Hasan (ed) *The Muslin World in the 21st Century* (Springer 2012) 23, 27.
[533] Suzanne Haneef, *What Everyone Should Know About Islam and Muslims* (14th ed, Library of Islam 1996) 11-12.
[534] The Holy *Qur'an*, chapter 98, verses 7-8. See also, chapter 43 verses 69-73: English translation of the *Qu'ran* by Maulana Muhammad Ali (2002).
[535] *Ibid*, verses 74-75.

Because Allah endowed humans with intellect and free will,[536] each Muslim must decide how to live his or her life. As it states in the *Qur'an*:

> Surely Allah changes not the condition of a people, until they change their own condition.[537]

The foundation of this decision is whether to accept Allah as the sole and true master or to follow other paths. Haneef explains:

> The greatest and most fundamental choice which every human being is called upon to make is to decide who is his Lord, for whom he lives his life, to whom is his goal, and who he worships, serves and obeys. Indeed, Islam emphatically proclaims, the choice is between only two possible ways: to be in bondage to human ideas and notions and desires, or to consciously and voluntarily commit oneself to be bound by the standards, criteria and laws of God alone.[538]

There are, then, no half measures in Islam. One is either a Muslim and faithful to Allah, or one is not. While Muslims are still human, and subject to temptation and imperfect reasoning, Islam is clear that faithful Muslims have an obligation to comply with the normative rules and behavioural scripts provided by Allah through his Prophet Muhammad (pbuh). While there is scope for interpretation, there is no picking or choosing to suit oneself and no compartmentalising of life. Being a Muslim is a way of life, and Allah's laws and guidance are comprehensive.

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[536] Shadiya Baqutayan, 'The Innovation of Human Nature in Islam' (2012) 2 *International Journal of Social Sciences and Education* 162.
[537] The Holy *Qur'an*, chapter 13, verses 11: English translation of the *Qu'ran* by Maulana Muhammad Ali (2002).
[538] Suzanne Haneef, *What Everyone Should Know About Islam and Muslims* (14th ed, Library of Islam 1996), 17.

Although Allah blessed humans with free will, and the capacity to choose, if a person accepts Islam then he or she also accepts that the word of God, as it is found in the *Qur'an* and the *sunna*, ontologically exists as an objective truth. As Halstead notes, 'what is considered *halal* (permitted) and *haram* (forbidden) in Islam is understood in terms of what God defines as right and good'.[539] As revealed knowledge, these sources of law and morality are pure truth and are not open to question. A devout Muslim is obliged to behave consistently with these moral truths. Subjective pluralism arises, however, because the teachings of the *Qur'an* and the *sunna* must be applied to situations not directly or explicitly covered. This can only be accomplished by the use of the interpretative techniques noted above.

The importance of this, for the purposes of this thesis, is the intention that lies behind Islam, as a religious way of life. This intention is for Islam and the *Sharia* to behave as an institutionalised guide for the life of a Muslim. The norms, beliefs, values and rules comprise the taken-for-granted institutional logics that shape the actions and decisions of Muslims in all aspects of the life. In so doing, the institutional logics of Islam create normative and mimetic isomorphic pressures on devout Muslims to follow the example of the Prophet Muhammad (pbuh) as embodied in the behaviour of respected Muslim scholars as exemplars of "successful" Muslims. Thus, as Haneef explains, one of the goals of Islam is to instil in every Muslim an Islamic personality,[540] reminiscent of the ethics of virtue, but consistent with Islam and the *Qur'an*.

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[539] J Mark Halstead, 'Islamic values: a distinctive framework for moral education?' (2007) 36 *Journal of Moral Education* 283.
[540] Suzanne Haneef, *What Everyone Should Know About Islam and Muslims* (14th ed, Library of Islam 1996), 73.

As in Islam, the focus of virtue ethics 'is on the virtuous individual and on those inner traits, dispositions, and motives that qualify her as being virtuous'.[541] Virtue ethics asks: 'What kind of person is it best to be?'.[542] Under the Aristotelian approach, 'the virtuous individual is someone who, without relying on rules, is sensitive and intelligent enough to perceive what is noble or right as it varies from circumstance to circumstance'.[543] Under this approach, the behaviour of a virtuous person acquires a legitimacy that flows from the recognition of the virtuous nature. The legitimacy that accompanies virtue creates a mimetic isomorphic pressure that influences others to follow their example and behave similarly. Through this mimetic isomorphism they develop the same innate sense of right and wrong that reflects the taken-for-granted norms and scripts of the institutional influences that shape the nature of virtue and the identification of a particular trait as virtuous.

Central to the divine law are the virtues of justice (*'adl*), compassion (*ihsan*), balance (*mizan*) and moderation (*la israf*).[544] Other Islamic virtues include: *taqwa* or a 'consciousness' of God; *iman*, or a deep faith in God; sincerity; responsibility; integrity; honesty, truthfulness and fairness;[545] self-discipline; humility, patience and gratitude; courage; dignity and honour; purity; kindness, charitableness and generosity; consideration of others; a sense of relation to all other Muslims;

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541 Michael Slote, 'Virtue Ethics', in Marcia W Baron, Philip Pettit, Michael Slote (eds) *Three Methods of Ethics* (Blackwell 1997) 175, 177.
542 George Sher, 'Ethics, Character, and Action', in Ellen Frankel Paul, Fred D Miller, Jeffrey Paul (eds) *Virtue and Vice* (Cambridge University Press 1998) 1.
543 Michael Slote, 'Virtue Ethics', in Marcia W Baron, Philip Pettit, Michael Slote (eds) *Three Methods of Ethics* (Blackwell 1997) 175, 178.
544 Masudul Alam Choudhury, 'Islam versus liberalism: contrasting epistemological inquiries' (2008) 35 *International Journal of Social Economics* 239, 245.
545 The Holy *Qur'an*, chapter 4, verse 135.

willingness to work ('And that man can have nothing but what he strives for');[546] and a love of knowledge.[547] As Asad explains:

> The devout Muslim seeks to cultivate virtue and repudiate vice by a constant awareness of her/his own earthly finitude, trying to achieve the state of equilibrium that the *Qur'an* calls an-nafs almutma'inna, 'the self at peace'.[548]

Along with developing the Islamic virtues, a faithful Muslim is guided by the *Qur'an* and the *sunna*, which detail those harmful things that are forbidden or *haram*. If it is not *haram*, then it is *halal*, or permissible. There are, however, things that are permissible and desirable, as well as those things that are permissible, but undesirable. There are also certain obligations (*fard*).[549] For example, moral obligations include: being honest and truthful; being just; respect for the property of others. Desirable behaviour includes working and creativeness. Undesirable behaviour includes the hoarding of money, which should be kept in circulation and it is *haram* to gain wealth by gambling, exploitation or demands for payment of interest on loans or debts. Economic practices that cause harm are also forbidden.[550] This creates a moral system that goes beyond a binary right or wrong to allow for the characterisation of behaviour as permissible, but either desirable or undesirable. As will become apparent in chapter six, the distinction between the desirable, or *tayyib*, and the undesirable, but permissible is relevant to the distinction between compliance with the *Sharia* in spirit and a merely technical or formal compliance. As such,

546 The Holy *Qur'an*, chapter 53 verse 39.
547 Suzanne Haneef, *What Everyone Should Know About Islam and Muslims* (14th ed, Library of Islam 1996), 74-97.
548 Talal Asad, 'Agency and Pain: an Exploration' (2000) 1 *Culture and Religion* 29, 50.
549 Suzanne Haneef, *What Everyone Should Know About Islam and Muslims* (14th ed, Library of Islam 1996), 100.
550 Suzanne Haneef, *What Everyone Should Know About Islam and Muslims* (14th ed, Library of Islam 1996), 105-108.

tayyib is a useful concept for the holistically Islamic system of governance and regulation proposed in this thesis.

3.2.3 Contrasting the values of Islam and neoliberal capitalism

The Islamic character, Islamic morals and Islamic laws, as found in the *Qur'an*, the *sunna*, and as expressed through the *Sharia*, promote an attitude very different to capitalism. While personal wealth and the freedom to pursue a profit is not forbidden, Islamic social ontology characterises the individual as part of a greater whole, founded on a collective life,[551] and consisting of the community of Muslims. The Islamic emphasis on justice, moderation, faith, charity and the prohibition of exploitative economic practices, along with the sense of a Muslim community, all tend to encourage an equalisation of wealth rather than wealth maximisation.[552] Rather than prioritising wealth as a measure of success, Islam - and hence Islamic economics - emphasise *falah* (self improvement and well-being through following the teachings of Allah and the Prophet Muhammad (pbuh)).[553] As Chapra notes, 'two of the most important constituents of [the vision of Islam] ... are socio-economic justice and the well-being of all God's creatures'.[554] Similarly, Arif argues that: 'the philosophical foundations of Islam result in a world view based on socio-economic justice'.[555] Furthermore, Islam provides a moral code that is absent from capitalism.

[551] Elizabeth Shakaman Hurd, 'Political Islam and Foreign Policy in Europe and the United States' (2007) 3 *Foreign Policy Analysis* 345, 351.
[552] Suzanne Haneef, *What Everyone Should Know About Islam and Muslims* (14th ed, Library of Islam 1996), 118..
[553] Muhammad Arif, 'The Islamization of knowledge and Some Methodological Issues in Paradigm Building: The General Case of Social Science with a Special Focus on Economics' (1987) 4 *The American Journal of Islamic Social Sciences* 52, 66.
[554] M Umer Chapra, 'Is it necessary to have Islamic economics?' (2000) 29 *Journal of Socio-Economics* 21, 30.
[555] Muhammad Arif, 'The Islamization of knowledge and Some Methodological Issues in Paradigm Building: The General Case of Social Science with a Special Focus on Economics' (1987) 4 *The American Journal of Islamic Social Sciences* 52, 63.

Commercial and economic activity are as much subject to Islamic morality as any other part of life.[556]

Capitalism relies on the rationalities of efficiency, wealth maximisation and the belief that the market provides sufficient regulation. Neoliberal capitalism, in particular, combines the capitalist value of wealth with the liberal ontology of the autonomous individual competitively co-existing in a community of similarly autonomous individuals whose cooperation is predicated on self-interest. In contrast to the faith-based, family and community oriented Islamic ontology, the ontology of neoliberal capitalism relies on the secular,[557] hyper-rational, autonomous individual.[558] The 'moral, ethical and social vacuum'[559] created by the neoliberal capitalist agenda of wealth-maximisation and competitive individualism is evident in the financial crises and other scandals that have peppered the recent history of conventional finance. The limits of this approach are evidenced in the recognition that external regulation is required.

The institution of Islam is inherently moral and brings with it the self regulation of Muslim fidelity. This is not to suggest that Islamic finance should not be subject to regulation. Indeed, Muslims are just as fallible as anyone and capable of misguided behaviour, bad decision making and acting on inappropriate motivations. The point is, however, that while the discourse of capitalism requires tempering by external moral guides, and is subject to competing religious and social institutions, Islam

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[556] Clinton Bennett, 'Islam' in Jean Holm, John Bowker (eds), Making Moral Decisions (Continuum 1994) 95, 104.
[557] Elizabeth Shakaman Hurd, 'Political Islam and Foreign Policy in Europe and the United States' (2007) 3 *Foreign Policy Analysis* 345, 351.
[558] Ken Jowitt, 'After Leninism: The New World Disorder' (1991) 2 *Journal of Democracy* 11, 15-17.
[559] Masudul Alam Choudhury, 'Islam versus liberalism: contrasting epistemological inquiries' (2008) 35 *International Journal of Social Economics* 239, 254.

provides a unified institutional logic. This shifts the emphasis required for effective regulation from the need to counter the institutional influence of neoliberal capitalism by imposing a rationalised secular system of ethics to the need to standardise and reinforce the institutional influence of Islam. This will be returned to in chapter four.

3.2.3.1 Islam in the face of neoliberal capitalism

This conception of life as a Muslim, backed by the inevitability of judgment and reward or punishment in the afterlife, provides a powerful institutional force guiding the faithful. It is, however, complicated by the differing interpretations of the obligations imposed by Islam. It may also be further complicated by the influences of competing institutions, such as capitalism, liberalism and other Western values.[560] These may affect Muslims both as individuals and as communities, and this may be more likely in non-Muslim countries or in the context of globalisation.[561]

Writing in 2012, Crow muses:

> We may now be experiencing a generational moment in which Islam could conceivably offer a genuine alternative to the ongoing marketisation of societies ... Yet this moment might well be passing Muslims by. Are they instead being herded into a passive embrace

[560] Nazeem MI Goolam, '*Ijtihad* and its Significance for Islamic Legal Interpretation' (2006) *Michigan State Law Review* 1443, 1464.
[561] Masudul Alam Choudhury, 'Islam versus liberalism: contrasting epistemological inquiries' (2008) 35 *International Journal of Social Economics* 239, 252-253. Globalisation, since the mid 1970s at least, involves, as Choudhury notes, the spread of neoliberal ideas, including the rationality of free market economics.

> of the consumer society directed by the elite cliques at the helm of global neo-liberal capitalism?[562]

This reflects the concern that the behavioural norms and scripts that embody the institutional logics of capitalism in general, and neoliberal capitalism in particular, are successfully competing with the institutional norms of Islam. For example, in considering the influence of capitalism in Egypt, Asad notes the impact of the hegemony of the free market and the conception of 'agency as individual self-empowerment' and suggests:

> There is clearly a conflict between the disciplines of secular state and modern market and those of the Islamic tradition ...[563]

The danger of this is that neoliberal capitalist values become embedded alongside Islamic norms with both influences forming the institutional logics of Islamic finance. These potentially conflicting scripts may then be rationalised by Islamic finance professionals to produce financial products and services that cosmetically appear to be *Sharia* consistent, but will be essentially grounded in neoliberal capitalism. In other words, they will be structurally and symbolically[564] Islamic, but functionally capitalist.

The importance of appreciating the differing ontologies, and consequentially the differing values, lies in understanding the differing approaches of conventional and Islamic finance. Equally, the importance of the globalised neoliberal capitalist context for Islamic finance is the recognition of the potential for the two institutions to compete and conflict in the process of financial innovation and the development of

[562] Karim D Crow, 'In Search of "Islamic Lifestyle"' (2012) 3 *Islam and Civilisational Review* 654, 655.
[563] Talal Asad, 'Agency and Pain: an Exploration' (2000) 1 *Culture and Religion* 29, 51.
[564] Karim D Crow, 'In Search of "Islamic Lifestyle"' (2012) 3 *Islam and Civilisational Review* 654, 658.

new Islamic financial products and services. The gap between revealed and acquired knowledge raises the possibility that neoliberal capitalism may exert an influence on both the development of new financial products and the subsequent analysis carried out by the *Sharia* board to determine *Sharia* compliance. This will be considered further below.

3.2.4 *Sharia*

Etymologically, *Sharia* means the way or 'path to follow'.[565] In chapter 45, verse 18, the *Qur'an* states: '[t]hen We made thee follow a course in the Affair, so follow it, and follow not the low desires of those who know not'. Thus, Allah provided, through his Messenger, the Prophet Muhammad (pbuh), a way of life, or *Sharia*, for Muslims to follow. It is based upon the *Maqasid al-Sharia*, or the objectives of *Sharia*, which aim to promote the well-being and self-improvement essential to *Falah*.[566] In this regard, the *Maqasid* seek to protect the physical, mental and spiritual health of Muslims, as well as promote the Islamic virtues.[567]

This conception of *Sharia* is wide and, as Rohe has noted, it may be understood more restrictively as the 'legal rules regulating personal status, family and inheritance and corporal punishment'.[568] Yamani also identifies two distinct conceptions of *Sharia*. After noting that the *Sharia* is 'the all embracing legal system that regulates the lives

[565] Ahmed Zaki Yamani, 'The Eternal Shari'a' (1979) 12 *New York University Journal of International Law and Politics* 205.
[566] See text at n 563.
[567] Shadiya Baqutayan, 'The Innovation of Human Nature in Islam' (2012) 2 *International Journal of Social Sciences and Education* 162,170.
[568] Mathias Rohe, 'Application of Shari'a Rules in Europe - Scope and Limits' (2004) 44 *Die Welt des Islams* 323, 325.

of Muslims everywhere', he explains that there are broad and narrow interpretations.[569] For Yamani, the broad sense of *Sharia* is:

> everything that has been written by Muslim jurists throughout the centuries, whether dealing with contemporaneous issues of the time or with the anticipation of future ones. The jurists derived their principles from the Quran ... from the *sunna* ... from other sources of *shari'a* such as *ijma* ... and from public interest considerations. Looked upon in this wide scope, the *shari'a* constitutes a great juristic tradition, the value of which depends upon the individual jurist himself, his era, or even the particular problem confronting him.

The narrow sense of *Sharia* is:

> confined to the undoubted principles of the Quran, to what is true and valid of the *sunna* and the consensus of the community represented by its scholars and learned men during a certain period and regarding a particular problem, provided there was such consensus.

In its narrow sense, the *Sharia* reflects revealed knowledge and has an absolute binding authority. In its broad sense, it reflects acquired knowledge and is of 'scholastic value'. In this latter sense, it is context specific and not binding.[570]

Nielsen also identifies the dichotomy of *Sharia*, noting that: 'at its simplest ... the Shari'a expresses God's will for human behaviour'. This 'immutable' form is then

[569] Ahmed Zaki Yamani, 'The Eternal Shari'a' (1979) 12 *New York University Journal of International Law and Politics* 205.
[570] Ahmed Zaki Yamani, 'The Eternal Shari'a' (1979) 12 *New York University Journal of International Law and Politics* 206.

subject to '*Fiqh* ... the process of human interpretation ... the extrapolation of the immutable Shari'a into the rules of everyday living'.[571] This dichotomy is one source of divergence and disagreement about what is *Sharia* compliant and it gives rise to three questions:[572]

1. 'Where is the demarcation line between immutable Shari'a and human interpretation?'
2. 'How do the intellectual interpretation and the impact of the community implied in *ijtihad* and *ijma* relate to the textual sources?'
3. 'Who has the authority to engage in *fiqh*?'

The divergence and disagreement over *Sharia* is compounded by the existence of distinct schools of Islamic jurisprudence (*Madhhab*).[573] Although there are many *Madhhab*, there are five main schools, the *Shi'ite* school of *Ja'fari* and the *Sunni* schools of *Hanafi*, *Maliki*, *Shafi'i* and *Hanbali*.[574] The opportunity for diverse interpretations, through allegiance to different schools of jurisprudence: 'leads to at times radically different Islamic economic systems and policies ... rooted in differences of opinion on what can and should be included and utilised as legitimate sources of Islamic jurisprudence'.[575] This divergence could be further facilitated by the traditional Islamic practice of *ijtihad*,[576] which requires *Sharia* scholars to

[571] Jorgen S Nielsen, 'Shari'a Between Renewal and Tradition', in Jorgen S Nielsen, Lisbet Christoffersen (eds), *Shari'a as Discourse: Legal Traditions and the Encounter with Europe* (Ashgate 2010) 1, 4.
[572] *Ibid*.
[573] See Samiul Hasan, 'Islamic Jurisprudence: Sources and Traditions Creating Diversity in Human Relationships' in Samiul Hasan (ed) *The Muslin World in the 21st Century* (Springer 2012) 23, 28*ff* for a discussion of the different jurisprudential approaches.
[574] Wael B Hallaq, *An Introduction to Islamic Law* (Cambridge University Press 2009), 31. The most significant division is between *Sunni* and *Shia*, with *Shi'ites* believing that *mujtahids* (current scholars) have an equal right of interpretation as scholars of the past: Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 23.
[575] Farhad Nomani, Ali Rahnema, *Islamic Economic Systems* (Zed Books Ltd 1994), 2.
[576] Masmoudi suggests that the practice of *ijtihad* effectively ceased in the fifth century of Islam and 'modern attempts to revive *itjihad* have so far been modest and not very successful': Radwan A

produce their *fatwas* through a process of individual or personal reasoning.[577] This scope for interpretation allows a system that can be developed to fit the needs of a particular society at a particular time, based on the immutable general principles of the *Sharia* as made relevant to the concrete circumstances by an unbiased selection of principles from the *Madhhab* and 'considerations of public interest and the communal welfare'.[578]

Thus, *Sharia* is a legal system that goes beyond the remit of conventional systems of law to deal with both religious matters and all aspects of human action, interaction and transaction. In part, then, *Sharia* is a fixed, immutable system of principles found in the *Qur'an* and the *sunna*. In part, the *Sharia* is also a pluralistic system open to interpretation and development consistently with the *fiqh* techniques of *ijma*, *qiyas* and *ijtihad*. This latter element of *Sharia* law allows the development of rules and principles that are appropriate for the specific context of that time and that place.[579] This makes *Sharia* a flexible, 'self-renewing system, a system for every age and every place'.[580] As Masmoudi comments: '[t]rue Shariah is a set of guiding principles to protect the individual and the society and not just a set of rules that are fixed in

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Masmoudi, 'Struggles Behind Words: Shariah, Sunnism, and Jihad' (2001) 21 *SAIS Review of International Affairs* 19, 22. This, however, may overstate the position: Ahmed Zaki Yamani, 'The Eternal Shari'a' (1979) 12 *New York University Journal of International Law and Politics* 206, 211. Furthermore, there is a distinction between the rejection of the practice by the *Sunni* schools and the retention of the practice by *Shi'ite* Muslims: Farhad Nomani, Ali Rahnema, *Islamic Economic Systems* (Zed Books Ltd 1994), 15-16. It perhaps also depends on precisely what is meant by the term: see, A Saeed, O Salah, 'Development of sukuk: pragmatic and idealistic approaches to sukuk structure' (2014) 29 *Journal of International Banking Law and Regulation* 41, 41-42.

[577] George Makdisi, 'The Significance of the Sunni Schools of Law in Islamic Religious History' (1979) 10 *International Journal of Middle East Studies* 1.

[578] Ahmed Zaki Yamani, 'The Eternal Shari'a' (1979) 12 *New York University Journal of International Law and Politics* 206.

[579] Farhad Nomani, Ali Rahnema, *Islamic Economic Systems* (Zed Books Ltd 1994), 19.

[580] Ahmed Zaki Yamani, 'The Eternal Shari'a' (1979) 12 *New York University Journal of International Law and Politics* 212.

time'.[581] While this means that the *Sharia* may interpreted to suit the context of its application, it also leaves that interpretation open to the conflicting influence of institutional logics external to Islam.

Before moving on to consider the specific application of *Sharia* to Islamic financial services, it should be noted that the development and application of *Sharia* is complicated by the dichotomies that exists between secularists and Islamists, and between moderates and extremists.[582] Filali-Ansary identifies a:

> divide between fundamentalism or Islamism on the one hand (which is not so much literalist as it is simply premodern in an epistemological sense), and on the other hand those scholars (some of whom may be called modern and others of whom lean towards traditionalism) who agree on the intrinsic limitations of the human mind, the inaccessibility of absolute truth, and the need for more historically accurate readings of textual traditions.[583]

Each of the three groups represented here - the fundamentalists, the traditionalists and the modernists - seek to reform Islam from distinctly different perspectives or views about the way the world is.[584] Thus, while fundamental Islamists emphasise the immutability of *Sharia*, enlightened 'liberal' Muslim scholars emphasise the

[581] Radwan A Masmoudi, 'Struggles Behind Words: Shariah, Sunnism, and Jihad' (2001) 21 *SAIS Review of International Affairs* 19, 21.
[582] *Ibid*, 20.
[583] Abdou Filali-Ansary, 'The Sources of Enlightened Muslim Thought' (2003) 14 *Journal of Democracy* 19, 21-22.
[584] See also the discussion in: Salah El-Sheikh, 'Islamic Economics and Finance, Then and Now: A Fiqhi-conomic Perspective on its Doctrines and Debates' (2011) 19 *International Journal of Economics, Management & Accounting* 77, 83-102.

relevance of 'necessarily situated and thus relative [human knowledge]' that makes at least elements of Sharia situational and context dependent.[585]

In conclusion of this brief explication of *Sharia*, it seems reasonable to say that, beyond the explicit principles in the *Qur'an*, there is no single *Sharia*,[586] but a diversity of related interpretations that are dependent on both historical and geographical context. Thus: 'The rules of sharia are not unambiguously laid down in the law, but rather they are formulated in scholarly explorations'.[587] The scope for divergent opinion is just as applicable to Islamic finance as other areas of life, but raises particular issues for governance, *Sharia* compliance, the risk of *Sharia* non-compliance and the possible loss of confidence in Islamic financial services. In the next section, the principles of *Sharia* and Islam that are more specifically relevant to Islamic finance will be addressed.

3.3 Islamic and *Sharia* principles applicable to financial services

The *Qur'an* contains around 500 'legal' injunctions, of which 20 deal with economic matters.[588] Additional detail on these may be found in the *hadith*, but the *Qur'an* is the most important source of the relevant principles. Also important is the ***Ijma*** or consensus opinion of Islamic scholars, which applies to the practical application of sharia. It is particularly relevant for Islamic finance because:

> models of Islamic banking are not mentioned in the *Qur'an* or in the *hadith*, although the basic principles which govern the system

[585] Radwan A Masmoudi, 'Struggles Behind Words: Shariah, Sunnism, and Jihad' (2001) 21 *SAIS Review of International Affairs* 19, 31.
[586] KS Vikor, *Between God and the Sultan: A History of Islamic Law* (Hurst 2005), 1.
[587] Jan Michiel Otto, 'Introduction: investigating the role of sharia in national law', in Jan Michiel Otto (ed), *Sharia Incorporated: A Comparative Overview of the Legal Systems of Twelve Muslim Countries in Past and Present* (Leiden University Press 2010) 19, 24.
[588] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 21.

are. Consequently the development of Islamic banking has been based to a large degree on the consensus of modern Muslim scholars and jurisprudents.[589]

These sources, as discussed above, are supported by *qiyas* and *ijtihad*.

Before considering the specific Islamic economic principles, it should be noted that a distinction may be drawn between two conceptions of Islamic finance. The first, and dominant, conception is of a financial system compliant with the *Sharia* principles discussed below. The second conception of Islamic finance, or Islamic economics, is of a socially just, equitable and moral system that goes beyond basic compliance and,[590] based on the idea of Islam as a "family" of Muslims, is also concerned with the 'needs and welfare of all', with the just distribution of wealth and with economic development.[591] The focus of this thesis is on *Sharia* compliance and so the explanation that follows will centre on the narrower conception of Islamic finance. As will be discussed, however, there is a tension between a formalistic approach of technical compliance and compliance that is measured more by the spirit of *Sharia* than by its technicalities.

Islam and the *Qur'an* permit private property, wealth, and a competitive market,[592] but the market is embedded in the social, moral and religious context of *Sharia*.[593]

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[589] *Ibid*, 22. As an example, they cite the *Handbook of Islamic Banking* published by International Association of Islamic Banks.
[590] Sayyid Abul A'la Mawdudi, 'The Economic Philosophy of Islam' in Khurshid Ahmad (ed), Ahmad Imam Shafaq Hashemi (trans), Sayyid Abul A'la Mawdudi (author), *First Principles of Islamic Economics* (The Islamic Foundation 2011), 81-86.
[591] Khurshid Ahmad, 'Foreword', in Khurshid Ahmad (ed), Ahmad Imam Shafaq Hashemi (trans), Sayyid Abul A'la Mawdudi, *First Principles of Islamic Economics* (The Islamic Foundation 2011) xiii, xxvi.
[592] Farhad Nomani, Ali Rahnema, *Islamic Economic Systems* (Zed Books Ltd 1994), 55.

Wealth is held on trust for Allah and is subject always to the *Qur'an*, the *sunna* and the *Sharia*.[594] Flaunting one's wealth, or hoarding it, for example, are unacceptable. Similarly, pursuing wealth as an end in itself is frowned upon.[595] Rather, the wealthy Muslim owes an obligation of support to the less well-off, first to his family and then to the wider community.[596] This concern reflects the importance placed on social justice and well-being by the *Qur'an*,[597] but the demands of social justice are open to interpretation and this can provide another source of divergence in economic policies that may impact on the characterisation of a financial service or product as Sharia compliant.[598]

El-Gamal notes that:

> the talented jurist Ibn Taymiyya ... famously stated that two prohibitions can explain the distinctions between contracts that are deemed valid or invalid: those of *riba* and *gharar*.[599]

Hourani identifies the prohibition of *riba*; PLS; and the prohibition *gharar* as the three 'benchmark principles of Islamic finance.[600] Lewis and Algaoud, go further and identify five basic Islamic principles that must be followed in the provision of financial services:[601]

1. prohibition of *riba*;

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[593] Salah El-Sheikh, 'Islamic Economics and Finance, Then and Now: A Fiqhi-conomic Perspective on its Doctrines and Debates' (2011) 19 *International Journal of Economics, Management & Accounting* 77, 81.
[594] See, the Holy *Qur'an*, chapter 20 verse 6.
[595] See, The Holy *Qur'an*, chapter 79, verses 37-39; Farhad Nomani, Ali Rahnema, *Islamic Economic Systems* (Zed Books Ltd 1994), 79-80.
[596] Farhad Nomani, Ali Rahnema, *Islamic Economic Systems* (Zed Books Ltd 1994), 26.
[597] See eg, The Holy *Qur'an*, chapter 51, verse 19; chapter 4, verses 36-38; chapter 9, verse 103.
[598] Farhad Nomani, Ali Rahnema, *Islamic Economic Systems* (Zed Books Ltd 1994), 36-38.
[599] Mahmoud A El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006), 8.
[600] Husam Hourani, 'The three principles of Islamic finance explained' (2004) 23 *International Financial Law Review* 46.
[601] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 28.

2. the importance of almsgiving or *zakat* (or *zakah*);
3. prohibition of goods or services contrary to Islamic values (*haram*);
4. avoidance of *maysir* (gambling) and *gharar* (uncertainty); and
5. provision of *Takaful* (insurance).

Monger and Rawashdeh, also rely on 'five tenets', which they suggest: 'help explain major differences' between Islamic and conventional finance. Unsurprisingly, the prohibition of interest is the first of these. Like Lewis and Algaoud, they also highlight the prohibition of 'uncertainty or speculation', and *haram* goods and services. They do, however, also include two additional tenets, which are:

- the matching of risk and reward through PLS; and
- the prohibition of making money from money without some intermediary "real" commercial transaction, such as the provision of a service or the ownership of goods.[602]

While also noting the prohibition of *riba* and speculative investments, Siebel and Imady instead emphasise the importance of 'brotherhood and solidarity' expressed through the PLS mechanism that joins the business partners to share in both the risks and the profits of any venture.[603] Visser similarly emphasises the importance of the general principles of *Tawheed* and brotherhood as the basis of Islamic social justice. He also notes the sin of excess, which prohibits hoarding and the accumulation of excessive wealth, before highlighting the specific duty of *zakat* and prohibitions on

[602] Rod Monger, Mufeed Rawashden, 'Islamic Finance Enters the Mainstream' (2008) 9 *Management Accounting Quarterly* 1, 2. See also: Alsadek H Gait, Andrew C Worthington, 'A Primer on Islamic Finance: Definitions, Sources, Principles and Methods' (2007) University of Wollongong School of Accounting and Finance Working Paper Series 07/05, 7.
[603] Hans Dieter Seibel, Omar Imady, 'Principles and Products of Islamic Finance' (2006) Working Paper University of Cologne, Development Research Center No 2006/1, <http://hdl.handle.net/10419/23655> accessed 12 February 2015. See also the emphasis on partnership and profit sharing in: Oliver Agha, 'Islamic Finance in the Gulf: A Practitioner's perspective' (2008) 1 *Berkeley Journal of Middle Eastern and Islamic Law* 179, 181.

riba, *maysir*, *gharar* and *haram* goods and services.[604] Siddiqi also emphasises the importance of justice (and equity), but includes growth alongside justice as the two principles underlying Islamic economic provisions. He goes on to explain that:

> the conception of growth in Islam is ... broader and more comprehensive than the narrowly conceived "economic growth" in capitalism. As implied by the verses of Quran (2:151 &3:164) ... it refers to an all rounded human personality.[605]

This growth is integral to the Islamic goal of *falah* (see above).

To these tenets and principles may be added the requirement, under Islam, for trading to be fair, honest and based on the open availability of adequate information.[606] For example, in the *Qur'an*, chapter 26, verses 181-183, it states:

> Give full measure and be not of those who diminish And weigh with a true balance. And wrong not men of their dues, and act not corruptly in the earth, making mischief.

Furthermore, the whole of chapter 83 is dedicated to condemning those who fail in their duty and who cheat or defraud others.

From this, it can be seen that Islamic finance is normative, based on underlying general Islamic principles of community-based justice as well as more specific and technical rules and principles that provide Islamic finance with its characteristic outward appearance. While both are important, there is a danger that the focus will fixate on the technical at the expense of, in particular, the principle of justice (*adl*). Focusing on the specific financial principles may facilitate the development of

[604] Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar 2009), 26.
[605] Mohammad Nejatullah Siddiqi, '*Riba*, Bank Interest and the Rationale of its Prohibition' (2004) Islamic Research and Training Institute Visiting Scholars' Research Series, 22.
[606] Farhad Nomani, Ali Rahnema, *Islamic Economic Systems* (Zed Books Ltd 1994), 56-57.

financial products that comply with *Sharia* in form, but not necessarily in spirit. This allows the institution of capitalism to encroach on Islamic finance resulting in an isomorphic effect that preserves technical distinctions but facilitates the convergence of values, with efficiency and profit taking precedence over brotherhood and social justice.

3.3.1 *Riba*

Of the relevant Islamic rules and principles, it is the prohibition of *riba* that is perhaps most identified as a unique feature of the narrow conception of Islamic finance.[607] It is also the most controversial principle. *Riba* literally means "excess" or "addition" and,[608] in the context of financial transactions, is defined as 'what is over and above the principal'.[609] It is variably equated to all forms of interest or to particular types of interest characterised as exploitative.[610] The debate engages with the meaning of usury, which is perhaps the closest semantic translation of the term, *riba*. Traditionally, usury applied to all forms of interest, but this is now seen as 'archaic' and the more modern meaning of the term is restricted to 'unconscionable or exorbitant' rates of interest.[611] Thus, those who argue against the interpretation of *riba* as interest, claim that the intention behind the prohibition of *riba* in the *Qur'an* is to prevent the exploitation of a debtor by unscrupulous lenders and this is of no

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[607] See, eg, the Holy *Qur'an*, chapter 2, verses 275-281.
[608] Erdem Bafra, 'Prohibition of "Riba" Over against Time Value of Money in Islamic Banking' (2014) 2 *Izmir Review of Social Sciences* 75, 76.
[609] Mohammad Nejatullah Siddiqi, '*Riba*, Bank Interest and the Rationale of its Prohibition' (2004) Islamic Research and Training Institute Visiting Scholars' Research Series, 36. Siddiqi draws this definition from the Holy *Qur'an*, chapter two, verses 275-280. Zaman points out that this definition is inadequate if *riba* is to be equated to interest while permitting profit and loss sharing partnerships, particularly where one partner is inactive: M Raquibuz Zaman, 'Usury (Riba) and the place of bank interest in Islamic banking and finance' (2008) 6 *International Journal of Banking and finance* 1, 6. To rectify this, the definition would need to be qualified as a wrongful, or unjust addition to the principal sum.
[610] See the discussion in : Abu Umar Faruq Ahmad, M Kabir Hassan, 'Riba and Islamic Banking' (2007) 3 *Journal of Islamic Economics, Banking and Finance* 1.
[611] The Merriam-Webster dictionary, <http://www.merriam-webster.com/dictionary/usury> accessed 13 September 2016.

relevance to the interest-based practices of conventional banks.[612] Those that argue in favour of equating *riba* to all interest see the charging of interest itself as wrong for a number of reasons, including concerns of justice and its corrupting impact on both society and individual human personality.[613]

Pressley and Sessions provide a summary of the arguments in favour of characterising the prohibition of *riba* as applying to all forms of interest:

1. Saving money is simply an '[abstention] from consumption'. Doing nothing does not justify a reward.
2. Similarly, simply lending money is insufficient to justify a reward.
3. Any increase in capital must come through enterprise and risk. To receive a return on a loan it must contribute to such a risky enterprise and the return should reflect the proportion that the loan contributes to the overall endeavour,
4. The return on a loan should be determined by the success of the project, the 'risk and work effort supplied'.
5. 'The lender becomes a partner in the business or project, sharing in the provision of enterprise'.[614]

The consequence of these arguments may be summarised as follows. Any return on a loan is not fixed, but is dependent on the successfully productive use of the loan as part of a risky enterprise. Both the lender and the borrower have a claim to share in

[612] Timur Kuran, 'The logic of financial westernization in the middle east' (2005) 56 *Journal of Economic Behaviour and Organization* 593, 595.
[613] Mohammad Nejatullah Siddiqi, '*Riba*, Bank Interest and the Rationale of its Prohibition' (2004) Islamic Research and Training Institute Visiting Scholars' Research Series, 41.
[614] John R Pressley, John G Sessions, 'Islamic Economics: The Emergence of a New Paradigm' (1994) 104 *The Economic Journal* 584, 586.

any profits or loss, with the share determined by the proportionate investment in the enterprise.[615]

3.3.1.1 Riba and the Islamic conception of money

The points made by Pressley and Sessions may be further supported by the Islamic conception of money as solely a means to an end and not an end in itself. As Choudhury notes: '[m]oney cannot be commodified as in the ... model of the liberal order ... The only return on money is from the real economic activities that carry the blessings of being in the good and productive things of life'.[616] Justice Mufti Umani quotes the twelfth century (CE) Islamic philosopher Imam Al-Ghazali, who explained that Allah created money, not to have intrinsic value, but as a means to ensure fairness in acquiring commodities and services.[617] Based on an analysis of the *Qur'an*, Choudhury similarly describes money as a device for 'assigning exchange values to real goods and services transacted in an ethicized market mechanism'.[618]

The consequence of this is that:

> the one who is using money in a manner contrary to its basic purpose is, in fact, disregarding the blessings of Allah. Consequently, whoever hoards money is doing injustice to and is defeating its actual purpose ... And whoever effects the transactions of interest on money, is in fact, discarding the blessing of Allah, and is committing injustice, because money is created for some

[615] *Ibid*, 586-587.
[616] Masudul Alam Choudhury, 'Islam versus liberalism: contrasting epistemological inquiries' (2008) 35 *International Journal of Social Economics* 239, 257.
[617] See also, Irfan Shahid, 'Rational for the Prohibition of Interest in Islamic Economics' (September/December 2013) *New Horizon* 14.
[618] Masadul Alam Choudhury, *Money in Islam: A Study in Islamic Political Economy* (Routledge 1997), 12.

> other things, not for itself ... if it is allowed for him to trade in money itself, money will become his ultimate goal, and will remain detained with him like hoarded money.[619]

Thus, money is 'a medium of trade and not an object of trade itself'. Charging interest on a loan involves no other object of trade and so makes money the object, and is therefore forbidden by the *Qur'an*.[620]

To the Muslim, the value of money is derivative on the commodities and services that it may be exchanged for.[621] In contrast to money from a capitalist perspective, it is not a measure of success, which is determined not by wealth, but by reference to *falah* or well-being and self-improvement. In a capitalist system, profit, as measured by money, is the driving force, with the presumption that the competitive struggle for wealth through a free market is the most efficient means of encouraging economic growth and indirectly improving social welfare. In Islam, profit as a motivation is, or should be, secondary to and derivative from social welfare. Money, although capable of private ownership, is a public good and carries with it a public obligation to the less well off.[622] Hart explains that:

> Money in capitalist societies stands for alienation, detachment, impersonal society, the outside ... money is the principal source of

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[619] Al-Ghazali, Ihya'ul'uloom, v.4, (Beirut 1997) 348, as quoted by Justice Mufti Muhammad Taqi Usmani, 'Present Financial Crisis: Causes and Remedies From Islamic Perspective' (2010) <http://www.muftitaqiusmani.com/index.php> accessed 13 September 2016. Justice Mufti Usmani is a leading *Sharia* scholar in the field of Islamic finance, sitting on a number of *Sharia* boards.

[620] Justice Mufti Muhammad Taqi Usmani, 'Present Financial Crisis: Causes and Remedies From Islamic Perspective' (2010) <http://www.muftitaqiusmani.com/index.php> accessed 13 September 2016.

[621] Islam allows that commodities may have a time value, which legitimises credit sales: Abu Umar Faruq Ahmad, M Kabir Hassan, 'The Time Value of Money Concept in Islamic Finance' 23 (2006) *The American journal of Islamic Social Sciences* 66, 75-77.

[622] For a table setting out the distinctions between the conceptions of Money under Islamic and capitalists systems see: Iraj Toutounchian, Isl*amic Money and Banking: Integrating Money in Capital Theory* (ebook, John Wiley 2009), table 1.3.

> our vulnerability in society and the main practical symbol allowing each of us to make an impersonal world meaningful ... money is the God of capitalist society.[623]

By contrast, under Islam, money is 'not ... an asset in its right', but 'a means of exchange and a numeraire'[624] that serves to connect those within the community, providing a means for helping to distribute Allah's bounty.

The consequence of this view is that, unlike capitalism, which encourages a direct profit motive, Islam does not allow money to generate money.[625] Wealth can only grow through production, trade for commodities and service (labour). Under Islam, money is only seen as capital with a time value when engaged in the "real" or productive economy of purchasing goods and services or investing in business where the chance of profit and the risk of loss is shared with the entrepreneur.[626] *Riba*, as an excess, *ex-ante* pre-determined time value simply accrued in the absence of production, trade or service, is not permitted.[627]

3.3.1.2 Riba: interest or usury?

On the distinction between usury and interest, Justice Mufti Umani argued that drawing such a distinction '[opens] the gate for [an] ever-growing universe of debt-based financial transactions that have no connection with [the] real economy' and generates a gap between 'real' money and the 'virtual' money created by debt. Here,

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[623] Keith Hart, 'Money: one anthropologist's view' in James G Carrier (ed) *A Handbook of Economic Anthropology* (Edward Elgar 2005) 160, 167.
[624] Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar 2009), 25.
[625] Abu Umar Faraq Ahmad, M Kabir Hassan, '*Riba* and Islamic Banking' (2007) 3 *Journal of Islamic Economics, Banking and Finance* 1 17.
[626] Abu Umar Faruq Ahmad, M Kabir Hassan, 'The Time Value of Money Concept in Islamic Finance' 23 (2006) *The American journal of Islamic Social Sciences* 66, 71-73; Erdem Bafra, 'Prohibition of "Riba" Over against Time Value of Money in Islamic Banking' (2014) 2 *Izmir Review of Social Sciences* 75, 80.
[627] Abu Umar Faruq Ahmad, M Kabir Hassan, 'The Time Value of Money Concept in Islamic Finance' 23 (2006) *The American journal of Islamic Social Sciences* 66, 86

Umani again turns for support to Imam Al-Ghazali, who argued that *riba* was prohibited because it creates a disjunction between wealth and the 'real economic activities ... [of] industry and construction'.[628] A similar point is made by Lewis and Algaoud, relying on Muhammad Razi,[629] that interest provides income without industry or effort and serves to slow the progress and prosperity of society.[630]

In 2001, it was noted that the debate over whether *riba* equates just to usury or to all forms of interest appears to have largely been determined in favour of the latter approach.[631] This view continues to persist, with the majority of Islamic scholars maintaining that *riba* includes all forms of interest.[632] Not all, however, would agree with this characterisation of *riba* as all forms of interest, particularly where the focus is on the spirit of the *Sharia*, rather than the functional mechanics of the financial product. El-Gamal, for example, argues that:

> even the most conservative contemporary jurists do not consider all forms of what economists and regulators call interest to be forbidden *riba*. A simple examination of *riba*-free Islamic financial methods such as mark-up credit sales (*murabaha*) and lease (*ijara*) financing shows that those modes of financing are not "interest-free"... Conversely, the prohibition of *riba al-fadl* illustrates

[628] Justice Mufti Muhammad Taqi Usmani, 'Present Financial Crisis: Causes and Remedies From Islamic Perspective' (2010) <http://www.muftitaqiusmani.com/index.php> accessed 13 September 2016.
[629] Muhammad Razi, *Mafatih al-Ghayb* (al-Matba'ah al-Misriyah al-'Amiriyah 1862).
[630] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 38.
[631] *Ibid*, 2.
[632] Muhammad Ayub, '*Qur'an*, Hadith and Riba Connotation' (2012) 2 *Journal of Islamic Business and Management* 1, 3; Erdem Bafra, 'Prohibition of "Riba" Over against Time Value of Money in Islamic Banking' (2014) 2 *Izmir Review of Social Sciences* 75, 77.

definitively that there are forms of forbidden *riba* (illegitimate increase in exchange) that do not include interest.[633]

Similarly, Fadel notes that: 'It is now generally recognized, at least among scholars, that Islamic law permits numerous transactions which at the very least incorporate implicit interest in their structure'.[634] And, Fazlur Rahman has argued that the meaning of *riba* is context dependent and the spirit behind *riba* is to prohibit exorbitant but not all forms of interest.[635]

The criticism of the dominant approach to *riba* as interest raises two related issues. First, should *riba* be restricted to those forms of exploitative interest that might be characterised as usury or should it apply to all interest? If, as the dominant view maintains, *riba* includes all forms of interest then the application of the prohibition in practice appears to focus on compliance only in form, but not spirit. One possible solution to this is to accept the dominant view that *riba* equates to all forms of interest, but then to characterise some forms of *riba* as prohibited in order to prevent sliding down a slippery slope into the more categorically harmful forms of *riba*. Such a distinction could then be used in conjunction with the principle of need or necessity, which allows a Muslim to do something that would otherwise be forbidden where it is necessary for well-being. In the context of a competitive and global market economy, this could legitimise interest-bearing loans as necessary for the flourishing of modern enterprise.[636] A second approach, found in the work of El-

633 Mahmoud A El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006), 51-52. *Riba al-fadl* prohibits the exchange of goods for goods of the same genus in different quantities.
634 Mohammad H Fadel, '*Riba*, Efficiency, and Prudential Regulation: Preliminary Thoughts' (2008) 25 *Wisconsin International Law Journal* 655, 656.
635 Fazlur G Rahman, 'Riba and Interest', (1964) 3 *Islamic Studies* 1-41.
636 This was the approach taken by Abd al-Razzaq al-Sanhuri, who drafted the Egyptian Civil Code: see, Mohammad H Fadel, '*Riba*, Efficiency, and Prudential Regulation: Preliminary Thoughts' (2008) 25 *Wisconsin International Law Journal* 655, 681-685.

Gamal, is to identify the basis for the prohibition as the function of protecting individual welfare through the promotion of a fair price. Here the focus would not be on the precise form of the return, but on whether that return was fair.[637]

That the issues regarding the true meaning and extent of *riba* remain ongoing is illustrated by the prolonged series of legal cases on the matter in Pakistan. Despite a number of decisions by both Pakistan's Supreme Court's Shariat Appellate Bench and the Federal Shariat Court (FSC), the issue has not been finally resolved. The FSC, which in 1991 held that the *riba* prohibition applied to all forms of interest,[638] was due to rehear the issue on March 24 2014,[639] but the case was de-listed as no judges were available.[640] Prior to that, the Supreme Court, in the *Khaki* case in 1999,[641] defined *riba* expansively to 'include any element of interest'.[642] This, however, was set aside by the Supreme Court in 2002 and returned for consideration to the FSC.

Perhaps the source of the disagreements over *riba* derives from its non-specific prohibition in the Qur'an.[643] The passages prohibiting *riba* do so in general terms

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[637] Mahmoud A El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006), 49-57.
[638] Akhtar Hamid, 'Addendum on Recent Devleopments', in Effros RC (ed), *Current Legal Issues Affecting Central Banks*, vol 1 (IMF 1992) 420, 427-428; 115/90 Shariat Petitions and three Shariat Suo Moto Notice Cases, *Dr Mahmood-ur-Rahman v Federation of Pakistan*, 1991 SSM No 2, 3, 4/I. Summary available at: <http://www.federalshariatcourt.gov.pk/8.html>, accessed 07 September 2016.
[639] Hasnaat Malik, 'Shariat court to take up 22-year-old Riba case on March 24', *The Express Tribune* (Pakistan 2 March 2014) <http://tribune.com.pk/story/677902/shariat-court-to-take-up-22-year-old-riba-case-on-march-24/> accessed 07 September 2016.
[640] 'Judge absent: Snag delays FSC hearing on Riba', *The Express Tribune* (Pakistan 24 March 2014) <http://tribune.com.pk/story/686201/judges-absent-snag-delays-fsc-hearing-on-riba/> accessed 07 September 2016.
[641] *Dr M Aslam Khaki v Syed Muhammad Hashim* (2000) 1 SLR 73.
[642] Tariq Hassan, 'Eliminating Riba: The Holy Alliance between Law and Economics in Pakistan' in, *Proceedings of the Fifth Harvard University Forum on Islamic Finance: Islamic Finance: Dynamics and Development* (Center for Middle Eastern Studies, Harvard University. 2000, 2011), 69-73, Appendix 1 <http://ifpprogram.com/login/view_pdf/?file=Eliminating%20Riba.pdf&type=Project_Publication> accessed 07 September 2016.
[643] Mahmoud A El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006), 27.

and, barring *riba al-jahiliyya*,[644] with no examples to guide interpretation. This allows greater scope for divergent views on the nature of *riba* and the type of products that are acceptable. Much of the disagreement over what constitutes *riba*, then, flows from what Fadel terms the 'ex-ante *riba*-based restrictions on contracts', with 'some schools of jurisprudence - principally the Zahiris - refus[ing] to extend the application of these restrictions to transactions other than those specified in the relevant statements of the Prophet'.[645] Additional disagreements developed in relation to *riba al-fadl* (riba of excess) and *riba* of "delay".[646]

3.3.1.3 Riba and the institutional logic of Islam

As part of the institutional logic of Islam, the controversy and ongoing disagreements over *riba* creates a tension that perhaps makes the confidence in Islamic finance fragile and vulnerable to an external shock. Although in practice there is a pragmatic agreement that *riba* applies to all forms of interest, the criticism that interest is implicit in some "Sharia compliant" Islamic financial products creates a potential catalyst that might accelerate a crisis of confidence. This is compounded by the associated complaint that the fetish with form over substance risks 'accomplishing nothing other than imposing dead weight costs in the form of increased transaction costs', with the prohibition of *riba* exploited 'for the gain of the private financial sector'.[647] Such a risk may be reduced by a strong system of governance, with a coherent and standardised approach, that can provide an additional source of

[644] *Riba al-jahiliyya* refers to the practice of charging a mark-up on a loan that the debtor was unable to repay on time: Holy *Qur'an* chapter 2, verse 280.
[645] Mohammad H Fadel, '*Riba*, Efficiency, and Prudential Regulation: Preliminary Thoughts' (2008) 25 *Wisconsin International Law Journal* 655, 660. The *Zahiri* school is a minority *Sunni* school that rejects the use of analogy: See, Ignaz Goldziher, *The Zahiris: Their Doctrine and History* (Wolfgang Behn (trans), Brill 1971).
[646] Mohammad H Fadel, '*Riba*, Efficiency, and Prudential Regulation: Preliminary Thoughts' (2008) 25 *Wisconsin International Law Journal* 655, 661-666.
[647] *Ibid*, 702.

confidence for the consumer. The relevance of governance and regulation will be further considered in the subsequent chapters.

3.3.2 *Gharar*

In addition to prohibiting *riba*, *Sharia* also forbids transactions that involve excessive *gharar*, which refers to uncertainty, speculation or excessive risk and the closely related *maysir*/*maisir*, which refers to transactions based on chance (effectively gambling).[648] Lewis and Algaoud point to *ahadith* for support and explain: 'In business terms, *gharar* means to undertake a venture blindly without sufficient knowledge or to undertake an excessively risky transaction'.[649] Al-Saati also notes the prohibition of *gharar* in the Hadith. He further argues that, although *gharar* is not explicitly forbidden in the *Qur'an*, *al-batil* (vanity or falsehood) is condemned and, in the context of the relevant verses, this has been interpreted as including *gharar* transactions. Chapter four, verse 161 of the *Qur'an*, for example, condemns the false 'devouring' of property in transactions.[650]

Gharar focuses specifically, but not exclusively, on the certainty of existence of the object of the transaction.[651] It may be characterised as the 'unknown or doubtful', or as ignorance of, or uncertainty regarding, the existence of the subject matter.[652] It does not completely preclude either risk or uncertainty, but there is disagreement

[648] See: The Holy *Qur'an*, chapter 5, verse 90. See also: James M Garner, 'A Critical Perspective on the Principles of Islamic Finance Focusing on Sharia Compliance and Arbitrage' (2013) 1 *Leeds Journal of Law and Criminology* 69.
[649] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 30.
[650] See also, the Holy *Qur'an*, chapter 2, verse 188.
[651] F Vogel, S Hayes, *Islamic Law and Finance: Religion, Risk and Return*, vol 16 (Arab and Islamic Law Series, 1st ed, Kluwer Law International 1998) 89.
[652] Abdul-Rahim Al-Saati, 'The Permissible *Gharar* (Risk) in Classical Islamic Jurisprudence (2003) 16 *Islamic Economics* 3, 6.

regarding the precise degree of uncertainty required.[653] It does, however, prohibit 'the sale of nonexistent or uncertain objects, even if the relative risk is very low'.[654]

In essence, because transactions are inherently risky, determining whether a transaction involves excessive *gharar* requires a cost-benefit type of analysis.[655] The prohibition is a matter of degree and, for example, precludes trading in futures, short selling and many types of insurance.[656] However, because it requires judgment regarding the degree of risk or uncertainty, the concept of *gharar* is open to interpretation in its application to particular products, which provides another opportunity for divergent opinion, lack of certainty and an associated loss of confidence. As Garner has commented, there is 'an element of flexibility within the prohibition of *Gharar* that is not present within *Riba*. This flexibility has allowed for a greater diversity of Islamic financial products to arise through innovation'.[657]

3.3.3 *Takaful*

While many forms of insurance are characterised as *gharar or maysir*, and so forbidden by *Sharia*, cooperative insurance, or *Takaful*, is nevertheless permitted.[658] Rather than focus on insurance as an individual issue, *Takaful*, as a 'collective model' of social insurance, shifts the viewpoint to centre on the benefit to the community. Under this system, community resources are pooled to provide insurance for any

[653] *Ibid*.
[654] Hania Masud, 'Takaful: An Innovative Approach to Insurance and Islamic Finance' (2011) 32 *University of Pennsylvania Journal of International Law* 1133, 1140. Masud gives the examples of an uncaught fish or an unborn calf.
[655] Mahmoud A El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006), 59.
[656] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 30.
[657] James M Garner, 'A Critical Perspective on the Principles of Islamic Finance Focusing on Sharia Compliance and Arbitrage' (2013) 1 *Leeds Journal of Law and Criminology* 69, 74.
[658] Sayyid Abul A'la Mawdudi, 'The Economic Philosophy of Islam', in Khurshid Ahmad (ed), Ahmad Imam Shafaq Hashemi (trans), Sayyid Abul A'la Mawdudi (author), *First Principles of Islamic Economics* (The Islamic Foundation 2011) 188.

member of the community in times of need. In other words, 'members [of the community scheme] ... protect each other from loss'.[659] Although it might be more accurate to characterise some forms of *Takaful* as requiring *mushama*, or contribution, the basis of all forms of *Takaful* is found in the concept of *tabarru'*, meaning gift, with each participant willingly accepting the obligation to assist other participants in times of need or peril.[660] It derives its legitimacy from both the *Qur'an* and the *hadith*. Bekkin identifies the relevant section of the *Qur'an* as chapter five, verse two, which states that people should 'help one another in righteousness'.[661] He goes on to note that, in the *hadith*, the Prophet praised those who dealt with hardship by communally sharing their belongings.[662]

3.3.4 Prohibitions

Islam also imposes constraints on investments in particular kinds of commercial enterprises. It is, for example, forbidden, or *haram*, to invest in businesses that deal with *haram* commodities, such as alcohol and pork meat, or with *haram* services, such as gambling. Furthermore, priority should be given to the production of essential goods.[663]

3.3.5 *Zakat*

Finally, *Sharia* requires the payment of *zakat*/*zakah*, which is a levy on all income, fixed in practice at 2.5% and determined after the assets have been held for a year.

[659] Hania Masud, 'Takaful: An Innovative Approach to Insurance and Islamic Finance' (2011) 32 *University of Pennsylvania Journal of International Law* 1133, 1142.
[660] Renat I Bekkin, 'Islamic Insurance: National Features and Legal Regulation' (2007) 21 *Arab Law Quarterly* 109, 113-114.
[661] *Ibid*, 109-110. See also: Mohd Ma'sum Billah, 'Sources of Law Affecting Takaful (Islamic Insurance)' (2001) 4 *International Journal of Islamic Finance* 24.
[662] Renat I Bekkin, 'Islamic Insurance: National Features and Legal Regulation' (2007) 21 *Arab Law Quarterly* 109, 110.
[663] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 30.

There are many references to the levy in the *Qur'an*,[664] and the philosophy behind *zakat*, is that wealth is held on trust for Allah and meant for the benefit of all. Property and wealth are capable of individual ownership, but both have an essentially social aspect that creates a duty to others.[665] While Allah allows an uneven distribution of wealth, those that have more than they need are required to help alleviate the needs of the poor. It is obligatory, but only where payment would not cause hardship. In other words, it is a levy on excess wealth, and payment serves to "purify" the Muslim's remaining wealth.[666]

3.4 Islamic banks and financial organisations

The role of banks within the Islamic financial system is similar to the role played by their conventional counterparts, with Islamic banks 'resembl[ing] ... universal bank[s]' by engaging with both commercial and investment activities.[667] Islamic and conventional banks operate by administrating the payments system within the economy, providing credit and acting as financial intermediaries, addressing the imperfect nature of the financial markets. Much of their business is involved with offering 'basic retail and commercial business services'.[668] Islamic financial organisations, however, may be distinguished from conventional financial organisations by the different institutional influences that guide their behaviour. As already noted, for the conventional financial system, the main influences are the sometimes competing institutions of the 'capitalist market, [the] bureaucratic state,

[664] For example, see: The Holy *Qur'an*, chapter 6, verse 141; chapter 17, verse 26; chapter 22, verses 41, 78.
[665] Masudul Alam Choudhury, 'Islam versus liberalism: contrasting epistemological inquiries' (2008) 35 *International Journal of Social Economics* 239, 258.
[666] Mosab I Tabash, Ray S Dhankar, 'The Relevance of Islamic Finance Principles in Economic Growth' (2014) 3 *International Journal of Emerging Research in Management and Technology* 49, 52; M Metwally, 'Economic Consequences of Applying Islamic Principles in Muslim Societies (2006) 23 *Journal of Islamic Banking and Finance* 11, 14.
[667] Hjh Siti Faridah Abd Jabbar, 'Islamic finance: fundamental principles and key financial institutions' (2009) 30 *Company Lawyer* 23, 25.
[668] *Ibid*, 26.

democracy, nuclear family, and Christian religion'.[669] For the organisational field of Islamic finance, however, the dominant institution is Islam. As a consequence, while 'the conventional finance system focuses primarily on the financial aspects of transactions, the Islamic system places equal emphasis on the ethical, moral, social and religious dimensions'.[670]

It is this institution of Islam that provides the basis for the definition of Islamic financial organisations as 'those that are based, in their objective and operations, on Koranic principles'.[671] It is the duty of every Muslim to live according to the principles of the *Qur'an* and this applies as much in business as in any other aspect of a faithful life. This obligation applies both to individual Muslims and to Islamic business organisations.[672] Thus, Islamic banks and other financial institutions must conform with the principles discussed previously. In so doing, they engage in 'equity-orientated' transactions based on a non-exploitative partnership,[673] with the sharing of profit, risk and loss. While the Islamic paradigm is the PLS partnership, non-PLS models are permissible as long as they involve the sharing of risk.[674] Furthermore, all transactions must have some connection with a material endeavour and cannot solely involve money disconnected from enterprise.[675]

[669] Roger Friedland, Robert R Alford, 'Bringing Society Back In: Symbols, Practices, and Institutional Contradictions' in Powell, WW, DiMaggio PJ (eds) *The New Institutionalism in Organizational Analysis* (University of Chicago Press 1991) 232.
[670] Abu Umar Faruq Ahmad, M Kabir Hassan, 'Riba and Islamic Banking' (2007) 3 *Journal of Islamic Economics, Banking and Finance* 1, 20.
[671] Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh University Press 2000) 5.
[672] Rahmad Hakim, Elvan Syaputra, 'Business as Al-Amanah and the Responsibilities of Islamic Business Managers' (2012) 6 *La Riba* 199, 200-201.
[673] Abdul Ghafar Ismail, 'The theory of Islamic Banking: Look Back to the Original Idea' (2011) 7 *Journal of Islamic Economics, Banking and Finance* 9, 13.
[674] Muhammad N Siddiqui, *Dialogue in Islamic Economics* (Islamic Foundation 2002), 175.
[675] Dahlia El-Hawary, Wafik Grais, Zamir Iqbal, 'Regulating Islamic financial institutions: The nature of the regulated' (2004)World Bank Policy Research Working Paper 3227, 5; Alsadek H Gait, Andrew C Worthington, 'A Primer on Islamic Finance: Definitions, Sources, Principles and Methods' (2007) University of Wollongong School of Accounting and Finance Working Paper Series 07/05, 7.

Despite the controversy and ongoing debate over the meaning of *riba*, the development of Islamic finance and Islamic banks is most strongly influenced by 'neo-revivalist' thinking, which treats all interest as *riba*, and hence *haram*.[676] Although *riba* is forbidden, this does not preclude the lender from getting a return on a loan or investment, but the basis for this it to share in the risk of the endeavour.[677] Thus, the investor shares in either the profit, if the endeavour is successful, or the loss, if it is not.[678] The advantage of a PLS approach, over an interest-based approach, is that the focus shifts from creditworthiness of the borrower to the soundness of the entrepreneur's project.[679] Furthermore, the partnership basis of an Islamic bank's involvement in financial transactions, when coupled with the principle of *Maslahah*,[680] an Islamic juristic device used to promote the public good of welfare or well-being, means that: '[Islamic] banks must not be solely oriented towards profit, rather they must seek to promote ... social welfare'.[681] In this regard, where *zakat* is not already collected by the state then the Islamic bank has an obligation to establish a *zakat* fund for collecting and redistributing to the needy.[682]

While Islamic banks in principle are quite different in character from their conventional counterparts, it has been noted that 'Islamic scholars have developed products that resemble conventional banking products, replacing interest rate

[676] Abu Umar Faruq Ahmad, M Kabir Hassan, 'Riba and Islamic Banking' (2007) 3 *Journal of Islamic Economics, Banking and Finance* 1, 16.
[677] Mohamed Ariff, 'Islamic Banking' (1988) 2 *Asian-Pacific Economic Literature* 48, 50, 51.
[678] Syed Farhan Shah, Muhammad Wajid Raza, Malik Rizwan Khurshid, 'Islamic Banking Controversies and Challenges' (2012) 3 *Interdisciplinary Journal of Contemporary Research in Business* 1018, 1019.
[679] *Ibid*, 1020.
[680] *Maslahah* may be defined as the public interest in avoiding harm and fostering benefit by 'nurturing religion, life, offspring, intellect, and property', with interpretations of the *Sharia* informed by '*daruriyat* (necessities), *hajiyat* (needs), and *tahsiniyat* (improvements)': Salah El-Sheikh, 'Islamic Economics and Finance, Then and Now: A Fiqhi-conomic Perspective on its Doctrines and Debates' (2011) 19 *International Journal of Economics, Management & Accounting* 77, 80.
[681] Rahmad Hakim, Elvan Syaputra, 'Business as Al-Amanah and the Responsibilities of Islamic Business Managers' (2012) 6 *La Riba* 199, 205.
[682] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 29-30.

payments and discounting with fees and contingent payment structures'.[683] Khan examined Islamic finance and found that it was not as Islamic in practice as it was portrayed in principle, with much of the business involving less risky non-PLS products[684] that implicitly rely on 'interest-based financing'.[685] The focus has arguably been centred too much on *Sharia* compliance more in form than in spirit, narrowing any gap that might have existed between Islamic and conventional banks. Chong and Liu, for example, found that in Malaysia the PLS model accounted for only 0.5% of the bank's investments (assets), although it was more prominent on the deposit side (70%).[686] Chong and Liu also found that, even though the deposits were structured on an interest-free model, the 'investment rates are closely linked to conventional deposit rates', suggesting compliance in theory (or form), but not in substance, with *mudarabah* deposits (see below) behaving more like debt than equity devices.[687]

Chong and Liu suggest that this similarity to conventional interest-based financial practice is a result of competition within the banking sector.[688] Islamic banks in Malaysia coexist alongside conventional banks and must compete with them for business. The influence of the institution of the capitalist market in the dual banking system, suggests that the coexistence of the two systems brings the institutional influence of Islam into conflict with the institutional influence of capitalism and raises the question of whether the context in which Islamic banking operates affects

[683] Thorsten Beck, Asli Demirguc-Kunt, Ouarda Merrouche, 'Islamic vs conventional banking: Business model, efficiency and stability' (2013) 37 *Journal of Banking and Finance* 433, 433-434.
[684] Hjh Siti Faridah Abd Jabbar, 'Islamic finance: fundamental principles and key financial institutions (2009) 30 *Company Lawyer* 23, 26.
[685] Feisal Khan, 'How "Islamic" is Islamic Banking?' (2010) 76 *Journal of Economic Behaviour and Organization* 805, 808-810.
[686] Beng Soon Chong, Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based? (2009) 17 *Pacific-Basin Financial Journal* 125, 127.
[687] *Ibid*, 140.
[688] *Ibid*, 140.

the characterisation of products, services and practices as *Sharia* compliant. Islamic banking may be provided by distinct Islamic organisations, by Islamic subsidiaries of conventional banks, by Islamic banking windows within conventional banks, or as a hybrid Islamic/conventional bank. These organisations may operate within an Islamic jurisdiction, a non-Islamic jurisdiction, or a mixed jurisdiction, such as Malaysia.[689] Furthermore, Islamic banks can operate within country that only permits Islamic banking or in those that allow both Islamic and conventional banking. Chong and Liu's study, raises the possibility that, in certain contexts, divergence of opinion regarding *Sharia* compliance may be influenced by the institution of capitalism through the perceived need to compete economically with conventional banking services.[690] This influence may have a practical impact on the design of new financial products through competitive and institutional isomorphism, which may explain the tendency to model Islamic financial products on conventional counterparts.[691]

Before moving on to consider Islamic financial products, the other key distinguishing feature of Islamic banks and financial organisations should be noted. *Sharia* advisory/supervisory boards play a central role in *Sharia* governance.[692] Their role is to ensure that the products, services and practices of the financial organisation are indeed *Sharia* compliant. How they function, and how well they perform their role, will be considered further in the subsequent chapter.

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689 Zulkifli Hasan, 'Regulatory Framework of *Shari'ah* Governance System in Malaysia, GCC Countries and the UK' (2010) 3 *Koyoto Bulletin of Islamic Area Studies* 82.
690 See also, Dahlia El-Hawary, Wafik Grais, Zamir Iqbal, 'Regulating Islamic financial institutions: The nature of the regulated' (2004)World Bank Policy Research Working Paper 3227, 3; Mervyn K Lewis, 'Islamic Banking in Theory and Practice' (2007) 3 *Monash Business Review* 1, 5.
691 see text at n 55-59 and n 693.
692 Mervyn K Lewis, 'Islamic Banking in Theory and Practice' (2007) 3 *Monash Business Review* 1, 3.

3.5 Islamic financial products

The defining characteristic of Islamic finance is, as discussed above, that all practices, services and products must be *Sharia* consistent. This means that they must be free of *riba* and *gharar* and must avoid investment in *haram* commodities. Although *Sharia* consistent products meet a need within Muslim communities for *halal* financial services, there is also a pressure to be competitive with conventional financial services. Thus, it has been noted that: 'For almost all conventional financial products there is nearly always an analogous Islamic finance product'.[693] In this section, the main products offered by Islamic banks and other financial organisations will be defined. This will help to give a fuller understanding of Islamic finance and clarify the key products that will be referred to throughout this thesis..

The *mudaraba* and *musharaka* are considered to be the 'twin pillars of Islamic banking'.[694] Both of these are based on the PLS principle that is central to the philosophy of Islamic financing. Under a *mudaraba* contract, one party finances a second party to undertake an entrepreneurial venture. The financier, or *rabb al-mal*, is a silent partner or *mudarib*.[695] Rather than imposing the financial risk on the borrower, as in the case of interest-based contracts, the financial risk of a *mudaraba* contract lies with the lender.[696] Risk sharing is a fundamental element of Islamic

[693] Alsadek H Gait, Andrew C Worthington, 'A Primer on Islamic Finance: Definitions, Sources, Principles and Methods' (2007) University of Wollongong Scholl of Accounting and Finance Working Paper Series 07/05, 2.
[694] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 45.
[695] Mervyn K Lewis, 'Islamic Banking in Theory and Practice' (2007) 3 *Monash Business Review* 1, 4.
[696] Abraham L Udovitch, *Partnership and Profit in Medieval Islam* (Princeton University Press 1970), 170.

finance and,[697] although not sharing the financial risk, the *mudarib* risks losing the time and effort of the labour invested in the venture.[698]

These *mudaraba* contracts may be utilised by the bank in a two tiered system. In the first tier, the depositor acts as the financier, while the bank takes the role of the entrepreneur. In the second tier, the bank becomes the financier and the borrower takes the entrepreneurial role.[699] This arrangement allows the bank to effect its role as a financial intermediary by engaging in *mudaraba* contracts that connect depositors to the borrowers through the bank, which acts as the common partner. The alternative to this, which is more commonly utilised by Islamic banks, is to accept deposits on the basis of *mudaraba*, but then use alternative contracts, such as *musharaka*, *murabaha*, and *ijara* as the basis for providing funds to entrepreneurs.[700]

Although it is sometimes claimed that the legal basis for the *mudaraba* may be found in the *Qur'an*,[701] for example at chapter 73, verse 20,[702] the *Qur'an*, only legitimises entrepreneurial activity and not the particular form of the *mudaraba*.[703] It has also been claimed that a legal basis may be found in the *sunna* and *hadith*,[704] but this too has been disputed by Aziz et al, who conclude that *mudaraba* contracts have no

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[697] Edana Richardson, 'The Shari'ah Prohibition of Interest' (2008) 11 *Trinity College Law Review* 78, 90.
[698] Farooq Aziz, Mahwish Anjam, Syed Muhammad Fahim, Faisal Saleem, 'Mudarabah in Islamic Finance: A Critical Analysis of Interpretations and Implications' (2013) 3 *International Journal of Asian Social Science* 1236, 1237.
[699] Muhammad Abdullah Al-'Arabi, 'Contemporary Bank Transactions and Islam's Views Thereon' (May 1966) *The Islamic Review* 10, 14; Hjh Siti Faridah Abd Jabbar, 'Islamic finance: fundamental principles and key financial institutions (2009) 30 *Company Lawyer* 23, 25.
[700] Munawar Iqbal, Ausaf Ahmad, Tariqullah Khan, 'Challenges Facing Islamic Banking' (1998) Islamic Development Bank: Islamic Research and Training Institute Occasional Paper No 1, 14-15.
[701] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 41.
[702] See also, the Holy *Qur'an*, chapter 2, verse 198; chapter 62, verse 10.
[703] Farooq Aziz, Mahwish Anjam, Syed Muhammad Fahim, Faisal Saleem, 'Mudarabah in Islamic Finance: A Critical Analysis of Interpretations and Implications' (2013) 3 *International Journal of Asian Social Science* 1236, 1238.
[704] Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001), 41.

'legitimate base' and so are unlawful.[705] This is a surprising conclusion and unlikely to be correct. While Aziz et al may have shown that the precise form of the *mudaraba* contract receives no direct support in the *Qur'an* or the *hadith*, neither is it prohibited. As Khan and Mirakhor state:

> Islam permits a wide freedom in establishing contracts, assuming the contract[s] are not in violation of the Shari'ah, and approves any agreement based on the consent of the parties involved, so long as the shares of each are contingent on uncertain gains.[706]

The *musharaka* contracts are based on the equity participation of multiple parties in an active partnership. All parties having a delegable managerial responsibility and share the profit and loss on the basis of their contribution,[707] which includes both financial and labour investments. The share of the profit is determined on the basis of agreed ratios, which will depend on both on initial contributions as well as subsequent labour investment. Any financial loss is shared on the basis of just the initial contribution.[708] This approach means that the amount of return cannot be fixed in advance, but must be related to the success of the venture. Any attempt to fix the return by linking it directly to the contribution, without taking account of the profit or loss, would invalidate the partnership. There is, however, disagreement between

[705] Farooq Aziz, Mahwish Anjam, Syed Muhammad Fahim, Faisal Saleem, 'Mudarabah in Islamic Finance: A Critical Analysis of Interpretations and Implications' (2013) 3 *International Journal of Asian Social Science* 1236, 1239-1242.
[706] Mohsin S Khan, Abbas Mirakhor, 'Monetary Management in an Islamic Economy' (1994) 6 *Journal of the King Abdulaziz University: Islamic Economics* 3, 6.
[707] Noraziah Che Arshad, Abdul Ghafar Ismail, 'Shariah parameters for Musharakah Contract: A comment' (2010) 1 *International Journal of Business and Social Science* 145, 147.
[708] Edana Richardson, 'The Shari'ah Prohibition of Interest' (2008) 11 *Trinity College Law Review* 78, 93.

jurists as to whether the parties can consent to varying the share of the profit or whether it must equate precisely to the share of the contribution.[709]

The legal acceptability of such partnerships is said to derive from the acceptability of property sharing found in the *Qur'an*'s explanation of the rules of inheritance (chapter four, verse 12). This analogous reasoning is supported by the *hadith*, the lack of any prohibition in *Sharia* and the public interest benefits of allowing such financial partnerships.[710] Even though the form of partnership is generally accepted, there are disagreements over the specifics. All partners must make a contribution to the capital, and some jurists accept that this may include a contribution of assets other than money, such as cars or other distinguishable commodities. Most jurists, however, restrict the acceptable contribution to fungible monies. Some (e.g. *Hanafis*) allow the contribution of different types of currency such as gold and silver, or different currencies. Other jurists (e.g. *Shafi'i*) go further and argue that true partnership requires a contribution of the same indistinguishable asset, such as identical currency, which allows a complete mixing and redistribution of the capital.[711]

Apart for these two PLS transactions, Islamic banks also rely on "mark-up" arrangements that may be described as 'synthetic [debt-based] loans'.[712] Under these schemes, the bank buys an asset and then resells or leases the asset to the customer with an agreed mark-up, which is intended to reflect the bank's labour investment

[709] Noraziah Che Arshad, Abdul Ghafar Ismail, 'Shariah parameters for Musharakah Contract: A comment' (2010) 1 *International Journal of Business and Social Science* 145, 154.
[710] Noraziah Che Arshad, Abdul Ghafar Ismail, 'Shariah parameters for Musharakah Contract: A comment' (2010) 1 *International Journal of Business and Social Science* 145, 148.
[711] *Ibid*, 150.
[712] Andreas Jobst, 'The Economics of Islamic Finance and Securitization' (2007) IMF Working Paper, 5.

and the risk it accepts in property ownership. Under, the *murabaha* contract, which in practice is more commonly used than the PLS *mudaraba*,[713] the bank buys the goods (appointing the customer as an agent to make the actual purchase)[714] and resells with the mark-up affording a profit. This is seen as acceptable since the transactions always involve money for goods and never money for money, which would be prohibited as *riba*. It may be argued that the mark-up is interest by any other name. Richardson, for example, claims it 'appears to be a blatant contradiction to the prohibition of interest and could be criticised for not fulfilling the mission of Islamic banks'.[715] Ariff, however, argues that it can be distinguished from *riba* because the bank takes on the responsibility and risks of ownership during the period between the purchase and resale on to the customer.[716]

A similar transaction is *bai'muajjal*, which utilises the purchase and resale mechanism, but allows deferred payment. As Ariff explains, 'it is considered lawful in *fiqh* (jurisprudence) to charge a higher price for a good if payments are to be made at a later date' because the transaction is characterised as a trade rather than a loan.[717] Related to the purchase-resale mechanism is the purchase and lease transaction, or *ijara*, which may includes the option for the customer to buy the goods or property by instalment.[718] Other transactions may include beneficent, zero-return, loans (*Quard al-Hasanah*); a manufacturing contract with payment linked to the progress

[713] Abdul Ghafar Ismail, 'The theory of Islamic Banking: Look Back to the Original Idea' (2011) 7 *Journal of Islamic Economics, Banking and Finance* 9, 10; Mohamed Ariff, 'Islamic Banking' (1988) 2 *Asian-Pacific Economic Literature* 48, 58.
[714] Nima Mersadi Tabari, 'Islamic finance and the modern world: the legal principles governing Islamic finance in international trade' (2010) 31 *Company Lawyer* 249, 252.
[715] Edana Richardson, 'The Shari'ah Prohibition of Interest' (2008) 11 *Trinity College Law Review* 78, 94.
[716] Mohamed Ariff, 'Islamic Banking' (1988) 2 *Asian-Pacific Economic Literature* 48, 52.
[717] *Ibid*.
[718] *Ibid*.

of the job (*istisna'*);[719] purchase with a deferred date of delivery (*Bai'Salam* or *Bai'Salaf*); transactions with a service charge, such as a consultation (*Jo'alah*);[720]

Particularly controversial products include *tawarruq* and *bay' al-'inah*, both of which are open to the criticism that they misuse the technical forms of acceptable Islamic financial techniques to create a product that is essentially designed to function as the equivalent of an interest-bearing loan.[721] *Tawarruq* involves the purchase of a commodity from financial institution. The commodity is immediately sold on to a third party and the financial institution is reimbursed with profit over a fixed period.[722] *Bay' al-'inah*, used in Malaysian financial markets, involves a credit sale of an asset, which is then immediately repurchased for a lower cash price. The difference in credit and cash price provides a profit to the financial institution. It relies on an acceptable technique of allowing deferred payment for the purchase of an asset that is then sold on for a profit by the trader. The problem with *bay' al-'inah* is that the asset itself is essentially irrelevant, with neither party having any real intention to use it in trade. The sole intention is to provide a loan with a fixed-return that is equivalent to interest, but can technically avoid being labelled as *riba*.[723]

Takaful, the Islamic type of insurance that relies on a social co-operative approach, has already been discussed. Another financial instrument worth mentioning at this point is the *sukuk*, which are Islamic securities. These are sometimes referred to as

[719] Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar 2009), 62.
[720] Mohsin S Khan, Abbas Mirakhor, 'Monetary Management in an Islamic Economy' (1994) 6 *Journal of the King Abdulaziz University: Islamic Economics* 3, 8.
[721] Walid S Hegazy, 'Contemporary Islamic Finance from Socioeconomic Idealism to Pure Legalism' (2007) 7 *Chicago Journal of International Law* 581, 596-598.
[722] Holly E Robbins, 'Soul Searching and Profit Seeking: Reconciling the Competing Goals of Islamic Finance' (2010) 88 *Texas Law Review* 1125, 1131-1132.
[723] Saiful Azhar Rosly, Mahmood Sansui, 'Some Issues of *Bay' al-'inah* in Malaysian Islamic Financial Markets' (2001) 16 *Arab Law Quarterly* 263.

Islamic bonds, but, as Saeed and Salah note, '*sukuk* have elements that might resemble both shares and bonds, depending on the applicable underlying Islamic financial contracts and structures'.[724] The key distinction between *sukuk* and bonds is that:

> a bond is a contractual debt obligation whereby the issuer is contractually obliged to pay bondholders ... interest and principle. In contrast ... Sukuk holders each hold an undivided beneficial ownership in the underlying assets and a share in the revenues generated by the Sukuk assets as well as a share in the proceeds upon realization of the Sukuk assets.[725]

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has defined a *sukuk* as:

> ... certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity ...[726]

The structure of the different varieties of *sukuk*, depend on the nature of the underlying type of contract. They may be based on a single type of transaction, for example a *mudaraba*, *musharaka* (equity based), or *ijara* contract; or they may be hybrid in nature, based on, e.g. *ijara*, *istisna'* and *murabaha* contracts.[727]

[724] A Saeed, O, Salah, 'Development of sukuk: pragmatic and idealistic approaches to sukuk structure' (2014) 29 *Journal of International Banking Law and Regulation* 41.
[725] Mohamed Saad Lahlou, Joseph Tanega, 'Islamic securitisation: Part II - a proposal for international standards, legal guidelines and structures' (2007) 22 *Journal of International Banking Law and Regulation* 359, 366.
[726] AAOIFI, Shari'ah Standard No 17 on Investment *Sukuk*, article 2.
[727] A Saeed, O, Salah, 'Development of sukuk: pragmatic and idealistic approaches to sukuk structure' (2014) 29 *Journal of International Banking Law and Regulation* 41, 47-50.

While these *sukuk* provide an important opportunity for Muslims to 'share in the profits of large enterprises',[728] equity-based *sukuk* have been criticised for being designed to resemble conventional financial securities,[729] with a return that is effectively interest-based, and an unacceptable disconnection between the invested money and "real" or tangible assets.[730] The criticism was followed by the AAOIFI issuing a resolution on *sukuk*, in which they instructed, *inter alia*, that profit shortfalls should be managed by the establishment of a reserve account rather than by interest free loans, and that repurchasing assets at nominal value at maturity was unacceptable.[731] Since the resolution, the use of equity-based *sukuk* declined and the market is currently dominated by the *ijara*-based *sukuk* structure.[732]

The final product that should be mentioned is the Islamic finance version of the deposit bank account. The *wadiah*, meaning custody, allows banks to hold deposits on trust and invest them as they see fit. The depositor is guaranteed repayment on demand, but is not entitled to any return on the deposit. It is common practice, however, for the bank to periodically "gift" the depositor a sum of money as a competitive alternative to the payment of interest.[733]

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[728] Muhammad Taqi Usmani, 'Sukuk and their Contemporary Applications' (AAOIFI Shariah Council 2007) <http://alqalam.org.uk/wp-content/uploads/Sukuk.pdf> accessed 13 September 2016.
[729] Omar Salah, 'Islamic Finance: The Impact of the AAOIFI Resolution on Equity-Based Sukuk Structures' (2011) TISCO Working Paper Series on Banking, Finance and Services No 02/2011, 1-2 <http://www.peacepalacelibrary.nl/ebooks/files/375282432.pdf> accessed 13 September 2016.
[730] Muhammad Taqi Usmani, 'Sukuk and their Contemporary Applications' (AAOIFI Shariah Council 2007) < http://alqalam.org.uk/wp-content/uploads/Sukuk.pdf> accessed 13 September 2016.
[731] Shari'ah Board AAOIFI, AAOIFI Resolution on Sukuk, February 2008.
[732] Omar Salah, 'Islamic Finance: The Impact of the AAOIFI Resolution on Equity-Based Sukuk Structures' (2011) TISCO Working Paper Series on Banking, Finance and Services No 02/2011, 21 <http://www.peacepalacelibrary.nl/ebooks/files/375282432.pdf> accessed 13 September 2016.
[733] Holly E Robbins, 'Soul Searching and Profit Seeking: Reconciling the Competing Goals of Islamic Finance' (2010) 88 *Texas Law Review* 1125, 1130-1131.

As has already been noted, one of the criticisms of Islamic banking is that, because they are 'less attractive ... than financial products that more closely resemble conventional interest-bearing debt',[734] use of the paradigmatically Islamic PLS arrangements is dwarfed by the use of *murabaha* and *ijara* contracts.[735] These transactions may be criticised for a design that appears to provide a fixed rate of return for the bank, which is seen as interest by a different name.[736] However, they remain widely accepted in practice as justified under *Sharia*, primarily on the basis that the bank takes on the risks of temporary ownership and possession.[737]

Although these types of transactions may be acceptable, it is arguable that the emphasis needs to be returned to PLS to maintain the 'credibility' of Islamic finance as a distinct and more equitable service than conventional finance.[738] Furthermore, they pose a greater risk to the confidence that Islamic finance is genuinely *Sharia* compliant. As Siddiqi comments: 'It would be a caricature of Islamic finance if ... *murabaha* was used as a trick to do what conventional finance is doing, i.e. lending on the basis of interest'.[739] Such a criticism may be levelled at the controversial practice of *tawarruq*, which uses a *murabaha* contract to allow customer to avoid

[734] Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar 2009), 93.
[735] Feisal Khan, 'How "Islamic" is Islamic Banking?' (2010) 76 *Journal of Economic Behaviour and Organization* 805, 808-810; Beng Soon Chong, Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based? (2009) 17 *Pacific-Basin Financial Journal* 125, 127; Timur Kuran, *Islam and Mammon: The Economic Predicaments of Islamism* (3rd ed, Princeton University Press 2006) 11.
[736] Muhammad Shaukat Malik, Ali Malik, Waqas Mustafa, 'Controversies that make Islamic banking controversial: An analysis of issues and challenges' (2011) 2 *American Journal of Social and Management Sciences* 41, 42; Muhammad Akram Khan, 'The Future of Islamic Economics' (1991) 23 *Futures* 248, 258.
[737] M Umer Chapra, 'The Case Against Interest: Is it Compelling?', in Salaman Syed Ali, Ausuf Ahmad (eds), *Islamic Banking and Finance: Fundamentals and Contemporary Issues* (Islamic Development Bank 2007) 25, 41.
[738] M Nejatullah Siddiqi, 'The Comparative Advantages of Islamic Banking and Finance' (2000) Proceedings of the Fifth Harvard University Forum on Islamic Finance: Dynamics and Development 183, 187.
[739] M Nejatullah Siddiqi, 'The Comparative Advantages of Islamic Banking and Finance' (2000) Proceedings of the Fifth Harvard University Forum on Islamic Finance: Dynamics and Development 183, 186.

liquidity issues when buying and selling commodities.[740] Furthermore, relying on interest-based benchmarks, such as the London Interbank Offered Rate (LIBOR), as the means for calculating the mark-up in *murabaha* contracts can undermine credibility and confuse customers as to what is acceptable.[741]

The reliance on debt-based, or asset-based, transactions, over PLS, is understandable from a pragmatic perspective. This sees PLS as the ideal, but acknowledges that debt-based transactions are less financially risky and commercially more viable. From the realist's point of view, an emphasis on these transactions is inevitable because they allow Islamic finance to be competitive with conventional finance.[742] The danger with seeking to compete on financial terms with conventional finance, however, is that the core institution of Islam will come into conflict with the institution of the capitalist market. Indeed, this danger has already been realised and may be found in the gap that has been identified between the profit-based motivations of managers of Islamic banks and the more faith-based motivations of *Sharia* scholars who seek to ensure *Sharia* compliance.[743] As Choudhury has noted:

> Modern *Taqlid* of Muslims is marked by a reliance without deep questioning, on the bastion of neo-liberal thinking with only a palliative of Islam in it. This attitude has entered lock stock and

[740] Nagaoka Shinsuke, 'Critical Overview of the History of Islamic Economics: Formation, Transformation and, New Horizons' (2012) 11 *Asian and African Area Studies* 114, 127-128. See also the case study on tawarruq in: Holly E Robbins, 'Soul Searching and Profit Seeking: Reconciling the Competing Goals of Islamic Finance' (2010) 88 *Texas Law Review* 1125, 1144-1149.
[741] Shaikih Muddassir Siddiqui, 'Form and Substance' (April/June 2013) *New Horizon* 36.
[742] Nagaoka Shinsuke, 'Critical Overview of the History of Islamic Economics: Formation, Transformation and, New Horizons' (2012) 11 *Asian and African Area Studies* 114, 124-125.
[743] Shakir Ullah, Ian A Harwood, Dima Jamali, '"Fatwa Repositioning": The Hidden Struggle for Shari'a Compliance Within Islamic Financial Institutions' (2016) *Journal of Business Ethics*, doi:10.1007/s10551-016-3090-1.

> barrels [into] the body framework of Islamic economics and finance as a fashion of the present times.[744]

The result of this conflict may be the presentation of effectively interest-based products as *Sharia*-compliant, which in turn may undermine the credibility of Islamic finance.

3.5.1 Islamic financial products, conflicting institutional influences and isomorphism

Financial products, if they are to be characterised as Islamic, must be compliant with the principles and rules of Islam and *Sharia*. The risk is that situating Islamic finance in the global financial context necessarily exposes the institutional logics of Islam to those of neoliberal capitalism. As Asutay notes: 'The realities of financial markets, which prioritise economic incentives rather than religious behavioural norms ... has forced [Islamic finance] to become part of the international financial system by adopting the commercial banking model'.[745] The context dependent pressures of Islamic finance are exacerbated by the historical development of Islamic finance, which had its origins in the marriage of classical Islamic jurisprudence with modern finance. As El-Gamal comments:

> Islamic finance is not constructively built from classical jurisprudence. Rather, Islamic alternatives or modifications are sought whenever the latter is deemed forbidden.[746]

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[744] Masudul Alam Choudhury, 'Islam versus liberalism: contrasting epistemological inquiries' (2008) 35 *International Journal of Social Economics* 239, 262. *Taqlid* refers to following the opinion of others based on their status as an authority.
[745] Mehmet Asutay, 'Conceptualisation of the Second Best Solution in overcoming the Social Failure of Islamic Banking and Finance: Examining the Overpowering of *HomoIslamicus* and *Homoeconomicus*' (2007) 15 IIUM *Journal of Economics and Management* 167, 175.
[746] Mahmoud A El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006), 8.

This means that from its very origins, Islamic finance has developed as a constraint of capitalist financial theory and practice,[747] with 'much of its discourse ... located within the jargon and dialectic of the mainstream neoclassical paradigm'.[748] Coupled with a legally formalistic approach,[749] this perhaps explains the identification of Islamic finance with the prohibition of *riba*. Focusing on the technical form of finance, rather than on its substantive justice or its relevance to welfare,[750] allows for more definitive rules that makes Islamic finance more readily governed. However, the joint origins of Islamic jurisprudence and modern finance, together with the sidelining of non-technical Islamic values, provides easy access for capitalist values to remain overly influential. This is facilitated by the epistemology of acquired knowledge and the Islamic methods of interpretation. These rely on both subjective individual analysis as well as consensus, and provide a mechanism for the institution of neoliberal capitalism to influence the application of *Sharia* to novel financial products and services. The first, and main, issue, then, is whether Islamic financial products have tended to isomorphically mimic conventional financial products. Related to this, the second, and subsidiary, issue is whether the uptake of these financial products and services also demonstrates an isomorphism that helps to legitimise those products and services.

[747] See the discussion of the Islamization of economics in: Mohamed Aslam Haneef, Hafas Furqani, 'Contemporary Islamic Economics: The Missing Dimension of Genuine Islamization' (2009) 19 *Thoughts in Economics* 29.
[748] Abdulkader Cassim Mahomedy, 'Islamic economics: still in search of an identity' (2013) 40 *International Journal of Social Economics* 556, 558.
[749] See: Michael H Lubetsky, 'Losing Interest: Financial Alchemy in Islamic, Talmudic and Western Law' (2010) 19 *Transnational Law and Contemporary Problems* 231; Walid S Hegazy, 'Contemporary Islamic Finance from Socioeconomic Idealism to Pure Legalism' (2007) 7 *Chicago Journal of International Law* 581.
[750] See the discussion in: MA Muqtedar Khan, 'The Mythology of Islamic Economics and the Theology of the East Asian Economic Miracle' (2000) *Proceedings of the Fourth Harvard University Forum on Islamic Finance: Islamic Finance: The Task Ahead* 35.

I have noted above the prominence given to debt and asset-based products over the more paradigmatically Islamic PLS products and service. This is particularly problematic when the LIBOR is used as the mechanism for determining a fair rate of return Such an approach may at least be criticised as being inconsistent with the spirit of *Sharia*. The controversial practice of *tawarruq* was singled out, but the criticism may be applied more generally to any financial innovation that manipulates *Sharia* compliant components to create a product that effectively mimics conventional financial products and provides a rate of return that is interest by any other name. As Zaman and Asutay comment:

> Rather [than realizing the original goals of Islamic economic theory], the [Islamic banking and finance] industry seems to have grown as part of the conventional financial sector in the global capitalist economy.[751]

Zarka suggests that:

> Islamic economics is an interdisciplinary branch of knowledge. It derives some of its basic ingredients from ... the science of traditional economics. Some other ... are derived from Islamic *Shari'ah* and the *Fiqh* related to it.[752]

If this model of Islamic economics is accepted, then it is easy to see how the dominant conventional economic theories could influence the development of Islamic finance.

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[751] Nazim Zaman, Mehmet Asutay, 'Divergence Between Aspirations and Realities of Islamic Economics: A Political Economy Approach to Bridging the Divide' (2009) 17 *IIUM Journal of Economics and Management* 73, 74.
[752] Muhammad Anas Zarkas, 'Duality of Sources in Islamic Economics, and its Methodological Consequences' (2008) *Conference Papers: The 7th International Conference on Islamic Economics* 23.

From an educational perspective, the professionals involved in Islamic finance will have been exposed to conventional economic theory,[753] which would allow neoliberal capitalist values to influence the development of Islamic financial products and services from within the institution of the Islamic financial system itself.[754] As Haneef explains in describing his experience of studying economics in Malaysia:

> As an undergraduate student at the International Islamic University Malaysia, my experience in studying economics was quite unique in the sense that while being exposed to mainstream neoclassical economics, there was an explicit mention that economics was to be taught in a comparative and critical manner. At the same time, due to events of the late 1970s and early 1980s, developing Islamic economics was one of the goals in a few Muslim countries, including Malaysia. I discovered that there was also a mainstream school among those writing on Islamic economics, modeled along neoclassical lines, working almost within the boundaries of neoclassical theory, with some adjustments to incorporate teachings/norms/values that reflected certain requirements of Islam.[755]

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[753] Abdulkader Cassim Mahomedy, 'Islamic economics: still in search of an identity' (2013) 40 *International Journal of Social Economics* 556, 560.
[754] See, Mehmet Asutay, 'Conceptualisation of the Second Best Solution in overcoming the Social Failure of Islamic Banking and Finance: Examining the Overpowering of *HomoIslamicus* and *Homoeconomicus*' (2007) 15 IIUM *Journal of Economics and Management* 167, 168-169.
[755] Mohamed Aslam Haneef, 'Can There Be an Economics Based on Religion? The Case of Islamic Economics' (2005) Issue 34 *Post-autistic Economics Review* <http://www.paecon.net/PAEReview/issue34/Haneef34.htm> accessed 28 January 2015.

This experience suggests that Islamic finance was, and is, being taught as a modification of neoclassical conventional economics.[756] Such an approach necessarily exposes future Islamic finance professionals to the norms and values of capitalism, even if only implicitly through conventional economic theory.

This educational influence is reinforced by the external influence of the institution of capitalism, particularly given the globalisation of conventional finance and neoliberal capitalism that began following the demise of Bretton Woods (see chapter two). This latter institutional logic, as noted above, produces a competitively driven mimetic isomorphic pressure on Islamic financial innovation that, when coupled with the legitimisation of conventional economic norms through the educational experience of Islamic finance professionals,[757] creates an institutional logic that facilitates the convergence of Islamic and conventional financial products.[758] As Islamic finance continues to develop and mature as an organisational field, these two influences combine to provide an institutional logic that embeds capitalist norms alongside the Islamic values that allow the financial system to be characterised as Islamic. The danger of this developmental chronology, which has materialised at least to some extent, is that Islamic structures simply provide window dressing for the neoliberal capitalist content of hastily developed Islamic financial products.[759]

[756] Haneef and Furqani argue that 'bold' changes are needed in educational curricula to allow the Islamisation of economics to create a distinct discipline with a deep Islamic identity: Mohamed Aslam Haneef, Hafas Furqani, 'Contemporary Islamic Economics: The Missing Dimension of Genuine Islamization' (2009) 19 *Thoughts in Economics* 29, 47.
[757] Muhammad Hanif, 'Economic substance or legal form: an evaluation of Islamic finance practice' (2106) 9 *International Journal of Islamic and Middle Eastern Finance and Management* 277, 292.
[758] See section 1.6.1.1 for a discussion of competitive, mimetic and normative isomorphism
[759] Abdulkader Cassim Mahomedy, 'Islamic economics: still in search of an identity' (2013) 40 *International Journal of Social Economics* 556, 565.

The impact of the conflicting interaction between Islam and capitalism on Islamic financial professionals is amplified by similar institutional influences affecting the behaviour and demands of the Muslim as a consumer.[760] There is a strong consumerist drive from young Muslims, particularly in Muslim minority countries such as the UK and mixed culture countries such as Malaysia, wanting to enjoy the same products and services as their western counterparts. This demand, facilitated by the capitalist market ethos of the modern middle-class Muslim,[761] remains conditional on 'the halal stamp of approval'.[762] The risk of this *Sharia* constrained consumerism is that the demand will reinforce the already conflicting logics of Islamic finance and result in an isomorphic feedback loop in which there is pressure to innovate new products and services that offer the same advantages as conventional financial products, while retaining a structure that remains technically *Sharia* compliant.

The current consumerism of affluent Muslims continues a trend that began in the 1970s with the growth in Islamic finance on the back of the oil boom. Rather than focusing on the social goals of the early pioneers of Islamic finance, the interest of the oil-enriched entrepreneurs and policy makers was directed more towards a politically acceptable,[763] profit motivated, competitive Islamic alternative to conventional finance. As Hegazy explains:

> IFI's objective at this stage shifted from attempting to solve the social and economic problems of Muslims to offering a lawful or

[760] Karim D Crow, 'In Search of "Islamic Lifestyle"' (2012) 3 *Islam and Civilisational Review* 654, 662-667, 671.
[761] Vali Nasr, *Forces of Fortune* (Free Press 2009), 22-23.
[762] Economist Intelligence Unit, *The Sharia-Conscious Consumer Driving Demand* (Kuwait Finance House 2012), 8-9.
[763] Haider A Hamoudi, 'The Impossible, Highly Desired Islamic Bank' (2014) 5 *William and Mary Business Law Review* 105, 153-156.

> permissible (halal) platform for financial products capable of attracting the savings of the more affluent Muslims. The challenge IFIs faced at this stage was to find an IFI model that could offer halal financial products while maintaining, as much as possible, the prevailing structures and tools of conventional finance.[764]

In part, at least, the direction of Islamic finance towards a technically *Sharia* compliant version of conventional finance was also facilitated by the Islamic banks' early flirtation with the PLS *mudaraba* contract. As Warde notes:

> The first Islamic banks plunged into *mudaraba* with great enthusiasm and virtually no experience. The result was, to put it mildly, disappointing, and as a result, virtually all institutions decided to steer clear from profit-and-loss sharing , and focus instead on sale-based, or mark-up transactions.[765]

In other words, the profit-motivated pressure on Islamic banks resulted in a competitively driven isomorphic effect with Islamic financial products imitating the substance of conventional products while retaining the form of *Sharia* compliant instruments.[766]

This approach, which uses formal legal analysis to Islamicise conventional financial products, is facilitated by the contextually situated development of Islamic finance

[764] Walid S Hegazy, 'Contemporary Islamic Finance from Socioeconomic Idealism to Pure Legalism' (2007) 7 *Chicago Journal of International Law* 581, 590. As an influential example, Hegazy points to: Muhammad Baqir as-Sadr, *al-Bank alla Rabawi fi al-Islam* (Maktabat Jami' al-Naqi al-'Ammah 1969).
[765] Ibrahim Warde, 'The Relevance of Contemporary Islamic Finance' (2009) 2 *Berkeley Journal of Middle Eastern & Islamic Law* 159, 166.
[766] Muhammad Hanif, 'Economic substance or legal form: an evaluation of Islamic finance practice' (2106) 9 *International Journal of Islamic and Middle Eastern Finance and Management* 277, 278, 291-292.

and the educational background of the professionals involved in the innovation of Islamic financial products. Thus, as the theoretically sole institutional influence, Islamic *Sharia* must effect its normative and behavioural scripts in the face of the competitive influence of capitalist markets, the normative scripts of professionals trained in conventional economic theory and the legitimising scripts of domestic legal regulation and commercial practice,[767] which will often be informed essentially by neoliberal capitalist values. As Hamoudi explains in relation to US regulatory laws: 'banks are not supposed to operate under profit and loss sharing principles'.[768]

The combined effect of these competitive, legitimising and normative scripts create an environment that encourages a mimetic isomorphism (figure 11). Consider, for example, Lavoie and Moghul's observation on Islamic financial innovation in the US:

> the design of Islamic financial structures generally begins with a conventional paradigm in mind. Sometimes a conventional product - or more accurately its economics and functional utility - is sought by the Islamic investor. Hence it is with such a financial structure that the process of design begins. Goals, products, and evaluation metrics are identified within a conventional paradigm and mostly by persons largely, if not purely, trained in conventional subjects.[769]

[767] McKean James Evans, 'The Future of Conflict Between Islamic and Western Financial Systems: Profit, Principle and Pragmatism' (2010) 71 *University of Pittsburgh Law Review* 819, 832-834.
[768] Haider A Hamoudi, 'The Impossible, Highly Desired Islamic Bank' (2014) 5 *William and Mary Business Law Review* 105, 121. As an example he points to the general prohibition on banks owning real estate, which makes Islamic home financing problematic unless bank ownership of the home is essentially nominal, in a transaction that 'is "functionally equivalent" to a secured loan (at 123).
[769] David R Lavoie, Umar F Moghul, 'Redistributive Pedagogy: A Case Study in Islamic Finance Education and Student-Centred Learning' (2014) 7 *Albany Government Law Review* 446, 463.

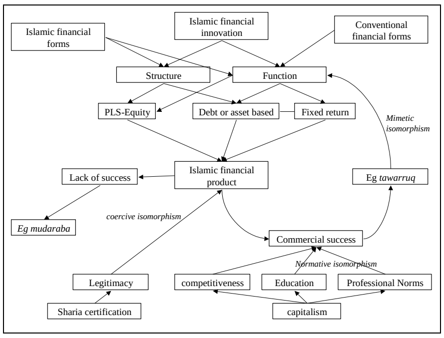

Figure 11: Islamic Financial Products and Isomorphism

Designs, legitimised by their certification as *Sharia* compliant, that provide competitive returns mimicking conventional financial products are likely to be the most successful products.[770] This success will reinforce those products, resulting in competitive pressure to innovate similar products.[771] This will lead to a structural isomorphism driven by the need for the legitimisation that follows certification as *Sharia* compliant. It will also, however, result in a functional isomorphism, through which Islamic financial products increasingly resemble conventional financial products.[772] The subsequent danger for the credibility of Islamic finance, is that a

[770] It is no surprise that some mixed countries, such as Malaysia, and minority countries such as the UK, are seen as more permissive when it comes to determining *Sharia* compliance, than are Muslim countries such as Saudi Arabia: Oliver Agha, 'Islamic Finance in the Gulf: A Practitioner's perspective' (2008) 1 *Berkeley Journal of Middle Eastern and Islamic Law* 179, 187-188.
[771] See Richardson's comment that: 'The task of the Muslim scholar is not simply to distil and apply Islamic teachings. They are also required to ensure the economic viability of these concepts': Edana Richardson, 'The Shari'ah Prohibition of Interest' (2008) 11 *Trinity College Law Review* 78, 100.
[772] See, Haider Ala Hamoudi, 'Jurisprudential Schizophrenia: On Form and Function in Islamic Finance' (2007) 7 *Chicago Journal of International Law* 605, 616-618.

respected Islamic authority will then question a previously accepted product, which may then be deemed non-compliant.[773] This retrospective rescinding of approval may threaten to undermine confidence in other products that might be seen as similarly vulnerable.[774] Such a loss of confidence, which may be exacerbated by the limits on the legal enforceability of *Sharia*,[775] could prove very damaging if it were to spread contagiously.[776]

3.6 Conclusion

The discourse of Islamic economics is more socially oriented than that of conventional economics, which focuses more on efficiency and rational individualism. The institutional influence of Islam infuses the organisational field of Islamic finance with a moral purpose. It permits a competitive market, but only one that is consistent with *Sharia* law and principles. By contrast, the conventional financial system is predominantly influenced by a capitalist ideology. Prior to the 2007 financial crisis this was an extreme neoliberal version, but since then the approach has been moderated, with the increasing influence of a constraining regulatory institutional logic. Since being a Muslim is a complete way of life, in principle the institution of Islam should provide a pure influence on Islamic finance. However, Islamic finance must often coexist and compete with conventional finance,

[773] Oliver Agha, 'Islamic Finance in the Gulf: A Practitioner's perspective' (2008) 1 *Berkeley Journal of Middle Eastern and Islamic Law* 179, 189. Agha points to the impact of Sheikh Taqi Usmani's memo on problematic *sukuk* structures.
[774] 'The risk of unexpected rule changes is one of the central and most widely discussed obstacles to expanding Islamic finance into the mainstream and non-Muslim population': Holly E Robbins, 'Soul Searching and Profit Seeking: Reconciling the Competing Goals of Islamic Finance' (2010) 88 *Texas Law Review* 1125, 1135.
[775] This is a particular issue for non-Islamic countries, which do not see *Sharia* as a national law for choice of law purposes: *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2004] EWCA Civ 19; [2004] 1 WLR 1784, [40]. See also: Holly E Robbins, 'Soul Searching and Profit Seeking: Reconciling the Competing Goals of Islamic Finance' (2010) 88 *Texas Law Review* 1125, 1137.
[776] The dramatic drop (66%) in the *sukuk* market in 2008, has been attributed, in significant part, to Usmani's criticisms (see n 258, above): Syed Imad-ud Din Asad, 'An overview of the sukuk market', March 2009, *Investor's Business & Financial Journal* <https://www.scribd.com/document/17277901/An-Overview-of-the-Sukuk-Market>, accessed 13 September 2016.

to a greater or lesser degree, and this juxtaposition sets up the possibility for the purity of Islam to be discoloured by the muddy waters of capitalism.

The dangers of capitalist influences affecting Islamic finance are amplified by the development of new debt-based products and by the divergence of opinion that exists amongst Islamic scholars. The risk is that products passed as *Sharia* compliant may later be rejected as non-compliant. Rejection of a single product previously certified as *halal* can raise doubts over other products and this is compounded by the criticism that technically compliant products are nevertheless inconsistent with the spirit of *Sharia*.[777] Through the process of contagion, this might consequently undermine confidence in Islamic finance as a system, distinguishable from conventional finance and offering Muslims and others, a genuine *halal* alternative. The risk of this systemic failure may be minimised by a strong system of governance and regulation and it is this topic that provides the focus for chapter three.

[777] Mohammad Akram Laldin, Hafas Furqani, 'The Objective of Shari'ah in Islamic Finance: Identifying the Ends and the Means' (April/June 2013) *New Horizon* 26.

Chapter Four: Islamic Finance, Risk and Sharia Governance

In chapter two, the concept of a financial system was analysed and its function was identified as being: *to facilitate the flow of money within the community*. Despite this singular function, the financial system is subject to a number of goals or aims that may sometimes conflict. Depending on one's role within the system and the perspective that comes from that role, from one's position within the community and from self-interest, these goals may include: the economic development and growth of the community; the development of the financial system; the growth of particular individual organisations within the system; personal success and wealth; a socially just distribution of wealth, or at least opportunity.

Where these goals conflict a tension arises that must be resolved in favour of one or other of the competing aims. The resolution of these tensions will largely be determined by the institutional framework that provides the normative rules and behavioural scripts that guide the acts and decisions of the individual actors. As discussed in chapter two, the institutional influence of neoliberal capitalism drove the risky behaviour that resulted in the sub-prime mortgage collapse, which in turn triggered the global financial crisis. Similarly, in chapter three, it was argued that the conflicting institutional influences of Islam and neoliberal capitalism, when situated in the competitive milieu of global finance, has created isomorphic pressures that have driven the development of new Islamic financial products. The consequence of these competitive and mimetic isomorphic influences is a convergence of Islamic financial products with their conventional counterparts and the criticism that Islamic finance is *Sharia* compliant only in form, but not in spirit.

Both the global financial crisis and the homogenisation of Islamic and conventional financial products highlight the problem of the risks that arise out of the tensions that are both generated and resolved largely through the institutional influences that provide the behavioural framework and decisional heuristics for life within the community. These risks may be managed by dismantling, modifying or replacing undesirable institutional influences. For example, as discussed in chapter two, one response to the global financial crisis was the call for change in the type of capitalism, with the aim of shifting the norms from the market fundamentalism of neoliberal capitalism to a more socially just variety of capitalism. An alternative and supplemental approach, is to constrain the undesirable consequences of a particular institution and guide the resolution of institutional tensions or conflicting goals through governance and regulation.

In this chapter, the governance and regulation of Islamic finance will be critically analysed. The analysis has three aims. First, is to provide some context for the analysis of *Sharia* governance. This context includes both the risks characteristically faced by Islamic finance, as well as the development of corporate governance as a theoretical and practical approach to managing risk and the activity of the firm's managers. As part of this analysis, the institutional logics that shape the corporate governance approaches and, hence, subsequently influence corporate managerial behaviour, will be critically examined. Second, is to consider the ideal Islamic approach to corporate governance, and hence to *Sharia* governance. Third, is to specifically consider the management of the risk of *Sharia* non-compliance through *Sharia* governance. At this stage, the analysis will not be specific to any particular firm or jurisdiction. It will, instead, consider the main problems with the current general approach to *Sharia* governance. A key issue for *Sharia* governance is that it must function within the competitive environment of the more firmly established western capitalist approaches to corporate governance. Thus, the chapter will also include a discussion of the interaction between capitalist and Islamic logics, which is a crucial aspect of the analysis of *Sharia* governance.

The analysis will start with a consideration of risk, governance and regulation generally, before explaining the risks that are particularly characteristic of Islamic finance. Corporate governance from a western perspective, will then be discussed. This will include an analysis of the institutional logics that drive the theoretical models and their application in practice. These initial sections provide the context for the subsequent, narrower focus on the governance of Islamic finance and *Sharia* risk. Initially, an ideal Islamic approach to corporate governance will be considered, before the approach to *Sharia* governance in practice is examined. The chapter is then brought to a conclusion by an analysis of the impact of the competing institutional logics of Islam and capitalism.

4.1 Corporate governance and the management of risk

4.1.1 The institution of risk

In chapter one it was noted that the social structure of the world may be characterised on the basis of risk. Within this structure there are those who create particular risks and those who subsequently face the risks so created. These risks may be global or local, systemic or limited to individual entities. The nature of the risk serves to define those that create and face the risk.[778] It also informs the approach to managing the risk, which is the main focus of this chapter and the thesis as a whole.

While risk itself is not an institution, the socio-political discourse that developed in response to the increase in risk and awareness of risk has established an institution of risk that shapes attitudes, risk-taking behaviour and risk management priorities.[779] As such it provides a 'cognitive framework' that enables individuals to engage effectively with their environment.[780] These environments, however, are context dependent and individuals operating within specific contexts are affected, not just by a single institution, but by a convergence of institutions unique to the relevant organisational field. The different combination of institutional influences will result in different biases affecting the identification, assessment and management of risk.[781]

The institutional logics of risk in the organisational field of western financial institutions will be affected by the norms and scripts of neoliberalism, capitalism, classical western economic theory and the legal system that both enables and regulates the provision of financial services. This is likely to result in an approach to risk that prioritises a mathematical cost-benefit analysis that conceptualises all types of harm in monetary terms and is predicated on the taken-for-granted goal of optimising profit. This presupposes money as the sole medium of '"social exchange"', favours utility over other measures of justice and oversimplifies the connection

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[778] Ulrich Beck, 'Critical Theory of World Risk Society: A Cosmopolitan Vision' (2009) 16 *Constellations*, 3.
[779] See the characterisation of an institution in section 1.6.1.2.
[780] J Rogers Hollingsworth, 'Doing institutional analysis: implications for the study of innovations' (2000) 7 *Review of International Political Economy* 595, 603.
[781] Howard C Kunreuther, Eryl V Ley, 'Overview' in Howard C Kunreuther, Eryl V Ley (eds), *The Risk Analysis Controversy: An Institutional Perspective* (Springer-Verlag 1982) 3, 5.

between ends and means, 'ignoring ... [the] "irrational"' non-economic consequences of the harm caused when a risk materialises.[782]

Given that Islamic finance has never fully divorced itself from western economic theory, there is likely to be at least some overlap in the equivalent institutional logics of risk. The institutional influence of Islam, however, is also likely to have exerted significant influence on the development of the institution of risk in the organisational field of Islamic financial institutions. The effect of Islam will be tempered by the influence of capitalism on Islamic finance as well as the influence of international bodies such as the World Bank and regulatory agreements such as the Basel accords.[783] Nevertheless, the relevance of Islam on Islamic finance is clear, at least in form, on the requirement for *Sharia* compliance. This obligation creates the unique risk of *Sharia* non-compliance, which identifies Islamic finance and distinguishes it from conventional finance.

One of the primary motivations of conventional finance is profit, although this may be tempered by social values such as the maintenance of reputation for trustworthy dealing. Islamic finance, however, should be primarily driven by the duty to provide for the religious needs of the Muslim community, with profit simply being of

[782] Volker Ronge, 'Risks and the Waning of Compromise in Politics' in Howard C Kunreuther, Eryl V Ley (eds), *The Risk Analysis Controversy: An Institutional Perspective* (Springer-Verlag 1982) 115, 116. For a current example of this type of approach, see the Thomas Cook debacle. The firm of travel operators initially responded to the tragic death of two children from carbon monoxide poisoning by taking a self-interested, legally and economically "rational" approach. The public response to this approach subsequently saw the firm take measures to appear more compassionate. The cynic might suggest that this remains driven by an economically rational concern for long term profit maximisation since the firm faced a threat of public boycott. See Kamal Ahmed, 'Thomas Cook chief executive apologises to family over Corfu tragedy' (Online, 20 May 2015) *BBC News* <http://www.bbc.co.uk/news/business-32809439> accessed 13 September 2016; Anon, 'Thomas Cook boss apologises over Corfu gas deaths' (Online, 20 May 2015) *BBC News* <http://www.bbc.co.uk/news/uk-england-leeds-32809770> accessed 13 September 2016.
[783] For a discussion of the interaction between western economic theory, capitalism and Islamic finance, see section 3.5.1.

instrumental importance for the viability of the Islamic financial organisation. The risk of *Sharia* non-compliance is not primarily a threat to the balance sheet, but to the religious integrity of both the organisation and those Muslim professionals responsible for providing *Sharia*-compliant products. When *Sharia* risk materialises, particularly where it arises from a capitalist driven interest in profit, this threatens to destroy confidence in the Islamic finance institution. Where the risk is seen to arise from an institutionally embedded capitalist profit motive exacerbated by the short-term entrepreneurial view of risk,[784] confidence in Islamic finance as a whole may be undermined. The significance of Islamic finance goes far beyond the profit that may be generated and engages with Muslim identity. This is compounded by the realisation that risk management is not just about the scientific actuality of risk, but also about the social perception of risk.[785] As such, a failure of Islamic finance cannot simply be solved by financial measures and prevention is undoubtedly better than cure. In order to maintain confidence in Islamic finance, an effective system of governance to ensure *Sharia* compliance is essential.[786]

4.1.2 Risk and corporate governance

As discussed in chapter one, risk may be defined as the probability of a particular harm.[787] Since harm is undesirable, risk is also seen as undesirable. The problem is that some risk is unavoidable and, in order to achieve our goals, it is necessary to balance the risk of harm against the gain that will likely accrue. Where the risk and possibility of gain coincide, then it is for the individual to decide whether the risk is

[784] Michael Thompson, Aaron Widavsky, 'A Proposal to Create a Cultural Theory of Risk' in Howard C Kunreuther, Eryl V Ley (eds), *The Risk Analysis Controversy: An Institutional Perspective* (Springer-Verlag 1982) 145, 155.
[785] *Ibid*, 147-148.
[786] Abdurrahman Raden Aji Haqqi, 'Shariah Governance in Islamic Financial Institution: An Appraisal' (2014) 11 *US-China Law Review* 112, 118.
[787] This is a general conception of risk rather than a technical financial definition: Glyn A Holton, 'Defining Risk' (2004) 60 *Financial Analysts Journal* 19.

worth taking. Where the gain and risk do not so neatly coincide the issue becomes more problematic. While the principle of autonomy may justify the self-imposition of a risk, it does not justify imposing risks on others. In the context of a modern society, however, it is impossible to avoid at least some separation between the risk creators and the risk facers. In this context, risky behaviour may well be justifiable for the good of society. Entrepreneurship may create risk, but if the risk is well managed, it will lead to economic growth that can benefit all. The caveat expressed here is that risk needs to be managed and, given that those facing the risk may have little or no control over the risk, it is prudent to oversee and manage the risky behaviour of those who stand to gain. In the context of financial institutions, this need is met through regulation and corporate governance.

In managing risky behaviour, regulatory frameworks must engage with the responsibility of the autonomous agent within a complex system. While specific agents, individually or collectively, may be identified as causally responsible for a particular risk, whether the risk materialises will depend on whether a number of necessary causal factors within that complex system combine to produce a set of causal elements sufficient to allow the harm to occur.[788] It is, of course, the harm, rather than the risk per se, that risk management seeks to prevent. This may be achieved by a regulatory framework aimed at preventing individual risky behaviour, but it is unlikely that human error - or even intentional risk taking - can ever be fully eliminated. Thus, it is also important to take a systems based approach to reduce the opportunity for a risk triggered by human activity to materialise as the potential

[788] Thomas B Sheridan, 'Risk, Human Error, and System Resilience: Fundamental Ideas' (2008) 50 *Human Factors* 418, 421.

harmful consequence of that activity.[789] The aim being to ensure a safe resilient system that reduces risk to an "acceptable" level.[790]

The lower level of acceptability will be determined by government policy and national laws, but this does not preclude organisations, individually or collectively, from setting a higher standard with a lower level of acceptability. In both cases, what is considered acceptable is likely to be determined by the interaction of the various institutional discourses that define the culture of the community. Neoliberal capitalism will tend to encourage a more individual approach to risk that prioritises efficiency over the avoidance of harm and allows individuals the liberty to engage in risky behaviour, but holds them responsible for any harm that ensues. A more socially just approach, such as the ideal of Islam, would prioritise risk avoidance over efficiency. Insofar as Islamic finance is motivated by the capitalist goal of efficient short term production of profit, there is a potential for risk management protections to be compromised.[791] This highlights the tension between efficiency and risk that must be managed by effective governance.

Before turning to consider the theoretical and actual approaches to governance, it is first important to appreciate the nature of the risks that must be managed. Although the primary focus of this thesis is on *Sharia* risk, the most relevant of the other risks faced by Islamic banking will be outlined, as these will all impact on the approach to governance. This, in turn, is likely to have at least an indirect influence on *Sharia*

789 Nancy G Leveson, 'Applying systems thinking to analyse and learn from events' (2011) 49 *Safety Science* 55.
790 Thomas B Sheridan, 'Risk, Human Error, and System Resilience: Fundamental Ideas' (2008) 50 *Human Factors* 418, 419, 423.
791 Thomas B Sheridan, 'Risk, Human Error, and System Resilience: Fundamental Ideas' (2008) 50 *Human Factors* 418, 423.

governance, in part through the development of institutional logics and cultural attitudes to risk and risk management. Furthermore, the other risks faced by Islamic banks provide a source of pressure that compounds the competitive isomorphic effect of conventional finance and the profit motive of capitalist scripts. All of these encourage innovative risk taking with a consequential increase in the risk of divergent *Sharia* judgments and the possibility of *Sharia* non-compliance. As the Basel Committee noted with regard to credit risk, market risk (see below for definitions), effective governance requires a comprehensive approach to risk management since the risks faced by banks tend to be interrelated.[792] The relationship between these risks means that attempts to manage one risk are likely to also impact on other risks.[793] For example, if the risk of *Sharia* non-compliance materialises this increases reputational risk, fiduciary risk, legal risk and withdrawal risk.[794] Furthermore, effective financial risk management as a way of avoiding harm and as a measure of efficient use of resources is normatively required by *Sharia*,[795] which provides a direct connection between financial risks and the risk of *Sharia* non-compliance.

4.2 Particular risks of Islamic finance

To begin with, it should be noted that: 'By its very nature, Islamic banking is a risky business compared with conventional banking, for risk-sharing forms the very basis

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[792] Basel Committee on Banking Supervision, *Principles for the Management of Credit Risk* (2000), 1. <http://www.bis.org/publ/bcbs75.pdf> accessed 26 May 2015.
[793] Karim Ginena, Shari'ah risk and corporate governance of Islamic banks' (2014) 14 *Corporate Governance* 86, 90-92.
[794] Chapra and Ahmed found that 85.6% of depositors in Bahrain, 94.6% in Sudan and 66.8% in Bangladesh would withdraw funds as a consequence of *Sharia* non-compliance: M Umer Chapra, Habib Ahmed, 'Corporate Governance in Islamic Financial Institutions' (2002) Islamic Development Bank Islamic Research and Training Institute, Occasional Paper No 6, 120.
[795] Azlin Alisa Ahmad, Salmy Edwati Yaacob, 'The Principle of Risk Management: *Sharia* Perspectives' (2012) 8 *Journal of Applied Sciences Research* 3335, 3335, 3341.

of all Islamic financial transactions'.[796] PLS shifts risk to investment depositors, but this risk reduction is more than offset by an increase in risk on the asset side and from the more complex administrative demands of Islamic financial services.[797] Beyond this, there are a number of risks that are unique, or particularly relevant, to Islamic finance, creating a distinctive risk profile. In this section, the main risks that form this profile will be introduced.

Certain risks, such as *Sharia* compliance risk, are unique to Islamic finance. Other risks, that serve to form part of a distinctive risk profile, are not unique but operate differently in Islamic finance because of the distinct structure of its products and services.[798] The following risks are characteristic: *Sharia* non-compliance risk; liquidity risk; credit risk; displaced commercial risk; and operational risk.[799]

4.2.1 *Sharia* non-compliance risk and *Sharia* arbitrage

The most uniquely identifying risks of Islamic finance are the risk of *Sharia* non-compliance and the related risk of *Sharia* arbitrage. *Sharia* non-compliance is the risk that a product or service that is not *halal* will nevertheless be certified as *Sharia* compliant. It arises, at least in part, from the diversity of opinion amongst *Sharia* scholars or jurists regarding the compliance of particular transactions,[800] but it may also arise from individual failure, failure in the processes and system of *Sharia*

[796] Mohamed Ariff, 'Islamic Banking' (1988) 2 *Asian-Pacific Economic Literature* 48, 52.
[797] Seyed Nezamuddin Makiyan, 'Risk Management and Challenges in Islamic Banks' (2008) 4 *Journal of Islamic Economics, Banking and Finance* 45, 46.
[798] Sultan Alaydan, 'Why Islamic finance system could not be an alternative to conventional finance system - an analysis of inherent risk specific to Islamic finance', (2011) Dissertation submitted as part of LLM, 12.
[799] *Ibid*, 15-41.
[800] Michael Ainley, Ali Mashayekhi, Robert Hicks, Arshadur Rahman, Ali Ravalia, *Islamic Finance in the UK: Regulation and Challenges* (FSA 2007), 16.

governance, or external governance and regulatory failure.[801] *Sharia* arbtirage is a particular form of regulatory arbitrage that can feed into the risk of *Sharia* non-compliance. This may occur when '[c]onventional financial products are used as building blocks for the re-engineered Islamic products approved by jurists', which may be achieved by using a special purpose vehicle to separate the Islamic finance customers from the interest-based line of credit provided by the parent bank.[802]

This risk of *Sharia* arbitrage is particularly relevant to the nature and purpose of Islamic finance because it involves financial products that are *Sharia* consistent in form only and not in spirit (see the discussion of this in chapter three). Using innovative combinations of conventional financial building blocks it is aimed at allowing Islamic finance to retain the profitable advantages of conventional finance while technically satisfying *Sharia* requirements. *Sharia*, however, as a spiritual way of life, is not simply about being technically consistent. Following form may be satisfy the ritual of religion, but it does nothing to achieve the *Maqasid al-Sharia* such as *adl* and *falah*. Appreciating the distinction between formal and substantial consistence with *Sharia* highlights the potential for differential judgments on *Sharia* consistency that goes beyond any variation in strictly technical interpretations of, for example, the meaning of *riba*. It also highlights the relevance of the institutional discourses influencing both the Islamic financial professionals responsible for developing new products, and the *Sharia* board members who must certify the product as *Sharia* compliant. Where the logics of neoliberal capitalism and conventional finance exert a powerful influence then the logics of *Sharia* may be

[801] Karim Ginena, Shari'ah risk and corporate governance of Islamic banks' (2014) 14 *Corporate Governance* 86, 92-96.
[802] Mahmoud A El-Gamal, 'Limits and Dangers of Shari'a Arbitrage', in Syed Nazim Ali (ed), *Islamic Finance: Current Legal and Regulatory Issues* (Islamic Finance Project, Harvard Law School 2005) 117.

subverted, becoming technicalities for circumvention rather than constraints of spiritual importance. In such a situation the risk of divergent judgements on *Sharia* compliance is amplified and the need for strong and consistent *Sharia* governance emphasised.

4.2.2 Liquidity risk

The Basel Committee on Banking Supervision (Basel Committee) explained liquidity as:

> the ability of a bank to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses.[803]

Liquidity risk is defined as the risk which is the outcome of a seller inability to quickly dispose an asset at an approriate market value or price.

In the financial sector, it 'represents a bank's ability to accommodate the redemption of deposits and other liabilities and to cover the demand for funding in the loan and investment portfolio'.[804] Banks are 'inherently vulnerable to liquidity risk', particularly funding liquidity risk, which the Basel Committee defined as:

> the risk that the firm will not be able to meet efficiently both expected and unexpected current and future cash flow and collateral needs without affecting either daily operations or the financial condition of the firm.[805]

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[803] Basel Committee on Banking Supervision, *Principles for Sound Liquidity Risk Management and Supervision* (2008), 1 <http://www.bis.org/publ/bcbs144.pdf> accessed 26 May 2015.
[804] Hennie van Greuning, Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank 2008), 150.
[805] Basel Committee on Banking Supervision, *Principles for Sound Liquidity Risk Management and Supervision* (2008), 1 <http://www.bis.org/publ/bcbs144.pdf> accessed 26 May 2015.

Liquidity risk is of specific relevance to Islamic financial organisations because the prohibition of *riba* means that they are unable to utilise the conventional money market.[806] Because of the limited access to *halal* money; the need for asset-backed securities and the limited number of market participants; the characteristics of Islamic financial products; and a high proportion of current demand deposit accounts, van Greuning and Iqbal explain that 'liquidity risk is one of the most critical risks facing Islamic banks'.[807] This is exacerbated by the lack of any 'independent inter-Islamic bank money market'.[808]

4.2.3 Credit risk

The Basel Committee defined credit risk as:

> the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms.[809]

In other words, it refers to the chance that a debtor will not repay the money owed consistently with the agreement, which can create liquidity issues. This is another risk faced by both conventional and Islamic financial organisations. Islamic financial organisations, however, face particular credit risks because of the unique nature of their financial products and services. These include credit risks associated with *murabaha*, where the bank delivers the asset, but does not receive payment. Or where the client refuses to accept the asset. With *istisna* or *Bai'Salam* contracts, the goods may not be supplied on time, or may be of a lower quality than agreed. With *mudaraba* contracts, credit risk may also arise because of the difficulty of monitoring

[806] Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar 2009), 92.
[807] Hennie van Greuning, Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank 2008), 154.
[808] Muhammad Ramzan, Muhammad Imran Zafar, 'Liquidity Risk Management in Islamic Banks: A Study of Islamic Banks of Pakistan' (2014) 5 *Interdisciplinary Journal of Contemporary Research in Business* 199, 202.
[809] Basel Committee on Banking Supervision, *Principles for the Management of Credit Risk* (2000), 1. <http://www.bis.org/publ/bcbs75.pdf> accessed 26 May 2015.

the *mudarib* (agent). These risks are exacerbated by the prohibition of *riba*, which precludes additional charges for late settlement.[810]

For completeness, it bears noting that, relatedly, 'market risk' refers to the risk of losses "*in on and off-balance sheet positions arising from adverse movements in market prices*".[811] It relates to risk from *all* positions held by banks (not solely in lender-borrower relationships) including commodity and foreign exchange risk poisitions that may be severely affected by market shocks and create liquidity crises. This in turn amplifies credit risk.

4.2.4 Displaced commercial risk

Displaced commercial risk arises where the financial organisation is 'under market pressure to pay a return that exceeds the rate that has been earned on assets financed by [account holders] ... when the return on assets is under-performing as compared with competitors' rates'.[812] The pressure on Islamic banks arises from floating customers willing to change banks to find a competitive rate of return for their investments and deposits. This creates a problem for the banks where the PLS schemes fail to perform as well as conventional interest-based products leaving the bank in the position of having to make up the shortfall or lose the customer.[813] To manage the problem, Islamic banks may decide to forgo their share of any profits, at the expense of the shareholders, but in favour of the depositors. This, however, can

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810 Hennie van Greuning, Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank 2008), 126-127.

811 European Banking Authority, Market Risk, <https://www.eba.europa.eu/regulation-and-policy/market-risk>

812 IFSB, *Guiding Principles of Risk Management for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services* (2005), para 104 <http://www.ifsb.org/standard/ifsb1.pdf> accessed 13 September 2016.

813 Heni Hassanah, Noer Azam Achsani, Ascarya Siregar, Hermanto Siregar, 'Displaced Commercial Risk: Empirical Analysis on the Competition between Conventional and Islamic Banking Systems in Indonesia' (2013) 7 *Advance in Natural and Applied Sciences* 292, 293.

'lead to insolvency risk in extreme cases'.[814] In response to the risk, it has become standard practice to maintain a reserve fund as a buffer against poor performance.

Displaced commercial risk is an interesting risk because it only exists where there is a competitive pressure to maintain a consistent return for depositors and investors regardless of the performance of the financial product. The risk of a lower return, or even a loss, is intrinsic to the concept of profit and loss sharing. The capitalist pressure to compete with conventional finance, however, means that lower profits and losses may not be passed on to the customer where it would result in a lower rate of return. The use of a reserve fund smoothes out the peaks and troughs of performance, but where a product under-performs to a greater extent, or for a longer period, than anticipated, then the bank must bear the loss. This creates a liquidity risk and, insofar as it uncouples the rate of return from performance, it arguably creates a risk of *Sharia* noncompliance.

4.2.5 Operational risk

Operational risk was defined by the Basel Committee as: 'the risk of direct or indirect loss resulting from failed internal processes, people and systems or from external events'.[815] It is a risk that is common to both conventional and Islamic financial systems, but the complexity added by the need for *Sharia* compliance, including the lack of standardised product, heightens the risk of operational failures.[816]

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[814] Hennie van Greuning, Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank 2008), 126-177.
[815] Basel Committee on Banking Supervision, *Operational Risk* (Consultation document) (January 2001), 2. See also: Basel Committee on Banking Supervision, *Principles for the Sound Management of Operational Risk* (June 2011), 3.
[816] Seyed Nezamuddin Makiyan, 'Risk Management and Challenges in Islamic Banks' (2008) 4 *Journal of Islamic Economics, Banking and Finance* 45, 47.

4.2.6 Incentive risk

In addition, Islamic finance faces the risk of adverse selection (incentive risk). The absence of any collateral requirement of *mudaraba* contracts may attract higher risk entrepreneurs. Furthermore, those entrepreneurs with a lower chance of success may be attracted to PLS contracts to minimise losses, while those with a better chance of success may prefer interest-based conventional financing to maximise profits. Thus, 'Islamic banks receive a disproportionately large share of the bad risks'.[817]

4.2.7 Other risks

Other risks include: withdrawal risk, which typically arises from the pressure to withdraw money during periods of low return; fiduciary risk, which may arise from an inability to comply with the *Sharia* requirements of a contract, or from a low rate of return; reputational risk, which is the danger that a firm's irresponsible activity will come to light and negatively impact on the reputation of the firm with the possibility that such reputational harm will spread throughout the industry; governance risk, which refers to the risk of poor governance resulting from a weak 'institutional environment';[818] legal risks, which are exacerbated by the legal uncertainty created by inconsistent opinions on *Sharia*-compliance,[819] are particularly relevant in common law and civil law countries where there is no mechanism for enforcing Islamic contracts.[820]

4.3 Corporate governance

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[817] Timur Kuran, *Islam and Mammon: The Economic Predicaments of Islamism* (3rd ed, Princeton University Press 2006) 12.
[818] Hennie van Greuning, Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank 2008), 179.
[819] Alejandro Lopez Mejia, Suliman Aljabrin, Rachid Awad, Mohamed Norat, Inwon Song, 'Regulation and Supervision of Islamic Banks' (2014) IMF Working Paper WP/14/219, 11.
[820] Habib Ahmed, Tariqullah Khan, 'Risk management in Islamic banking', in M Kabir Hassan, Mervyn K Lewis (eds) *Handbook of Islamic Banking* (Edward Elgar 2007) 144, 145.

Having explained the particular risks that must be managed, the focus turns to the governance of financial institutions. Beginning with general discussion, that focus will then narrow to specifically consider *Sharia* governance, which aims to manage the risk of *Sharia* non-compliance. In chapter one, the definition of corporate governance was discussed. For the purposes of the thesis, the definition was fixed on Sir Adrian Cadbury's explanation that:

> Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.[821]

In order to understand how to apply this conception of corporate governance, it is necessary to appreciate the development of the concept and its theoretical bases.

[821] Magdi R Iskander, Nadereh Chamlou, *Corporate Governance: A Framework for Implementation* (World Bank Group 2000), vi.

4.3.1 A brief history of corporate governance

The governance of corporations has been a concern for 'as long as the corporate form has allowed conflicts between investors and managers'.[822] Although commercial corporations began appearing from the late fourteenth century,[823] it was not until 1960 that the term "corporate governance" was first used by Richard Eells to refer to 'the structure and functioning of the corporate polity".[824] Modern approaches to corporate governance, however, have their origins in the US in the 1970s. In the mid 1970s, the US federal Securities and Exchange Commission (SEC) included corporate governance as part of its 'official reform agenda' aimed at combating the extensive bribery and corruption that had been identified.[825] In 1976, Jensen and Meckling, published a landmark paper that modelled the problems of agency resulting from a separation of ownership and managerial control.[826] It 'spawned a voluminous body of research', initially focused on the US.[827]

By the 1990s, corporate governance was a well established term and concept within both academic and regulatory discourse and in 1991 its regulatory agenda crossed the Atlantic with the establishment in the UK of the Cadbury Committee on the

[822] Harwell Wells, 'The Birth of Corporate Governance' (2010) 33 *Seattle University Law Review* 1247, 1251.
[823] Harold J Laski, 'The Early History of the Corporation in England' (1917) 30 *Harvard Law Review* 561. Laski notes the *communitas* of English merchants in Prussia granted a charter by Richard II in 1391 (at 580).
[824] Udo C Braendle, Alexander N Kostyuk, 'Developments in Corporate Governance' in Alexander N Kostyuk, Udo C Braendle, Rodolfo Apreda (eds), *Corporate Governance* (Virtus Interpress 2007) 2; Richard S Eells, *The meaning of modern business: an introduction to the philosophy of large corporate enterprise* (Columbia University Press 1960).
[825] Brian R Cheffins, 'The History of Corporate Governance' (2012) ECGI Law Working Paper No 184/2012, 2-3.
[826] Michael C Jensen, William H Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.
[827] Diane K Denis, John J McConnell, 'International Corporate Governance' (2003) 38 *Journal of Financial and Qualitative Analysis* 1.

Financial Aspects of Corporate Governance.[828] The Committee was formed in response to 'some unexpected failures of major companies and by criticisms of the lack of effective board accountability'.[829] The code subsequently published by the Cadbury Committee became a global model for corporate governance and triggered 'a wave of official and semi-official codes around the world'.[830] US approaches to corporate governance have also been globally influential, particularly as a consequence of the success of its economy in the 1990s and the Asian financial crisis of 1997 revealing weak corporate governance structures. In 1998, the international OECD created the Ad Hoc Task Force on Corporate Governance, which published a set of Principles in 1999.[831] By the end of the 20th century, 'corporate governance had clearly "arrived"' as an ongoing global concern.[832]

The interest in corporate governance grew in response to the separation between financial ownership and managerial control. The need for corporate governance was emphasised by the failure of organisations such as the Bank of Credit and Commerce International (BCCI), which 'resulted from weak oversight of a complex, multinational organisation whose business structures played one regulator off against others'.[833] The failure of the BCCI occurred in the context of an increasingly globalised market, which is a natural consequence of capitalism, and particularly

[828] Report of the Committee, *On The Financial Aspects of Corporate Governance* (Gee & Co 1992), para 2.1.
[829] *Ibid*, para 2.2.
[830] Donald Nordberg, Terry McNulty, 'Creating better boards through codification: Possibilities and limitations in UK corporate governance, 1992-2010' (2013) 55 *Business History* 348, 350.
[831] Ad Hoc Task Force on Corporate Governance, *OECD Principles of Corporate Governance* (1999), SG/CG(99)5.
[832] Brian R Cheffins, 'The History of Corporate Governance' (2012) ECGI Law Working Paper No 184/2012, 19-21.
[833] Donald Nordberg, Terry McNulty, 'Creating better boards through codification: Possibilities and limitations in UK corporate governance, 1992-2010' (2013) 55 *Business History* 348, 350.

neoliberal capitalist policies.[834] The global market provided the BCCI the opportunity to develop a complex structure 'designed to evade regulation', which facilitated the illegal activity and financial accounting manipulation that ultimately resulted in the bank's closure.[835] The initial rise of the BCCI is a testament to national policies that enable a light touch regulatory approach aimed at encouraging inward currency movement and characterised by conflicts of interest.[836] Its ultimate demise is testament to the power that nation-states retain within a global market to effectively regulate transnational corporations.

The subsequent failures of corporations, such as Enron in 2001, again raised global concerns with corporate governance, resulting in the Sarbanes-Oxley Act 2002 in the US and a revision of the corporate governance code in the UK, with the Financial Reporting Council (FRC) and the London Stock Exchange's UK Listing Authority reformed as government agencies. Concerns were then again raised following the 2007 global financial crisis resulting, in the UK, in a review of financial services governance and the updated UK Corporate Governance Code.[837]

The Sarbanes-Oxley Act 2002 has since been supplemented by the Dodds-Frank Act 2010, which was enacted in response to the 2007 financial crisis. Together they reflect an approach that relies on litigation after the event and relies essential on state

[834] Patricia J Arnold, Prem Sikka, 'Globalisation and the state-profession relationship: the case the Bank of Credit and Commerce International' (2001) 26 *Accounting, Organisations and Society* 475, 477, 479.
[835] *Ibid*, 481.
[836] Price Waterhouse acted both as external auditors in a regulatory context and as private advisers to further the interests of the bank.
[837] Donald Nordberg, Terry McNulty, 'Creating better boards through codification: Possibilities and limitations in UK corporate governance, 1992-2010' (2013) 55 *Business History* 348, 351-352.

rather than market regulation.[838] The focus of the US approach, which operates through the SEC, is on monitoring, disclosure of misconduct and punishment.[839] This '[t]op-down corporate governance' policy, which may be a necessary response to the market failures witnessed in the 2007 financial crisis, is limited by its *ex-post* reactive nature that may 'have formalized and sanitized the share-holder manager relationship, but ha[s] arguably done very little to improve... [its] underlying quality'.[840] With both shareholders and managers accusing each other of short-sighted self-interest,[841] this formal approach is unlikely to be sufficient without additional efforts to address the institutional norms and scripts governing behaviour within the commercial corporate context.

While the UK approach to corporate governance may share a common theoretical basis with the US (see below), it currently implements a very different scheme in practice. Backed by the "enlightened shareholder" hard law of the Company Act 2006,[842] the UK adopts a soft law and *ex ante* "comply or explain" approach based on the principles contained in the UK Corporate Governance Code.[843] The focus is more on informational asymmetry between the board and the shareholders than with share pricing, trading and market regulation.[844] The new code was drafted to address the failings in corporate governance exposed by the 2007 financial crisis. Supported by the UK Stewardship Code (2012), it explicitly aims to 'alter the "tone"' of corporate

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838 Bernhard Kuschnik, 'The Sarbanes-Oxley Act: "Big Brother is Watching You" Or Adequate Measures of Corporate Governance Regulation? (2008) 5 *Rutgers Business Law Journal* 64, 66.
839 *Ibid*, 70.
840 Tamara C Belenfanti, 'Shareholder Cultivation and New Governance' (2014) 38 *Delaware Journal of Corporate Law* 789, 806-807.
841 Justin Fox, Jay W Lorsch, 'What Good are Shareholders? (July-August 2012) *Harvard Business Review* <https://hbr.org/2012/07/what-good-are-shareholders accessed 08 June 2015.
842 Financial Reporting Council, *The UK Approach to Corporate Governance* (2010), 6
843 Andrew Mullineux, 'Is there an Anglo-American corporate governance model?' (2010) 7 *International Economics and Economics Policy* 437, 439.
844 *Ibid*, 440.

governance,[845] with the emphasis on 'following the spirit of the Code as well as its letter'.[846]

4.3.2 The theories and institutional logics of corporate governance

Corporate governance may be achieved through a combination of internal (e.g. monitoring and equity-based incentives)[847] and external mechanisms (e.g. legal and market regulation, and the threat of takeovers).[848] These may be shaped and supported by voluntary or mandatory codes of practice.[849] Nordberg and McNulty explain that: 'Codes provide the texts of corporate governance' and these texts help to shape both 'social context and behaviour'. Thus:

> the choice of terms, the phrasing, metaphors and figures of speech frame the debate, focusing our attention on a part of the landscape, helping us to concentrate on certain aspects while eliminating or hiding other form view. Language thus gives shape to the discussion and sets boundaries. Seminal texts set the terms of the debate, the logic.[850]

While this may be a reasonable explanation of the relevance of corporate governance codes, it begs the equally interesting and important question of the institutional origin of these seminal texts and code. As McConvill observes:

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845 Donald Norberg, Terry McNulty, 'Creating better boards through codification: Possibilities and limitations in UK corporate governance 1992-2010' (2013) 55 *Business History* 348, 352.
846 Financial Reporting Council, *The UK Approach to Corporate Governance* (2010), 2.
847 Henry L Tosi jr, 'Quo Vadis? suggestions for future corporate governance research' (2008) 12 *Journal of Management and Governance* 153, 161.
848 Diane K Denis, John J McConnell, 'International Corporate Governance' (2003) 38 Journal of Financial and Quantitative Analysis 1, 2-5; Igor Filatotchev, 'Developing an organizational theory of corporate governance: comments on Henry L Tosi jr (2008) "Quo Vadis? Suggestions for future corporate governance research"' (2008) 12 *Journal of Management and Governance* 171.
849 Petre Brezeanu, Andrei Stanculescu, 'Corporate Governance Models' (2008) 8 *Annals of the University of Petrosani, Economics* 15, 16.
850 Donald Nordberg, Terry McNulty, 'Creating better boards through codification: Possibilities and limitations in UK corporate governance, 1992-2010' (2013) 55 *Business History* 348, 353.

> Naturally it is the case that before everything else must be the norms, as the norms have provided the foundation upon which the guidelines and reports have subsequently been developed and revised, and by which mandatory rules setting in place formal benchmarks for corporate governance best practice could be enacted.[851]

It was noted above that the modern approaches to corporate governance began in the mid 1970s and developed to maturity over the last quarter of the twentieth century. This coincides with the rise of neoliberal capitalism, particularly in the US and UK where theoretical approaches to corporate governance combined to construct what is commonly referred to as the Anglo-American model.[852]

4.3.2.1 The Anglo-American shareholder model and transaction cost economics

The Anglo-American shareholder model is predicated on the narrow view that: 'Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment'.[853] This view in turn reflects the agency model of the corporation, centred on the distinction between the interests of the managers (agents) and the shareholders (principals).[854] Under the agency model, the principal trusts the agent to work in his or her interest,

[851] James A McConvill, 'Reflections on the Regulation of Contemporary Corporate Governance' (2006) 2 *The Corporate Governance Law Review* 1, 20.
[852] See, eg, Cagman Palmer, 'Has the Worldwide Convergence on the Anglo-American Style Shareholder Model of Corporate Law Yet Been Assured? ' (2011) Issue 11 *Opticon1826* <http://www.opticon1826.com/articles/abstract/10.5334/opt.111104/> accessed 08 June 2015; Thomas Clarke, 'A Critique of the Anglo-American Model of Corporate Governance' (2009) Comparative Research in Law & Political Economy, Research Paper No 15/2009.
[853] Andrei Shleifer, Robert W Vishny, 'A Survey of Corporate Governance' (1997) 53 *Journal of Finance*, 737.
[854] Michael C Jensen, William H Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305, 308-310.

but acknowledges that the agent may abuse this trust for personal gain. Even where the agent is trustworthy, he or she may not share the principal's attitude to risk.[855]

The agency model, which by the early 1990s had superseded a more corporate logic,[856] shares the ontological presumptions of neoliberal capitalism, in which humans are characterised as a rational, self-interested, profit-motivated agents. The focus on the shareholder as the sole principal is equally consistent with the liberal individualistic conception of the autonomous agent coupled with the efficient production of profit as the sole motivation. Based on this conception of the agent as self-interested, it is rational for the shareholder, through the board of directors, to oversee, and impose restrictions on, the agent. This governance, however, may be complicated by the informational asymmetry that disadvantages the principal.

The closely related theory of transaction costs economics (TCE) is predicated on the existence of an agency problem that, because of the transaction costs involved, cannot be resolved contractually.[857] It also relies on a self-interested and opportunistic conception of the agent. Rather than conceptualising the firm simply as a nexus of contracts, however, TCE views the firm as a governance structure, which may be organised to fill the gaps left by the nexus of inevitably incomplete contracts and reduce the transaction costs of 'misaligned actions'.[858] Governance structure provides a 'mechanism for making decisions' that are not determined contractually because the transactional costs accounting for them contractually would be too

[855] Christine A Mallin, *Corporate Governance* (4th ed, Oxford University Press 2013), 17.
[856] James D Westaphal, Edward J Zajac, 'A Behavioral Theory of Corporate Governance: Explicating the Mechanisms of Socially Situated and Socially Constituted Agency' (2013) 7 *The Academy of Management Annals* 607, 642.
[857] Oliver Hart, 'Corporate Governance: Some Theory and Implications' (1995) 105 *The Economic Journal* 678.
[858] Christine A Mallin, *Corporate Governance* (4th ed, Oxford University Press 2013), 18-19.

high.[859] This reduces corporate governance to a cost-benefit analysis that is entirely consistent with profit as the sole goal of capitalism.

4.3.2.2 The stakeholder model and enlightened value maximisation

Alternatives to the shareholder model began to develop in the 1990s.[860] Perhaps the main alternative is the stakeholder model, which widens the range of participants whose interests should be protected against the risk created by the acts of self-interested managers. Although the interests of shareholders remain important, other stakeholders, such as the employees, the customers, the community and the government, also become relevant to the governance of corporate behaviour.[861] While this model, which is more associated with continental Europe, still reflects the capitalist focus on profit, it takes a more social or relational approach to the corporation. Instead of seeing the firm as essentially constituted in the relationship between the owners and the managers, it embeds the firm in a wider social context.

One of the problems with the stakeholder approach is the lack of any measured objective to guide managers as to how to balance the interests of the various parties, or indeed how to distinguish stakeholders from non-stakeholders.[862] Corporations that rely on a stakeholder model have no principled way of measuring the performance of their managers, who remain unaccountable. This 'plays into the hands of self-interested managers allowing them to pursue their own interests at the

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[859] Oliver Hart, 'Corporate Governance: Some Theory and Implications' (1995) 105 *The Economic Journal* 678, 680.
[860] James H Davis, F David Schoorman, Lex Donaldson, 'Toward a Stewardship Theory of Management' (1997) 22 *Academy of Management Review* 20; Lex Donaldson, James H Davis, 'Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns' (1991) 16 *Australian Journal of Management* 49.
[861] Christine A Mallin, *Corporate Governance* (4th ed, Oxford University Press 2013), 20.
[862] Zamir Iqbal, Abbas Mirakhor, 'Stakeholders Model of Governance in Islamic Economic System' (2004) 11 *Islamic Economic Studies* 43, 47.

expense of society and the firm's financial claimants'.[863] As a solution, Jensen has suggested the theory of Enlightened Value Maximisation (EVM) that equates the collected interests of the various stakeholders with the long term market value of the firm.[864] This addresses the problems of excessive risk taking aimed at maximising short term profits regardless of the risk to the long term viability of the corporation. It still, however, maintains an essentially capitalist focus on profit, with value measured entirely in financial terms.

4.3.2.3 The stewardship model

Grounded in more rounded views of human agents as imperfectly rational decision-makers subject to a wide range of motivations and capable of unselfish action, the stewardship model has been developed as a further alternative.[865] These motivations, which extend beyond the financial self-interest of agency theory, include, the personal satisfaction that comes from responsibility, from meeting the challenges of demanding work, and from peer recognition and the appreciation of superiors.[866] Thus, stewardship theory runs counter to the agency theory that grounds the classical approach to corporate governance. Rather than conceptualising the manager as a wholly self-interested agent who requires constraint through governance to guide him or her to act in the interests of the corporation, stewardship theory argues that the manager will act in the interests of the corporation if the organisational structure is designed to facilitate 'effective action'.[867]

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[863] Michael C Jensen, 'Value Maximisation, Stakeholder Theory, and the Corporate Objective Function' (2001) 7 *European Financial Management* 297, 305.
[864] Michael C Jensen, 'Value Maximisation, Stakeholder Theory, and the Corporate Objective Function' (2001) 7 *European Financial Management* 297.
[865] James A McConvill, 'Reflections on the Regulation of Contemporary Corporate Governance' (2006) 2 *The Corporate Governance Law Review* 1, 28.
[866] Lex Donaldson, James H Davis, 'Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns' (1991) 16 *Australian Journal of Management* 49, 51.
[867] *Ibid*, 50.

4.3.2.4 Shareholder or stakeholder, agent or steward: model approaches and institutional logics

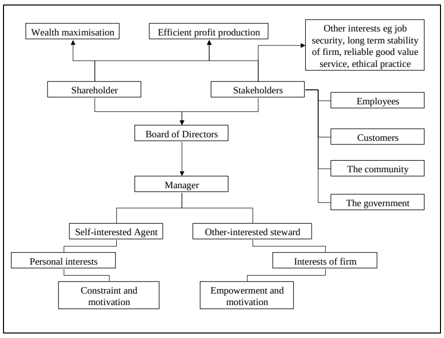

Figure 12: Corporate Governance

It should be noted that stewardship and agency theories provide alternative approaches to the way in which managers behave while shareholder, stakeholder, TCE and EVM models focus on whose interests matter. These are different regulatory axes that allow for a number of different combinations (see figure 12). Thus, the shareholder model, while traditionally associated with agency theory could alternatively be combined with stewardship theory This latter combination would still treat the shareholders' interests reflected through the share value as the driver for governance, but the governance structure would be based on stewardship theory and designed to facilitate effective action rather than constrain self-interested behaviour. A further alternative, taking a dialectic approach to the two behavioural theories, would be to acknowledge that there is truth in both agency and stewardship theories.[868] It would then follow that a combined approach might be the most appropriate, with governance structures organised to facilitate effective action while also maintaining a balance that constrains excessively self-interested behaviour that would harm the relevant interests, whether shareholder or stakeholder.

These different combinations would be consistent with, and may reflect, differing ideological institutional logics. The most paradigmatic neoliberal capitalist combination would be the shareholder model grounded in agency theory, while the most social combination would be a stakeholder model grounded in stewardship or mixed agency-stewardship theory. As Roe suggests, liberal economies tend to favour diffusely owned corporations with a shareholder model of corporate governance while more socially oriented politics favours concentrated or family owned firms and stakeholder approaches.[869] The purity of these distinctions. however, has been muddied by the isomorphic effect of global competition and the pre-financial crisis success of neoliberal capitalism resulting in a global trend towards a prioritisation of shareholder interests.[870]

To some extent the choice of model may also be influenced by the logics of the legal system. Thus, it has been observed that the common law system of the UK and US, which afford greater protection to the minority shareholders and so encourage investment, tend towards a shareholder model. In contrast, civil law systems have tended to encourage the persistence of family owned businesses and a stakeholder

[868] Lex Donaldson, James H Davis, 'Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns' (1991) 12 Australian Journal of Management 49, 60.
[869] Mark J Roe, 'Introduction' in Mark J Roe (ed) Corporate governance: Political and Legal Perspectives (Elgar 2005) 1, 1-6.
[870] Paddy Ireland, 'Shareholder Primacy and the Distribution of Wealth' (2005) 68 *Modern Law Review* 49, 50-51.

model.[871] It is interesting then, that the current UK code 'has its roots in and resonance with agency theory ... but its logic arises and evolves through a broader concept of accountability'.[872] Given that the main Code is also supported by the Stewardship Code, this suggests that the UK has, at least partly, shifted its regulatory approach from one grounded in the neoliberal capitalist conception of the manager as self-interested agent to a more social or relational conception of the manger as a steward.

The failure of regulatory and corporate governance mechanisms that contributed to the 2007 global financial crisis question the rationality of governance structures organised on the basis of agency theory. The response to the flawed individualism of agency theory is to argue for a more socially situated conception of the agent. This conception of the manager as a socially situated agent requires a deeper understanding of the influence of the manager's social context than is demanded by agency theory.[873] This highlights the relevance of the institutional logics, its norms and behavioural scripts that culturally embed the social agent. Thus, in determining the appropriate organisation of governance structures and processes, it is necessary to understand the main institutional influences that will affect the manager's behaviour. It should, however, be remembered that an established system of governance will itself provide institutional logics that may reinforce, conflict with, or constrain those other influences.[874]

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[871] R La Porta, F Lopez-de-Silanes, A Shleifer, R Vishny, 'Corporate Ownership Around the World' (1999) 54 *Journal of Finance* 471; Christine A Mallin, *Corporate Governance* (4th ed, Oxford University Press 2013), 17-18.
[872] Donald Nordberg, Terry McNulty, 'Creating better boards through codification: Possibilities and limitations in UK corporate governance, 1992-2010' (2013) 55 *Business History* 348, 356.
[873] James D Westaphal, Edward J Zajac, 'A Behavioral Theory of Corporate Governance: Explicating the Mechanisms of Socially Situated and Socially Constituted Agency' (2013) 7 *The Academy of Management Annals* 607, 610.
[874] *Ibid*, 634.

Corporate governance is ideologically value laden and its effectiveness will depend on understanding how its logics will interact with the logics of other coexisting institutions. For example, a neoliberal capitalist system of corporate governance will only serve to reinforce the norms and scripts of the neoliberal capitalism that itself gave birth to the very system intended to govern it. This, however, is complicated by the phenomenon of 'symbolic decoupling', through which managers give the impression of adopting governance policies that are consistent with institutional logics, but then do not implement those policies on practice.[875] This practice of symbolic governance has implications for the risk of *Sharia* non-compliance and would be consistent with the focus on compliance in form, while being less concerned with a lack of conformity in spirit. This issue was discussed in chapter three and it was suggested that it was a consequence of the competitive isomorphism of neoliberal capitalism interacting with the obligation to ensure that Islamic financial products are *Sharia* compliant. Given the potential for interaction between the institutional norms, the danger is that an inappropriate form of corporate governance may tend to reinforce the focus on form.

4.3.2.5 Western corporate governance: variations on a theme

The preceding analysis of western approaches to corporate governance suggests that they are essentially variations on a theme. The distinctions are built on different conceptions of agency and its social context, but all are predicated on an essentially capitalist notion that value is measured in financial terms.[876] Consider Jensen's EVM,

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[875] *Ibid*, 646.
[876] As Cernat notes, the concern of much research into western corporate governance is focused on the 'competitive advantage' provided by a particular system: Lucian Cernat, 'The emerging European corporate governance model: Anglo Saxon, Continental, or still the century of diversity?' (2004) 11 *Journal of European Public Policy* 147.

which was designed to resolve the problem of measuring performance under a stakeholder approach. Jensen argued that it is impossible to have multiple objectives and expect managers to make rational decisions, but this is predicated on the view that each objective should be maximally determined with no guidance for how to trade off one value against another.[877] Jensen further argued that long term market value can account for all the benefits and detriments that must be taken into account to produce a single objective that allows for rational decision-making. This treats all values as measurable in financial terms and it relies on the *homo economicus* conception of the agent as a perfectly rational decision maker. As discussed previously, however, human agents are imperfectly rational and, beyond the boundaries of capitalist discourse, not all values are reducible to money.

If Jensen's EVM model were to be applied in the context of Islamic Finance then *Sharia* compliance would simply be a function of the long term value of the firm. The economically rational answer would be that, if *Sharia* compliant products do not maximise value then they should be abandoned. Given that *Sharia* compliance is non-negotiable, however, then where compliance is financially inefficient the bank is under pressure to innovate more financially competitive products. This creates a competitive isomorphic pressure to mimic conventional financial products that results in financial products that are *Sharia* compliant in form but not spirit. EVM would provide a viable approach if Islamic banks were only competing with other Islamic banks, but it fails to account for the non-financial value of *Sharia* compliance that is exposed through competition with conventional banks. If EVM or other

[877] Michael C Jensen, 'Value Maximisation, Stakeholder Theory, and the Corporate Objective Function' (2001) 7 *European Financial Management* 297, 300-301.

western models of corporate governance are to be applied to Islamic finance, then they must be sensitive to context and in particular the *Maqasid al-Sharia*.

4.4 Islamic finance, corporate governance and the risk of *Sharia* non-compliance

4.4.1 An Islamic perspective on corporate governance

(see figure 13)

While profit maximisation and the long term value of the firm provide the goals for western corporate governance, from an Islamic perspective these should, but do not necessarily, take second place to the 'ultimate goal' of the *Maqasid al-Sharia*.[878] Hasan notes that, in practice, Islamic firms tend to rely on a shareholder approach, but argues that a modified stakeholder model based on *Tawhid*, *khilafah* (vicegerency) and s*hura* (consultation) may be more appropriate to the Islamic context.[879] Within this approach, he highlights that stakeholders 'as vicegerent[s] of Allah have [a] fiduciary duty to uphold the principles of distributive justice via the *Shuratic* process'.[880]

Abu-Tapanjeh argues that Islamic corporate governance should take a principle based approach characterised by the 'ethical norms and social commitments' of the *Sharia*.[881] He also highlights the importance of *shura* engaging all affected stakeholders and the role of the Muslim property owner as a vicegerent for Allah

[878] Zulkifli Hasan, 'Corporate Governance: Western and Islamic Perspectives' (2009) 5 *International Review of Business Research Papers* 277, 279.
[879] Zulkifli Hasan, Shari'ah Governance in Islamic Banks (Edinburgh University Press 2012), 32-39
[880] Zulkifli Hasan, 'Corporate Governance: Western and Islamic Perspectives' (2009) 5 *International Review of Business Research Papers* 277, 284.
[881] Abdussalam Mahmoud Abu-Tapanjeh, 'Corporate governance from the Islamic perspective: A comparative analysis with the OECD principles' (2009) 20 *Critical Perspectives on Accounting* 556, 557.

establishing an obligation to use the property not solely for personal gain and profit but with a view to social justice and ultimate accountability to Allah.[882]

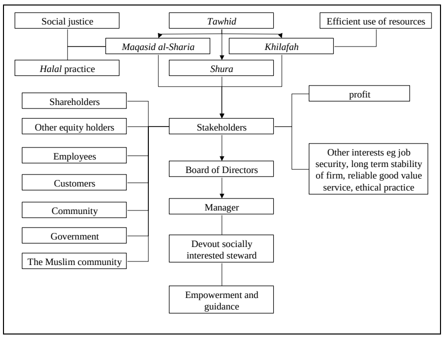

Figure 13: Islamic Corporate Governance

A similar approach is taken by Choudhury and Hoque, who argue that the framework of Islamic corporate governance should be built on four principles: implementation of the *Tawhid* through *shura*; the goal of 'justice as balance and fairness'; the goal of 'productive engagement of resources in social and economic activities'; and the iterative interaction of the first three principles.[883] The aim is to engage the corporation with the context of its social environment and balance the paired goals of profit with social justice and participation, and the productive use of resources with the avoidance of waste. They suggest that through an effective implementation of

[882] *Ibid*, 561-562.
[883] Masadul Alam Choudhury, Mohammad Ziaul Hoque, 'Corporate governance in Islamic perspective' (2006) 6 *Corporate Governance* 116, 123.

these principles as a system of corporate governance, Islamic financial institutions can approach the Islamic ideal by engaging all stakeholders in the process of *shura* that enables learning through an evolutionary process of consultation and discussion. This ideal is grounded in the cooperative nature of the Muslim community and sees social well-being and private shareholder wealth as a complementary balance of mutual stakeholder interests rather than as a competitive conflict of interests.[884]

Consistent with Cadbury's definition of corporate governance (see above and chapter one) and in the language of western corporate governance models, the Islamic perspective prefers a stakeholder model that recognises a wide range of stakeholders, including not just the shareholders, managers, employees and depositors, but also the whole Muslim community.[885] Central to this model is the need to actively engage all stakeholders, whether directly or through representation, in the process of *shura*.[886] The importance of *shura* to Islam is reflected in verse 38 of chapter 42 (*Al-Shura*) of the Holy Qu'ran, which praises those:

> ... whose affairs are (decided) by counsel among themselves ...

Although Islam acknowledges free will, albeit constrained by the commitment to Allah, the Islamic governance ideal relies on a stewardship, rather than on an agency, understanding of managerial behavioural roles.[887] This approach is consistent with, and follows from, the Islamic approach to property, which holds that Allah is the

[884] *Ibid*, 125-126.
[885] Reflecting the emphasis on social justice in Islam and embedding corporate social responsibility in corporate governance: Issa Al Mansour, 'Corporate governance in global Islamic Financial Institutions' (2015) 3 *International Journal of Education and Research* 125,133.
[886] Mervyn K Lewis, 'Islamic Corporate Governance' (2005) 9 *Review of Islamic Economics* 5, 15-16.
[887] Ishaq Bhatti, Maria Bhatti, 'Development of legal issues of corporate governance for Islamic banking' in Mohamed Ariff, Munawar Iqbal (eds) *The Foundations of Islamic Banking: Theory, Practice and Education* (Edward Elgar 2011) 87, 90; Maliah Dulaiman, Norakma Abd Majid, Noraini Mohd Arifin, 'Corporate Governance of Islamic Financial Institutions in Malaysia (2015) 8 *Asian Journal of Business and Accounting* 65, 76.

ultimate owner with human beings acting as trustees.[888] This trustee model of property ownership also explains why all members of the Islamic community are stakeholders in Islamic corporations. If all property is held on trust for Allah, then all Muslims have an interest in ensuring that the trust is not abused and that the property is used wisely and consistently with *Sharia*. While Islam allows and encourages private ownership and use of property, this must not infringe the rights of all Muslims to benefit, whether individually or collectively, from the resources provided by Allah.[889]

Theoretically, then, all Muslims are stakeholders in any Islamic business, including Islamic financial organisations. It would, however, be wholly impractical to engage all such stakeholders in the process of *shura*, although their interests that might be affected by the firm's activity should nevertheless be considered by the firm's managers. In practice this imposes an obligation on the managers to ensure that the firm's activities are *Sharia* compliant, on the firm's owners to ensure that the managers fulfil their obligation, and on Islamic governments to ensure that both of these respective obligations are fulfilled.[890]

4.4.2 *Sharia* governance

(see figure 14)

While the Islamic ideal of corporate governance may be framed in the terms used to define western models of corporate governance, the key feature that distinguishes it is the need to ensure compliance with *Sharia*. A failure to comply with *Sharia* may

[888] Holy Qu'ran, chapter 3, verse 189, English translation of the *Qu'ran* by Maulana Muhammad Ali (2002); Siraj Sait, Hilary Lim, *Land, Law & Islam: Property & Human Rights in the Muslim World* (Zed Books 2006), 14.
[889] Zamir Iqbal, Abbas Mirakhor, 'Stakeholders Model of Governance in Islamic Economic System' (2004) 11 *Islamic Economic Studies* 43, 50-51.
[890] *Ibid*, 58-59.

damage the relationship of trust between an Islamic bank and its investors and depositors. This in turn could lead to a loss of confidence and damage the reputation of the bank and possibly the Islamic finance industry as a whole.[891] These *Sharia* and reputational risks emphasise the importance of instituting a strong system of corporate governance that is capable of ensuring *Sharia* compliance, both in form and particularly in spirit.[892] This requires an Islamic approach to corporate governance that can manage both the technical requirements of *Sharia* and its ethical demands. As such it must reject the self-interested approach of agency theory and ground itself in the foundations of wider social interests. It should recognise that all property owners are Allah's stewards, holding the property in trust for the benefit of all Muslims.[893] This raises the question of how an Islamic model of corporate governance could be implemented, especially in non-Muslim countries.[894]

One option could be to base Islamic corporate governance on the institution of *hisbah*. This is a traditional form of Islamic governance, established under the Abbasids (750CE), that ensured 'all community affairs and market behaviour was conducted according to *Shari'ah* law'.[895] Functioning along the lines of an ombudsman, the institution of *hisbah* provides a social framework for monitoring corporate behaviour, 'empower[ing] individual Muslims ... by giving them a platform

[891] Wafik Grais, Matteo Pellegrini, 'Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services' (2006) World Bank Policy Research Working Paper 4054, 2.
[892] Hennie Van Greuning, Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank 2008), 181.
[893] Mervyn K Lewis, 'Islamic Corporate Governance' (2005) 9 *Review of Islamic Economics* 5, 14.
[894] Zulkifli Hasan, 'Corporate Governance: Western and Islamic Perspectives' (2009) 5 *International Review of Business Research Papers* 277, 287.
[895] Ishaq Bhatti, Maria Bhatti, 'Development of legal issues of corporate governance for Islamic banking' in Mohamed Ariff, Munawar Iqbal (eds) *The Foundations of Islamic Banking: Theory, Practice and Education* (Edward Elgar 2011) 87, 91.

for social action'.[896] It affords the opportunity for the community, as stakeholders, to engage directly with corporate governance and accountability. As Lewis comments, *hisbah* 'is a long-standing tradition of Islamic society that can be seen to represent a core element of Islamic corporate governance'. He goes on, however, to note the problem of reviving *hisbah* in its traditional form.[897]

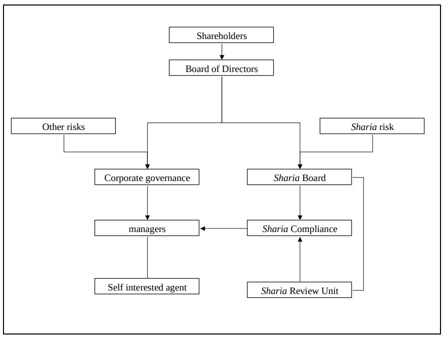

Figure 14: *Sharia* Governance

Rather than relying on *hisbah*, Islamic financial institutions have instead developed the *Sharia* board as a means of providing *Sharia* governance.[898] The widespread, although not universal, adoption of *Sharia* boards structurally distinguishes Islamic

[896] Abdussalam Mahmoud Abu-Tapanjeh, 'Corporate governance from the Islamic perspective: A comparative analysis with the OECD principles' (2009) 20 *Critical Perspectives on Accounting* 556, 564.
[897] Mervyn K Lewis, 'Islamic Corporate Governance' (2005) 9 *Review of Islamic Economics* 5, 17.
[898] Rather than have their own internal *Sharia* board, some firms rely on the advice of private *Sharia* advisory services.

corporate governance from conventional corporate governance, which is largely centred on the role of the board of directors.[899] Although the AAOIFI standard is for *Sharia* boards to be independent and appointed by shareholders,[900] they tend to be appointed by the board of directors. Usually constituted by 3-6 members, the core of the board will be Islamic scholars with expertise in *fiqh al-muamalat* (Islamic commercial law), but these jurists may be assisted by other members having a differing expertise in Islamic finance.[901] Their role in ensuring *Sharia* compliance involves: pre-certification assistance with product design;[902] *fatwas* that certify those products and services that, in the opinion of the board, are *Sharia* compliant; *fatwas* that verify compliance (ex post); the determination of *Zakat*; the provision of advice on the disposal of earnings that were not *Sharia* compliant; and advising on a fair distribution of income and expenses amongst the bank's equity holders (shareholders and investment account holders).[903] These functions are supplemented by *Sharia* Review Units,[904] which play a secondary role monitoring the firm's activity to ensure compliance with the *Sharia* board's *fatwas*. *Sharia* boards are also expected to publish an annual report of their activities.[905]

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[899] Sulaiman Abdullah Saif Alnasser, Joriah Muhammed, 'Introduction to corporate governance from Islamic perspective' (2012) 28 *Humanomics* 220, 222-223.
[900] AAOIFI, Governance Standards for Islamic Financial Institutions (1999, 2008).
[901] Bashar H Malkawi, 'A Bright Future: Towards an Enhanced Shariah Supervision in Islamic Finance' (Feb-March 2014) *The European Financial Review* 14, 14-15.
[902] Hichem Hamza, 'Sharia governance in Islamic banks: effectiveness and supervision model' (2013) 6 *International Journal of Islamic and Middle Eastern Finance and Management* 226, 228.
[903] Wafik Grais, Matteo Pellegrini, 'Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services' (2006) World Bank Policy Research Working Paper 4054, 4.
[904] Sulaiman Abdullah Saif Alnasser, Joriah Muhammed, 'Introduction to corporate governance from Islamic perspective' (2012) 28 *Humanomics* 220, 225.
[905] Bashar H Malkawi, 'A Bright Future: Towards an Enhanced Shariah Supervision in Islamic Finance' (Feb-March 2014) *The European Financial Review* 14, 16.

These *Sharia* boards, whose precise responsibilities vary from bank to bank, complement the internal corporate governance of Islamic banks.[906] Although *Sharia* boards are part of the corporate governance structure within a firm, they also raise five particular governance issues,[907] some of which were highlighted by the failure of BCCI to comply with *Sharia* principles by investing deposits made by Islamic financial firms in commodity contracts.[908] First, because the boards are employed by the banks there is a potential conflict of interest caused by a financial dependence on the bank whose interest in profit may clash with the board's duty to ensure *Sharia* compliance. Profit motivated managers 'may be tempted to use their leverage to influence [Sharia board] members' to be generous in their assessment of *Sharia* compliance.[909] This potential conflict is lessened by the high moral standard of the respected Islamic scholars who sit on the board. This, however, is in turn counteracted by the legalistic focus of *Sharia* scholars and the possibility that the board member may well have been involved in the design of the product being assessed.[910]

While the potential for a conflict of interest between the individual bank and scholar may be further lessened by the independence of the many scholars who sit on multiple boards,[911] this practice tends to favour the minority of top scholars and

[906] Bedj Bedj Toufik. 'The Role of Shari'ah Supervisory Board in Ensuring Good Corporate Governance Practice in Islamic Banks' (2015) 2 *International Journal of Contemporary Applied Sciences* 109.
[907] Hennie Van Greuning, Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank 2008), 189-191; Wafik Grais, Matteo Pellegrini, 'Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services' (2006) World Bank Policy Research Working Paper 4054, 5.
[908] Abdurrahman Raden Aji Haqqi, 'Shariah Governance in Islamic Financial Institution: An Appraisal' (2014) 11 *US-China Law Review* 112, 122.
[909] Wafik Grais, Matteo Pellegrini, 'Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services' (2006) World Bank Policy Research Working Paper 4054, 5.
[910] Volker Nienhaus, 'Islamic Finance Ethics and Shari'ah Law in the Aftermath of the Crisis: Concept and Practice of Shari'ah Compliant Finance' (2011) 18 *Ethical Perspectives* 591, 609-610.
[911] Ünal documents that the top 20 scholars each sit on upwards of 14 boards, with the top 2 scholars sitting on 85. It is hard to see how they are able to provide much beyond symbolic value to their

'raises serious doubts as to whether sufficient time and attention can be allocated to all institutions'.[912] Furthermore, because a relatively small number of elite scholars sit on multiple boards they create a transnational network with the '"power" to set and influence Shari'a standards for the firms and regulatory bodies to which they lend their services'. This transnational network allows firms to gain an important advantage from a close relationship with an elite scholar who can help them to 'feel the pulse of the [Islamic Finance Services] industry, allowing for careful (re)positioning and innovation in a sector that is based on both religious credibility and financial efficiency'.[913] Such a relationship of mutual dependence must at least raise questions regarding the impact of any conflict of interests.

There is empirical evidence that a conflict of interests is significant in at least some contexts,[914] suggesting that the issue is more than simply theoretical. Both the AAOIFI and the Islamic Financial Services Board (IFSB) standards stress that *Sharia* boards should be independent,[915] but it is hard to see how this can be fully realised while they are appointed and remunerated by the individual banks.[916] The lack of independence is compounded by the nature of the relationship between *Sharia* boards and the board of directors. This tends to be a relationship of advice rather than obligation, with the board of director's retaining ultimate responsibility for *Sharia*

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employers: Murat Ünal, 'The Small World of Islamic Finance: Sharia Scholars and Governance - A Network analytic Perspective' (Funds@Work 2011) Report from the Center of Islamic Economics and Finance , 12 <http://www.funds-at-work.com/intelligence/introduction.html> accessed 13 August 2015.

[912] Volker Nienhaus, 'Islamic Finance Ethics and Shari'ah Law in the Aftermath of the Crisis: Concept and Practice of Shari'ah Compliant Finance' (2011) 18 *Ethical Perspectives* 591, 610.

[913] David Bassens, Ben Derudder, Frank Witlox, 'Setting Shari'a standards: On the role, power and spatialities of interlocking Shari'a boards in Islamic financial services' (2011) 42 *Geoforum* 94, 98.

[914] Samy Nathan Garas, 'The conflicts of interest inside the Shari'a supervisory board' (2012) 5 *International Journal of Islamic and Middle Eastern Finance and Management* 88.

[915] AAOIFI, Governance Standards for Islamic Financial Institutions (1999, 2008); IFSB, *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services* (2009), principle 3.1.

[916] Hichem Hamza, 'Sharia governance in Islamic banks: effectiveness and supervision model' (2013) 6 *International Journal of Islamic and Middle Eastern Finance and Management* 226, 229.

compliance.[917] This is not to suggest that their role regarding *Sharia* compliance is superfluous as their guidance and supervision is important, but they may be insufficient in the absence of central regulation. This issue will be considered further in chapter six.

The practice of sitting on multiple boards creates the second issue, which is the access that *Sharia* board members have to confidential information from different competing banks. The third issue is the need for a range of competencies, including Islamic law, finance, commercial banking and accountancy. This has resulted in a relatively small bank of scholars capable of sitting on *Sharia* boards, with the consequence that they may be over stretched by their commitments and unable to focus on more than formal legal compliance. It should also be noted that the top scholars may sit not just on the *Sharia* boards of commercial Islamic banks, but also on the regulatory Central *Sharia* Boards, or be involved in the Islamic rating agencies, exacerbating the potential for a conflict of interests as discussed above.[918]

The fourth issue, which is the central concern of this thesis, is the problem of ensuring consistency of Sharia rulings. Van Greuning and Iqbal comment on a survey that found a 90% consistency and suggest that:

> the diversity of opinion is less widespread than expected. Nevertheless, as the industry expands, the number of conflicting

[917] Alejandro Lopez Mejia, Suliman Aljabrin, Rachid awad, Mohamed Norat, Inwon Song, 'Regulation and Supervision of Islamic Banks' (2014) IMF Working Paper WP/14/219, 15.
[918] Volker Nienhaus, 'Islamic Finance Ethics and Shari'ah Law in the Aftermath of the Crisis: Concept and Practice of Shari'ah Compliant Finance' (2011) 18 *Ethical Perspectives* 591, 611.

> rulings ... is likely to grow if no efforts are made to harmonize the standards.[919]

More recently, a comparative survey of Malaysia with Gulf Co-operation Council (GCC) countries found a higher level of disagreement with only 21.4% similarity between *fatwas*, while 54.3% of *fatwas* on the Islamic capital market were different (24.3% were unidentified).[920] This may, at least partly, be due to a decentralised approach and regional variations on the approach to applying the *Sharia*. Individuals and regions that have a conservative approach to Islam are likely to be more rigid than those with a liberal attitude.[921] Other commentators also point to the lack of standardisation of *fatwas* certifying financial products as *Sharia* compliant and the impact that this may have on the credibility of Islamic finance.[922]

The final governance issue is the transparency of *Sharia* boards.[923] This is required to avoid the problem of *gharar* and also serves to both facilitate external governance and maintain public confidence.[924] The problem was recognised by the IFSB, which criticised *Sharia* boards for issuing opaque technical *fatwas* that make it difficult for the judgments of *Sharia* compliance to be assessed by others.[925]

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[919] Hennie Van Greuning, Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank 2008), 190.
[920] Amir Shaharuddin, Muhammad Aunurochim Mas'ad, Yasmin Hanani Mohd Safian, Zurina Shafii, Ahmad Zaki Salleh, Mohammad Haji Alias, Junaidah Abu Seman, Mohammad Akram Laldin, Mohamed Fairooz Abdul Khir, 'Fatwas on Islamic Capital Markets: a Comparative Study Between Malaysia and Gulf Co-operation Council (GCC) Countries' (2012) ISRA Research Paper No 40/2012, 32-33.
[921] Hichem Hamza, 'Sharia governance in Islamic banks: effectiveness and supervision model' (2013) 6 *International Journal of Islamic and Middle Eastern Finance and Management* 226, 230.
[922] Murat Yoluker, 'Current challenges of Islamic Finance' (21 September 2011) *Islamic Finance News* 24, 25.
[923] Maliah Dulaiman, Norakma Abd Majid, Noraini Mohd Arifin, 'Corporate Governance of Islamic Financial Institutions in Malaysia (2015) 8 *Asian Journal of Business and Accounting* 65, 90.
[924] Wafik Grais, Matteo Pellegrini, 'Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services' (2006) World Bank Policy Research Working Paper 4054, 7.
[925] IFSB, *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services* (2009), para 59.

In many countries, such as the UK and the KSA, *Sharia* governance is left to the individual organisations as a form of self-regulation.[926] In other countries, including Malaysia, Kuwait and Pakistan, the individual *Sharia* boards are subject to external regulation. They may also be governed by a central *Sharia* board or authority.[927] Furthermore, international bodies such as the AAOIFI and the IFSB provide guidelines and standards,[928] although these are not legally binding and compliance is a noted issue.[929] *Sharia* governance is also supported by "Islamic rating", such as that carried out by the International Islamic Rating Agency. This body utilises the 'Fiduciary Ratings concept', which takes an approach built on the two pillars of financial strength and governance, including a separate rating for *Sharia* governance based on the standards set down by the IFSB and the AAOIFI.[930] Thus, while the IFSB and AAOIFI standards and guidelines are not legally binding, a failure to implement them may adversely affect the firm's Islamic rating, which might in turn make the bank a less attractive option for Muslim investors and depositors.

As a final point regarding the general approach to *Sharia* governance, it is worth noting that: 'For the most part, the corporate governance arrangements of Islamic banks are modeled along the lines of a conventional shareholder corporation'.[931] This may create a conflict of interest between shareholders and the PLS investment

[926] Aznan Hasan, Ruslan Sabirzyanov, 'Optimal Shari'ah Governance Model In Islamic Finance Regulation' (2015) 3 *International Journal of Education and Research* 243, 245.
[927] Hennie Van Greuning, Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank 2008), 188.
[928] Zulkifli Hasan, Shari'ah Governance in Islamic Banks (Edinburgh University Press 2012), 67-74.
[929] Mahmood Ahmed, Makasuda Khatun, 'The Compliance with Sharia Governance System of AAOIFI: A Study on Islamic Banks Bangladesh' (2013) 9 *Journal of Islamic Economics, Banking and Finance* 177.
[930] Sabeen Saleem, 'The Islamic International Rating Agency (IIRA) - A New Perspective' (2013) Q1 *Islamic Corporation for the Development of the Private Sector Bulletin* 6, 6-8. See also the Agency's website: <http://www.iirating.com/> accessed 30 July 2015.
[931] Hennie Van Greuning, Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank 2008), 184.

account holders, who through their deposits acquire an equity interest in the bank.[932] More importantly for this thesis, it reflects a tendency to '[tailor] conventional banking regulations for [Islamic banking] activities'.[933] This has resulted in a governance structure in which *Sharia* governance is implemented as a connected, but distinct system that operates in parallel to a western system of corporate governance. It is western corporate governance plus *Sharia* governance, rather than an integrated system of Islamic corporate governance. This approach creates the danger that having a distinct *Sharia* board serves to distinguish, rather than to integrate, *Sharia* issues from other corporate governance matters. As such it may widen rather than narrow the gap that has been identified between the motivations of managers and those of *Sharia* scholars. In other words, it may exacerbate the conflict between the objectives of management and the objectives of the *Sharia* board.[934]

4.4.3 *Sharia* governance structure and the competing institutional logics of Islam and capitalism

Like conventional banks, Islamic banks are profit motivated, Unlike conventional banks, however, they are subject to the *Sharia*. Although the *Sharia* does not lie in direct opposition to profit as a driving force, the message of Islam transmitted through the *Sharia* is one of moderation, a concern for others and social justice rather than, greed, self-interest and justice as individual entitlement. Consistent with this, *Sharia* imposes a number of technical constraints, such as the prohibition of *riba*, the emphasis on PLS and the need for financing to be connected to assets and the real economy (see chapter three). The problem is that the influence of capitalism and the

[932] Simon Archer, Rifaat Ahmed Abdel Karim, 'Corporate governance, market discipline and regulation if Islamic banks' (2006) 27 *Company Lawyer* 134, 135.
[933] Alejandro Lopez Mejia, Suliman Aljabrin, Rachid Awad, Mohamed Norat, Inwon Song, 'Regulation and Supervision of Islamic Banks' (2014) IMF Working Paper WP/14/219, 16.
[934] Shakir Ullah, Ian A Harwood, Dima Jamali, '"Fatwa Repositioning": The Hidden Struggle for Shari'a Compliance Within Islamic Financial Institutions' (2016) *Journal of Business Ethics*, doi:10.1007/s10551-016-3090-1.

pressure of commercial competition have resulted in an approach to *Sharia* compliance that means the risk-sharing PLS products have, at least on the asset side, become overshadowed as Islamic financial products have tended to mimic conventional counterparts with *Sharia* compliance focusing on form rather than spirit.[935]

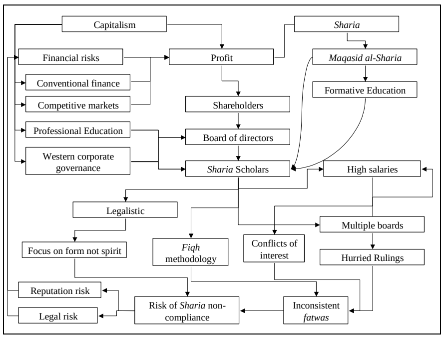

Figure 15: An Institutional View of *Sharia* Governance

[935] Alejandro Lopez Mejia, Suliman Aljabrin, Rachid Awad, Mohamed Norat, Inwon Song, 'Regulation and Supervision of Islamic Banks' (2014) IMF Working Paper WP/14/219, 6-7.

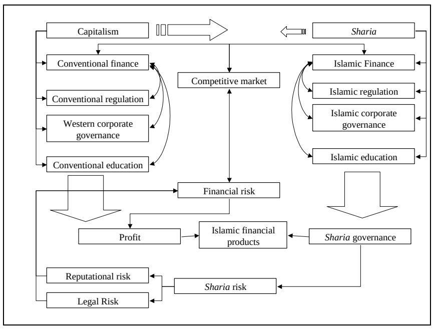

Figure 16: Institutional Influences on *Sharia* Governance

From an institutional perspective, as already noted, Islamic finance operates at the intersection between the two core institutions of Islam and capitalism (See figures 15 and 16). This exposes the professionals working in the field to the competing logics of profit maximisation and the *Maqasid al-Sharia*. *Sharia* compliance must be assured within a competitive commercial environment that prioritises money as a value and wealth as a goal. This exerts a pressure on the Islamic finance professionals to create products that mimic conventional finance while being formally consistent with the technical requirements of *Sharia*. This is more likely to occur in environments that take a relatively liberal approach to Islam, than in more conservative communities, encouraging diverse and sometimes inconsistent *Sharia*-compliance *fatwas*,[936] which is facilitated by the pluralistic approach to Islamic

[936] David Bassens, Ben Derudder, Frank Witlox, 'Setting Shari'a standards: On the role, power and spatialities of interlocking Shari'a boards in Islamic financial services' (2011) 42 *Geoforum* 94, 97.

jurisprudence and the legalistic focus of the *Sharia* scholars that sit on *Sharia* boards. Furthermore, the structural approach to *Sharia* governance simply adds an extra component to conventional governance rather than providing a genuinely Islamic model. This mirrors the development of Islamic finance more generally, in that Islamic finance is conventional finance modified to be *Sharia* consistent. Given this approach, in a global competitive capitalist environment, it is perhaps unsurprising that *Sharia* compliance has become a matter of form over substance, with Islamic financial products mimicking those of conventional finance and Sharia scholars acting as technical legal advisors rather than as 'guardians of business ethics'.[937]

The primary goal of *Sharia* governance is to counter the risk of *Sharia* non-compliance, ensuring that Islamic financial products and services are at least *halal*. Beyond this, *Sharia* governance should further aim for financial products and services that are not simply permissible, but approach the Islamic aspirational ideal. This requires a governance model that facilitates an appropriate stewardship of the resources held on trust for Allah to provide products and services that balance profit with social justice, while avoiding *riba*, *gharar* and *maysir*. Islamic finance must operate in a global commercial environment dominated by a liberal capitalist ideology modelled on self-interested, hyper-rational, agents. The behavioural norms and scripts of this form of capitalism emphasise the value of money and create a competitive goal of profit maximisation that requires agents to strive for ever increasing profit margins. Successful risk-taking behaviour is legitimised through financial and other rewards, while the agents remain relatively shielded from unsuccessful risk-taking since the risks are faced by investors and bonus payments

[937] Volker Nienhaus, 'Islamic Finance Ethics and Shari'ah Law in the Aftermath of the Crisis: Concept and Practice of Shari'ah Compliant Finance' (2011) 18 *Ethical Perspectives* 591.

will usually still be made. As was shown by the events surrounding the US sub-prime mortgage crash, it is only in the face of a crisis that these logics will be revisited, and even then they show a remarkable resilience.

In managing the risk of *Sharia* non-compliance, *Sharia* governance has tended to take a narrow legalistic approach that prioritises form over substance and treats the *Sharia* risk as largely independent of the financial risks,[938] which tend to be managed by an Anglo-American shareholder model of corporate governance operating in parallel to the *Sharia* board. This approach tends to ignore, and even facilitate, the norms and scripts of capitalism and conventional finance. From the Islamic perspective, the constraint on the logics conflicting with *Sharia* are essentially technical. If, however, Islamic finance is to forge a coherent Islamic identity that is consistent with *Sharia* in both form and substance then it must go beyond the purely technical and counter the conflicting institutional logics of capitalism and conventional finance. These conflicting logics include: self-interest; wealth maximisation (greed and hoarding); risk-taking that resembles the gambling 'symboli[c] of late capitalism';[939] shifting risk to the investor; the acceptability of interest and capital creation divorced from the "real" economy. To counter these logics, *Sharia* governance should operate as part of a fully integrated system of Islamic corporate governance. In other words, the best way to counter the conflicting logics of capitalism and conventional finance is to fully embed the logics of *Sharia* as a core structural and ideological institution of Islamic finance. The aim should be

[938] The financial risks, such as credit risk, liquidity risk and displaced commercial risk, increase the pressure on the Islamic financial professionals to design products and services with higher profit margins. This encourages creative design, which has tended to rely on mimicking conventional financial products so increasing the risk of *Sharia* non-compliance.
[939] The rise of state-sanctioned gambling accompanied the rise of neo-liberal capitalism and a move away from an ethic of 'hard work, thrift and savings' to one in which money is its own reward: Martin Young, 'Gambling, capitalism and the state: towards a new dialectic of the risk society?' (2010) 10 *Journal of Consumer Culture* 1, 6.

to create '[strong] intra- and extraorganizational relationships ...[that] can reinforce the influence' of *Sharia* logics, accommodate the capitalist profit motivation in a moderate *Sharia* consistent form and sideline or weaken the inconsistent logics.[940]

To realise the development of a system of *Sharia* governance that functions not merely as a technical constraint, but crucially also as an institution that appropriately influences behaviour through embedded scripts and norms, Islamic finance must address a number of issues. These have already been mentioned as part of the preceding discussion, but it may be helpful to summarise them here, before drawing this chapter to a conclusion. These issues include:

- *The structurally divided approach to corporate governance.*

  Sharia governance tends to be delivered as an addition to a parallel system implementing a western capitalist shareholder governance model that incorporates capitalist and conventional financial norms into Islamic finance. This is facilitated by the general lack of specific regulatory requirements for Islamic banks.[941] It is further compounded by the status of the *Sharia* board and its position within the structure of the firm.[942] As Song et al note:

  > In most cases it seems that ultimate overall responsibility for an Islamic bank's Shariah compliance lies with the Islamic bank's board of directors, which typically delegates the responsibility for day-to-day Shariah compliance to senior management. Senior management is required to ensure Shariah compliance

[940] Marya L Besharov, Wendy K Smith, 'Multiple Institutional Logics in Organizations: Explaining their Varied Nature and Implications' (2014) 39 *Academy of Management Review* 364, 368.
[941] Inwon Song, Carel Oosthuizen, 'Islamic Banking Regulation and Supervision: Survey Results and Challenges' (2014) IMF Working Paper WP/14/220, 16.
[942] Nawal Kasim, Sheila Nu Nu Htay, Sayed Ahmed Salman, 'Empowering the Shari'ah Committee towards Strengthening Shari'ah Governance Practices in Islamic Financial Institutions' (2016) 8 *Review of European Studies* 142, 145-147.

in line with Shariah board guidance, which implies that the relationship of an Islamic bank's Shariah board vis-à-vis the Islamic bank is advisory [although] ... highly respected.[943]

- *The current use of Sharia scholars needs to be reviewed and addressed.*

The issues that must be resolved include: an overly legalistic approach; the potential and actual conflicts of interest that encourage a profit-driven technical compliance rather than ensuring consistency with Islamic philosophy; the membership of multiple boards resulting in excessive workloads and limited time to fully assess compliance except in this superficial legalistic way; the lack of power for banking supervisory authorities to make pronouncements on whether members of the *Sharia* Board or *Sharia* Review units are 'fit and proper' persons for the role since the same standards are often applied uniformly to all banks regardless of whether they are conventional or Islamic.[944]

- *The problem of inconsistent fatwas on Sharia compliance.*

This has a multifactorial origin, including: Islamic *fiqh* methodology; different *Madhabs*; regional variations in religiosity; differing responses to the pressure to certify Islamic financial products and services that can readily compete with conventional finance; and a lack of standardisation of regulation and governance.[945]

- ***The failure to fully implement international standards exacerbating the previous issues.***

[943] Inwon Song, Carel Oosthuizen, 'Islamic Banking Regulation and Supervision: Survey Results and Challenges' (2014) IMF Working Paper WP/14/220, 17.
[944] Inwon Song, Carel Oosthuizen, 'Islamic Banking Regulation and Supervision: Survey Results and Challenges' (2014) IMF Working Paper WP/14/220, 15.
[945] Frederick V Perry, 'The Corporate Governance of Islamic Banks: A Better Way of Doing Business?' (2011) 19 *Michigan State Journal of International Law* 251, 271.

Nienhaus, for example, argues that the concentration of a small group of top scholars holding many of the *Sharia* board seats across multiple companies, the jurisdictional bias of *Sharia* board membership, the lack of transparency, and the triadic roles of *Sharia* scholars as product developers, individual *Sharia* board members and regulatory *Sharia* board members shows that:

> the actual practices of the Islamic finance industry deviate substantially from recommendations and best practice examples put forward by institutions such as AAOIFI, IFSB and Hawkamah.[946]

Song and Oosthuizen also found that Islamic banks may be limited to the same disclosure requirements as conventional banks and not required to formally disclose compliance with *Sharia*. While some jurisdictions required a statement of *Sharia* Compliance, 8 of 22 respondents indicated there was no such requirement.[947] They comment that: 'In order to reduce reputation and legal risk, there would seem to be a need to enhance transparency about the role and composition of Shariah board'.[948]

- *A lack of global standardisation of governance and regulation, which is reflected in inconsistent fatwas and the risk of Sharia non-compliance.*

As Perry explains, the IFSB has accepted the existence of a pluralistic approach to corporate governance, arguing against any hastily adopted and rigid rule-based approach.[949] This lack of standardisation allows a multiplicity of different Islamic products that depend on where one is in the

[946] Volker Nienhaus, 'Islamic Finance Ethics and Shari'ah Law in the Aftermath of the Crisis: Concept and Practice of Shari'ah Compliant Finance' (2011) 18 *Ethical Perspectives* 591, 610-611
[947] Inwon Song, Carel Oosthuizen, 'Islamic Banking Regulation and Supervision: Survey Results and Challenges' (2014) IMF Working Paper WP/14/220, 32.
[948] *Ibid* 35.
[949] IFSB, *Guiding Principles on Corporate Governance For Institutions Offering Only Islamic Financial Services* (2006), 2.

world, which runs contrary to the Basel approach that sees a standardised approach as crucial to a globally effective financial service.[950]

- *The complication of Islamic windows.*

  The governance of Islamic finance may be complicated in those countries where conventional banks are permitted to offer Islamic financial services through an Islamic financial window. While such windows may enhance competition and may benefit Muslims in countries where the Muslim population is too low to support Islamic banks, it creates a reputational risk arising from the possibilities of commingling assets, it complicates the supervision of IF, increases the possibility of regulatory arbitrage and complicates the resolution for distressed conventional banks.[951]

As a final point that emphasises the interaction between the capitalism of conventional finance and the approach to *Sharia* compliance in Islamic finance, it should be noted that outside the Gulf region, London and New York are major hubs and centres of influence within the global network if *Sharia* scholars.[952] The importance of these cities, which are major centres of conventional finance, again highlights the interaction between the capitalist values of conventional finance and the Islamic values of Islamic finance. In New York, for example, the Dow Jones Islamic Market Indexes relies on *Sharia* scholars to produce a set of global indices indicating permissible financial products, but the focus is on filtering out the impermissible rather than highlighting products and firms that are genuinely

[950] Frederick V Perry, 'The Corporate Governance of Islamic Banks: A Better Way of Doing Business?' (2011) 19 *Michigan State Journal of International Law* 251, 269.
[951] Inwon Song, Carel Oosthuizen, 'Islamic Banking Regulation and Supervision: Survey Results and Challenges' (2014) IMF Working Paper WP/14/220, 12.
[952] David Bassens, Ben Derudder, Frank Witlox, 'Setting Shari'a standards: On the role, power and spatialities of interlocking Shari'a boards in Islamic financial services' (2011) 42 *Geoforum* 94, 101.

Islamic.[953] This approach contributes to the blurring of boundaries between conventional and Islamic finance.

4.5 Conclusion

In this chapter, the analysis has examined *Sharia* governance situated against the background context of corporate governance, the management of risks, and the competing institutional discourses of *Sharia* and capitalism as mediated through conventional finance and western models of corporate governance. It was argued that the nature of *Sharia* risk was such that the impact of risk-materialisation was not capable of being completely reduced to a financial value. This emphasises the importance of *ex ante* risk management through *Sharia* governance. Following on from this it was argued that there were a number of issues with the current approach to *Sharia* governance. Those issues were summarised above, and it would be unduly repetitive to list them again here. Suffice it to say that there are a number of reasons why the system of *Sharia* governance could be significantly improved by restructuring the approach to corporate governance of Islamic banks and financial institutions. Key to that goal will be the integration of *Sharia* governance within a comprehensive and standardised Islamic system of corporate governance, which would be consistent with Cadbury's definition noted earlier in this chapter, and in chapter one. In chapter six, the options for reforming *Sharia* governance will be considered. Before that, however, in chapter five, the analysis of *Sharia* governance will be furthered by considering its implementation in practice in the three jurisdictions of the UK, Malaysia and the KSA.

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[953] Bill Maurer, 'Uncanny exchanges: the possibilities and failures of "making change" with alternative monetary forms' (2003) 21 *Environment and Planning D: Society and Space* 317, 327.

Chapter five: **Sharia** *Governance in Practice, Attitudes Towards Islamic Finance and Institutional Logics*

In the previous three chapters, both conventional and Islamic finance have been explored. In chapter two conventional finance was examined and the interaction between the institutional logics of capitalism and the conventional financial system was analysed. This included the impact of neoliberal capitalism on the growth of shadow banking and the development of risky financial products. The discussion of conventional finance provided the context for the subsequent analysis of Islamic finance in chapter three. As part of that discussion, the influence of capitalist logics on Islamic finance was considered and, particularly through competitive and mimetic isomorphism, the impact this has on the risk of *Sharia* non-compliance was analysed. Following from this, in chapter three, both Western and Islamic approaches to corporate governance were considered. Here it was argued that the risk of *Sharia* non-compliance cannot be fully reduced to a purely economic value, which heightens the importance of a strong system of governance to manage the risk effectively. It was also argued that the approach to *Sharia* governance should be restructured to produce a standardised and comprehensive system of regulation.

In this chapter, focus will be on *Sharia* governance within the United Kingdom (UK), Malaysia and the Kingdom of Saudi Arabia (KSA).[954] The UK was chosen for three reasons. First, it represents those states where Muslims are a significant minority. Second, the UK government has been supportive of Islamic finance, indicating that it wants London to be seen as and important Islamic finance hub.

[954] See sections 1.3 and 1.6.2.2 for the initial justification.

Islamic finance has had a presence in the UK since the 1980s, and in 2012 the UK was ranked as the 9th largest provider of *Sharia* compliant assets. With six fully compliant banks and a total of twenty institutions offering Islamic finance, the UK plays a significant role in delivering Islamic finance in the West.[955] Indeed, it has been described as 'one of the most advanced and sophisticated Islamic financial markets in the western world'.[956] Third, the institution hosting this research is based in England. Malaysia was chosen because it has been involved in Islamic finance from its very beginnings, plays a lead role in the development and delivery of Islamic Finance,[957] seeks to be a central hub for Islamic finance,[958] and is a non-Islamic country with a majority Muslim population. The KSA was chosen primarily because it represents an Islamic country, but also because, as the researcher's home nation, there is an obvious personal relevance of including the KSA. This is further supplemented by the advantage of personal knowledge. Finally, the KSA is also an important provider of Islamic finance.

The main methodological reason for choosing three jurisdictions is that they provide three different institutional settings for Islamic finance. In England, as noted above, the context is one of a minority Muslim population in a non-Islamic country. By contrast, Malaysia is a non-Islamic country, but with a majority Muslim population, while the KSA is a fully Islamic country. The chapter begins with an explication of the existing approaches to *Sharia* governance in each of these jurisdictions. This will

[955] Sharjil Ahmed, 'History of Islamic Finance in the UK' in UK *Excellence in Islamic Finance* (UKTI 2013) 10.
[956] Ahmend Belouafi, Abdelkader Chachi, 'Islamic Finance in the United Kingdom: Factors Behind its Development and Growth' (2014) 22 *Islamic Economic Studies* 37, 52.
[957] Tadashi Mizushima, 'Corporate Governance and Shariah Governance at Islamic Financial Institutions: Assessing from Current Practice in Malaysia' (2014) 22 *Reitaku Journal of Interdisciplinary Studies* 59, 65.
[958] Daromir Rudnyckyj, 'Islamic Finance and the Afterlives of Development in Malaysia' (2014) 37 *Political and Legal Anthropology Review* 69.

lead into a small, qualitative series of interviews,[959] carried out to identify and explore the attitudes towards Islamic finance and *Sharia* governance of a selection of professionals and academics working in the field of Islamic finance within one of the three jurisdictions. The primary reason for including academics in this discussion is the diversity of academic interpretations of the rules of *Shariah* finance; the research would not adequately cover the problems with standardisation if it did not address the fundamental disagreements on the level of academic interpretation. .

The aim of this chapter is to build on the previous analysis to further understand the issues with *Sharia* governance, as discussed in chapter four. In particular, it will further consider the significance of the interaction between the institutional logics of capitalism, and those of Islam within the organizational field of Islamic finance. The issue is the extent to which Islamic finance been shaped by the logics of conventional finance and capitalism. In particular, it has been argued, over the course of the previous three chapters, that a consequence of this interaction is the development of Islamic financial products that are *Sharia* compliant in form, but not spirit. This is compounded by a lack of standardisation allowing inconsistent *fatwas* and increasing the risk of non-compliance. There are a number of different approaches that may be adopted to reform *Sharia* governance in response to these issues. The discussion in this chapter, including the qualitative series of interviews, will supplement the analysis in chapter four, and provide the basis for assessing the advantages and disadvantages of the possible reforms that will be considered in chapter six.

[959] See section 1.6.2.2 for the methods employed in this study.

5.1 *Sharia* governance in the UK, Malaysia and the KSA

5.1.1 The UK

The UK,[960] as a western country with a well-developed conventional financial system and a recent history of neoliberal politics (see chapter two), is likely to provide a context that exposes Islamic finance to capitalist logics more overtly and powerfully than in either Malaysia or the KSA. This is, for example, reflected in the discussion of the results of a study looking at attitudes of Muslins and non-Muslims to Islamic finance in the UK. In this study, Woldi and Hossain found that, while profit was a more important motivating factor for non-Muslims in deciding whether to deposit money with an Islamic bank, non-Muslims would nevertheless use PLS based products. They conclude that:

> Islamic banks can find it profitable to offer their products to non-Muslim clients by putting aside their religious zeal. If they target the Muslim population only, they will not be able to achieve their target in a country like the UK.[961]

While it is not entirely clear what they mean by 'religious zeal', the implication is that, in the UK environment at least, Islamic banks must design their products to be financially attractive to both Muslims and non-Muslims. They should not be religiously dogmatic at the expense of products that can compete with conventional financial products. This highlights the type of competitive and mimetic isomorphic

[960] For an account of the development of Islamic finance in the UK see: Ahmend Belouafi, Abdelkader Chachi, 'Islamic Finance in the United Kingdom: Factors Behind its Development and Growth' (2014) 22 *Islamic Economic Studies* 37.
[961] Atsede Woldie, Md Mahit Hossain, 'The attitude of Muslims and Non-Muslims towards Islamic Products and Services in the UK' (2011) 10 *Indonesian Management & Accounting Research* 1, 9.

pressure exerted on Islamic finance, shaping the development of its products and services.

According to Song and Oosthuizen, in the UK: 'Islamic banking is considered to be an acceptable financial innovation whose presence further promotes that jurisdiction's standing as an international financial center'.[962] This is essentially a capitalist motivation, with the UK government seeing Islamic finance as a competitive opportunity to advance its own economy.[963] This is also apparent in the comments of Andrew Cahn, the Chief Executive of the government's UK Trade & Investment body. In seeking to 'position the UK as the global partner of choice', along with the growing involvement of UK companies with providing Islamic finance, he emphasised the UK's strength as a 'leading international' centre for conventional finance, the conventional financial expertise available in the UK and the importance of the UK's involvement in Islamic finance provision for trade and investment in the Gulf Cooperation Council countries.[964]

While the UK Government's economic motivations are understandable,[965] they do create a capitalist context for the development of Islamic Finance that prioritises competition over other ethical or religious concerns.[966] This is further exacerbated by the involvement of UK firms offering Islamic finance in addition to conventional

[962] Inwon Song, Carel Oosthuizen, 'Islamic Banking Regulation and Supervision: Survey Results and Challenges' (2014) IMF Working Paper WP/14/220, 7.
[963] Abdul Karim Aldohni, 'The Emergence of Islamic Banking in the UK: A Comparative Study with Muslim Countries' (2008) 22 *Arab Law Quarterly* 180, 189-90.
[964] UK Trade & Investment, *The City: UK Excellence in Islamic Finance* (2007), 1.
[965] See the goals of the UK's Islamic Finance Task Force launched in 2013: HM Treasury, 'Government launches first Islamic Finance Task Force', (Online, 11 March 2013) Press Release <https://www.gov.uk/government/news/government-launches-first-islamic-finance-task-force--2> accessed 21 November 2015.
[966] HM Treasury, *The development of Islamic finance in the UK: the Government's perspective* (2008), 13,

financial services. A UK Trade & Industry brochure notes that ten major banks in the UK offer Islamic financial services.[967] This is good for meeting demand and offering an alternative to conventional financial services, but it is Islamic finance as offered by conventional financial institutions. This does not necessarily mean that the Islamic financial services and products offered by these hybrids will be any less "Islamic" than those offered by dedicated Islamic banks, but it does help to maintain an environment in which Islamic financial professionals are subject to the same norms and behavioural scripts as conventional financial professionals.

The UK Trade & Industry brochure also provides a case study of the Bank of London and the Middle East (BLME), a dedicated Islamic financial institution.[968] In this case study, the emphasis is on the marriage of conventional finance expertise with experts in Islamic finance. According to Humphrey Percy, the CEO, the aim is to:

> provide business solutions using innovative Shariah-compliant investment and financing products to address the financial needs of our customers.[969]

While the importance of *Sharia* compliance is not forgotten, the primary goal is to meet the financial need using innovative products, with the implication that the BLME offers an essentially conventional financial service, but with products engineered to be *Sharia* compliant. This approach may make commercial sense from a capitalist perspective, but it highlights the pressures on Islamic financial products and services to behave similarly to conventional products and services.

[967] UK Trade & Investment, *The City: UK Excellence in Islamic Finance* (2007), 2.
[968] *Ibid*, 4.
[969] *Ibid*.

In the UK, the regulatory approach is the same regardless of whether the bank is conventional or Islamic.[970] Although changes have been made to ensure that Islamic finance is not prejudiced by UK tax regulations,[971] there is no legislation specifically aimed at the regulation or governance of Islamic Finance.[972] As such, there is no explicit requirement for *Sharia* compliance or *Sharia* Board supervision, but *Sharia* compliance is taken indirectly into account 'when considering issues such as consumer protection, internal controls, governance, and reputational risk'.[973] Adequate *Sharia* supervision may also be relevant to the Bank's duties, under the Financial Conduct Authority's Principles for Businesses, to execute responsible business and risk management strategies.[974] Thus, the FSA will expect banks offering *Sharia* compliant products to have a credible system, such as a *Sharia* board, to ensure the products are as described.[975] As an example of this, consider the governance arrangements at BLME. The bank employs a *Sharia* Supervisory Board (SSB) comprised of three members. This SSB provides an additional layer of governance that provides *Sharia* oversight for bank's activities (see figure 17).[976] Along with the other governance committees, it is responsible to the Board of Directors, which consists of a balance of conventional and Islamic finance members.

[970] Inwon Song, Carel Oosthuizen, 'Islamic Banking Regulation and Supervision: Survey Results and Challenges' (2014) IMF Working Paper WP/14/220, 13.
[971] See, e.g. The Financial Services and Markets Act 2000; The Finance Act 2003; The Finance Act 2005; The Finance Act 2006; The Finance Act 2007; The Finance Act 2010; The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2010.
[972] John Dewar, Munib Hussain, 'United Kingdom' in Rafael A Morales, Bishr Shiblaq (eds) *Islamic Finance & Markets* (Law Business Research Ltd, 2nd ed, 2014) 53.
[973] Inwon Song, Carel Oosthuizen, 'Islamic Banking Regulation and Supervision: Survey Results and Challenges' (2014) IMF Working Paper WP/14/220, 13.
[974] As required by principle 3: Financial Conduct Authority, *Principles for Businesses* (2013), 2.1.1; John Dewar, Munib Hussain, 'United Kingdom' in Rafael A Morales, Bishr Shiblaq (eds) *Islamic Finance & Markets* (Law Business Research Ltd, 2nd ed, 2014), 53, 54.
[975] Rodney Wilson, *Legal, Regulatory and Governance Issues in Islamic Finance* (Edinburgh University Press 2012), 116.
[976] Figure 17 adapted from: BMLE, *BMLE Holdings Corporate Governance* <https://www.blme.com/investor-relations/corporate-governance/> accessed 20 November 2015.

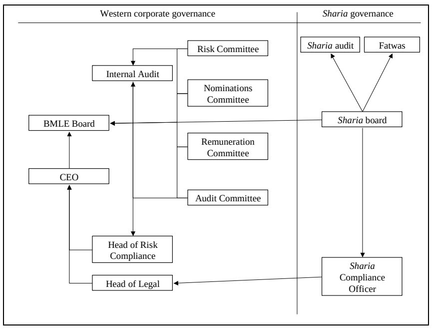

Figure 17: BMLE Governance

Rather than an integrated system of Islamic *Sharia* Governance, the structure is, as explained in chapter four, Western governance, with the addition of *Sharia* governance.[977] The SSB sits 2-3 times per year and has the responsibility to ensure *Sharia* compliance through issuing *fatwas* regarding generic products and to carry out an annual audit. The SSB is assisted by a *Sharia* Compliance Officer, who provides day-to-day guidance and liases between the SSB and the operational managers of the bank. The *Sharia* Compliance Officer reports any *Sharia* compliance issues to the Head of Legal, who conveys the issues to the Chief Executive Officer. The responsibility for implementing the *fatwas* and other SSB decisions lies with the bank's management.[978]

[977] See the BMLE website <https://www.blme.com> accessed 20 November 2015.
[978] BMLE Holdings, *BMLE Holdings Sharia'a Supervisory Board: Repsonsibilities and Terms of Reference* (2013) <https://www.blme.com/investor-relations/corporate-governance/board-terms-of-reference/> accessed 20 November 2015.

The structural arrangement of *Sharia* governance at the BLME is consistent with the approach discussed in chapter four. As explained, the structure does not seek to provide integrated Islamic governance. Rather, it is conventional western governance with the addition of *Sharia* constraint. This type of arrangement lends itself to a focus on form rather than spirit. Provided the technical constraints are met, the bank is free to develop products and services that mimic those developed by conventional finance. The approach to *Sharia* governance will ensure technical compliance, but is unlikely to provide any meaningful constraint on the institutional logics of neoliberal capitalism. Furthermore, it should also be noted that the current Chairman, Dr Al-Qassar, sits on numerous SSBs as well as holding a professorial position at the University of Kuwait,[979] raising the workload and conflict of interest issues identified in chapter four.[980]

The advisory, rather than managerial, role of the SSB and its members is important. While it leaves the responsibility for ensuring *Sharia* compliance to the firm's managers, it crucially means that the scholars may sit on multiple boards and do not have to satisfy the 'competence and capability' requirements imposed on a firm's directors. Provided the *Sharia* scholars remain purely advisory, they avoid the regulator's scrutiny.[981]

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[979] 17 according to: Bloomberg Business <http://www.bloomberg.com> accessed 20 November 2015; Hassan and Mahlknecht list him as holding 30 board positions, with 8 as chairman: Kabir Hassan, Michael Mahlknecht, *Islamic Capital Markets* (Wiley 2011), 121; Thomson Reuter, *Zawya*, 'Dr Abdulaziz Khalifa Al Qassar <https://www.zawya.com/officers/biography/61712/>accessed 20 November 2015.
[980] The other two members of the SSB also sit on numerous boards: Kabir Hassan, Michael Mahlknecht, *Islamic Capital Markets* (Wiley 2011), 121; Brian Kettell, *Introduction to Islamic Banking and Finance* (Wiley 2011), 28.
[981] Michael Ainley, Ali Mashayekhi, Robert Hicks, Arshadur Rahman, Ali Ravalia, *Islamic Finance in the UK: Regulation and Challenges* (FSA 2007), 13.

The attitude and approach of the UK to Islamic Banking, is well summed up in a few key sentences taken from a speech made in 2003 by Howard Davies, the Chairman of what was then the sole UK regulator, the Financial Services Authority (FSA).[982] Recognising the potential value of the development of Islamic finance in the UK, he said:

> London has prospered over the centuries by providing a congenial home for international financial institutions, and innovation has been its life blood. So we have a clear economic interest, as a nation, in trying to ensure that the conditions for a flourishing Islamic financial market are in place in London. The business opportunity is large and potentially very attractive.

He went on to explain that Islamic banks would face the same regulatory requirements as other banks and emphasised that, while this regulation would deal with financial, legal and documentation risks:

> it would not be appropriate, or even possible, for us to check compliance with Sharia law … That in our view, is a matter for the institution itself.

In other words, as long as the Islamic financial institutions are economically sound, and behaving lawfully under the UK regulations, the regulatory authorities are uninterested in whether the products and services are *Sharia* compliant.[983] Indeed,

[982] Howard Davies, 'Islamic Finance and the UK Financial Services Authority' (02 March 2003) Conference on Islamic Banking and Finance, Bahrain <http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2003/SP118.shtml> accessed 21 November 2015.
[983] Jonathan Ercanbrack, 'The regulation of Islamic finance in the United Kingdom' (2011) 13 *Ecclesiastical Law Journal* 69, 71.

the regulation is secular,[984] involving neutral and equal supervision of all banks and financial institutions, with faith-based restrictions seen as a matter for the individual institution.[985] Thus, there is no central *Sharia* board, and no legally required standards. The current regulatory authority, the Financial Conduct Authority,[986] does not review *Sharia* compliance and its ‘approach is to treat IFIs [Islamic Financial Institutions] as it would conventional firms’.[987] There is, of course, a demand from the Muslim customer base that the products and services should be *Sharia* compliant, but they also demand a service that is comparable to those offered by the conventional financial system. As Gordon Rankin, the current account director of Lloyds TSB Bank, commented:

> Our research shows that over three quarters of British Muslims want banking services that fit with their faith, but they also want all the benefits they have come to expect from a high street bank.[988]

Nevertheless, the FCA has taken some steps towards promoting Islamic finance. For example, it has removed the double stamp duty previously imposed on Islamic mortgages. Under Chapter 6 of Part 6 of the Corporation Tax Act, 2009, changes have been made to ensure that certain *Sharia*-compliant finance arrangements (including certain *murabaha* and *musharakah* arrangements) are taxed in a manner identical to the tax treatment of the equivalents of these isntruments in conventional finance. Further, under section 53 of the Finance Act 2007, the *sukuk* (a *Shariah*-

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[984] HM Treasury, *The development of Islamic finance in the UK: the Government's perspective* (2008), 19.
[985] Jonathan Ercanbrack, 'The regulation of Islamic finance in the United Kingdom' (2011) 13 *Ecclesiastical Law Journal* 69, 73-74
[986] Supported by the Prudential Regulatory Authority.
[987] John Dewar, Munib Hussain, ‘United Kingdom’ in Rafael A Morales, Bishr Shiblaq (eds) *Islamic Finance & Markets* (Law Business Research Ltd, 2nd ed, 2014), 53. 54.
[988] As quoted in: Anon, 'Islamic banking expands in London' (Online, 26 April 2005) *BBC News* <http://news.bbc.co.uk/1/hi/england/london/4487749.stm> accessed 24 November 2015.

compliant bond) will also be taxed in a manner similar to the tax treatmento conventional bonds).[989]

The dual demand for a service that is *Sharia* compatible, but also provides the same benefits as conventional finance creates a tension that underlies the isomorphic pressure on the Islamic financial system operating in the context of the conventional financial system. Indeed, a recent, albeit small, study of consumer perception found that, with 45% of respondents noncommittal, 37% agreed or strongly agreed that Islamic financial products in the UK resembled those of conventional finance (8.5 disagreed or strongly disagreed).[990] A strong, standardised system of *Sharia* governance would be likely to lessen the tension between *Sharia* compliance and profitability, reducing the temptation to mimic conventional financial products. The need for such a system is highlighted by the risk that previously approved products will be legally challenged on the basis of *Sharia* non-compliance,[991] and the refusal of English courts to treat *Sharia* as a system of law.[992] The current *ad hoc* approach, with its limited formal oversight and lack of legal enforceability, simply serves to exacerbate the pressure to sacrifice the Islamic quality of the products and services for a greater competitive edge.

As a final point, it is worth noting the approach of Al Rayan Bank (formerly known as the Islamic Bank of Britain) to its legal obligation to guarantee full return of any

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[989] Milbank, Tweed, Hadley & McCloy LLP,, 'Islamic Finance & Markets' (2014), Getting the Deal Through.

[990] Saeed Akbar, Syed Zulfiqar Ali Shah, Shahin Kalmadi, 'An investigation of user perceptions of Islamic banking practices in the United Kingdom' (2012) 5 *International Journal of Islamic and Middle Eastern Finance and Management* 353, 363.

[991] *The Investment Dar Company KSCC v Blom Devleopments Bank Sal* [2009] EWHC 2545 (Ch) , [16]. See also: Nicholas HD Foster, 'Encounters between systems: recent cases concerning Islamic commercial law in secular courts' (November/December 2006) Issue 68 *Amicus Curiae* 2.

[992] *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems NV & Others* [2002] All ER (D) 171; *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2004] 1 WLR 1784; [2004] EWCA Civ 19.

deposits paid into *Mudaraba* saving accounts regardless of any capital losses.[993] In order to both comply with English law, while retaining, as far as possible, the Islamic character of the product, the solution designed by the SSB was to offer the customer the full amount accompanied by a statement explaining that accepting the payment would be inconsistent with *Sharia*. In this way, the Bank sought to meet the conflicting obligations through transparently shifting the onus of *Sharia* compliance on to the customer. Despite this innovative solution, the current legal regulation has impacted on the use of two-tier *Mudarabas*, which have been used infrequently with banks preferring more secure investments that reduce the risk of a shortfall. While this example shows how innovative solutions may be designed to overcome regulatory constraints, it also demonstrates how regulation based on conventional finance can shape the development of Islamic finance and restrict its use of characteristically Islamic financial devices. Furthermore, forcing the banks to find innovative solutions to such issues may exacerbate the lack of standardisation as each bank designs its own solution.

5.1.2 Malaysia

The UK's approach has been to encourage the development of Islamic finance for primarily economic reasons, altering tax laws to remove barriers and maintaining a unitary system of regulation that effectively leaves *Sharia* governance as a matter of self-regulation for each individual organisation. The Malaysian government, like the UK government, was, and is, economically motivated to encourage the growth of

[993] For a criticism of the regulatory approach to this issue, see: Abdul Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A comparative look at the United Kingdom and Malaysia* (Routledge 2011), 175-179.

Islamic finance.[994] Unlike the UK government, however, and perhaps because of its desire to counter the effects of its previous secular approach to the economy,[995] it has taken the completely opposite approach, imposing specific regulations for issues that are specific to Islamic finance.[996] Under the 'comprehensive regulatory and supervisory framework', which establishes a 'strong Shari'ah framework',[997] Islamic banks are required to have an internal *Sharia* Committee (SC),[998] which is overseen by a national central *Sharia* board.[999] This central board, the *Sharia* Advisory Council (SAC) is given a formal legal status by s 51 of the Central Bank of Malaysia Act 2009. It is operated by the central bank of Negara Malaysia (BNM) and, along with the internal SC, is part of a 'two-tier *Sharia* governance infrastructure'.[1000]

The SAC is responsible for resolving differences of opinions regarding *Sharia* compliance. Under s 55 of the Central Bank of Malaysia Act 2009, financial institutions may refer to the SAC for advice or a ruling on a *Sharia* matter. Under s 56, arbitrators and courts must take into account any previously published SAC ruling and must refer a *Sharia* issue to the SAC for resolution. Under s 57, any rulings that result from a referral to the SAC are binding on the body making the referral. Under s 58, any inconsistent ruling by an Islamic financial institution is overridden by the SAC ruling. These provisions are given further force by section 29

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[994] Daromir Rudnyckyj, 'Islamic Finance and the Afterlives of Development in Malaysia' (2014) 37 *Political and Legal Anthropology Review* 69, 72.
[995] *Ibid*.
[996] Inwon Song, Carel Oosthuizen, 'Islamic Banking Regulation and Supervision: Survey Results and Challenges' (2014) IMF Working Paper WP/14/220, 13.
[997] Baljeet Kaur Grewal, 'Constraints on Growth in Islamic Finance' (Amman, Jordan 2011) IFSB 4th Public Lecture on Financial Policy and Stability, 20-21.
[998] Islamic Financial Services Act 2013, s 30(1).
[999] BNM, *Sharia Governance Framework for Islamic Financial Institutions* (2010) BNM/RH/GL 012-3, 1.2.
[1000] Sulaiman Abdullah Saif Alnasser, Joriah Muhammed, 'Introduction to corporate governance from Islamic perspective' (2012) 28 *Humanomics* 220, 223.

of the Islamic Financial Services Act 2013, which allows the BNM to issue obligatory standards based on SAC advice or rulings.

Through these provisions, and its supreme role in resolving disputes over *Sharia* compliance, the SAC plays a crucial role in developing a standardised approach to *Sharia* compliance,[1001] at least on a national level. It should be noted that this authority is restricted to the banking and *Takaful* industries, with the Islamic Capital Market regulated by the Malaysian Securities Commission, the Bursa Malaysia and the Lubuan Financial Services Authority, all of which have their own *Sharia* advisors.[1002] The problem caused by having multiple regulatory bodies, however, is addressed to a large extent by the Islamic Financial Services Act 2013. Under s 152, the BNM has the authority to:

> specify standards or issue codes for the purposes of developing, or maintaining orderly conditions or the integrity of, and ensuring compliance with Shariah in, the Islamic money market or the Islamic foreign exchange market.

Furthermore, under s 154(1) the BNM is required to:

> enter into arrangements with relevant supervisory authorities to coordinate on the regulation of Islamic financial instruments traded in the Islamic money market which are within the purview and oversight of the relevant supervisory authorities.

Both of these provisions should reduce the risk of diverse *Sharia* standards or rulings.

[1001] Amir Shaharuddin, 'Shariah Governance of Malaysian Islamic Banking Institutions' (2011) 14 *Jurnal Ekonom* 53, 55.

[1002] Rusni Hassan, Mohammad Azam Hussain, 'Scrutinizing the Malaysian Regulatory Framework on *Shari'ah* Advisors for Islamic Financial Institutions' (2013) 2 *Journal of Islamic Finance* 38, 42.

As with SSBs in the UK, the main role of Malaysian SCs is to ensure that all business activity complies with the *Sharia*. This includes certifying new products, but also monitoring the marketing and information provided as part of the product release. The members of the internal SCs are appointed and paid by the individual banks, raising the issue of independence. In order to reinforce the independence of the internal SC, removals, appointments and re-appointments of board members must be approved by the central SAC.[1003] Shaharuddin suggests, on the basis of interviews with four *Sharia* Scholars that, in practice, there is little need to be concerned with the issue of independence.[1004] It is, however, unlikely that *Sharia* scholars, particularly when named, will admit that they lack independence. On the other hand, it could plausibly be argued that the oversight provided by the central SAC will deter any undue pressure on internal SCs to issue favourable *fatwas.* A contrary ruling by the SAC on the *Sharia* compliance of a new product may undermine confidence in the bank issuing the new product.[1005]

The current BNM guidelines requires all Islamic banks 'to establish a sound and robust Shariah governance framework', which imposes ultimate responsibility for *Sharia* compliance on the board of directors. This responsibility is given a formal legal basis by s 28(1) of the Islamic Financial Services Act 2013, which requires that:

> An institution shall at all times ensure that its aims and operations, business affairs and activities are in compliance with Shariah.

[1003] Islamic Financial Services Act 2013, ss 31, 33; BNM, *Sharia Governance Framework for Islamic Financial Institutions* (2010) BNM/RH/GL 012-3, 3.8 (Principle 3).
[1004] Amir Shaharuddin, 'Shariah Governance of Malaysian Islamic Banking Institutions' (2011) 14 *Jurnal Ekonom* 53, 55.
[1005] This builds on the point made by the scholar Joni Tamkin in an interview as reported in: Amir Shaharuddin, 'Shariah Governance of Malaysian Islamic Banking Institutions' (2011) 14 *Jurnal Ekonom* 53, 55.

As part of the *Sharia* governance framework, the BNM guidelines require an SC with a majority membership of 'persons with appropriate qualifications and experience in Shariah', and effective management to support the implementation of *Sharia* governance. The SC is required to issue and disseminate *fatwas*, while other elements of the framework, which include internal *Sharia* officers and auditors, must conduct: *Sharia* research; continuous *Sharia* review; regular *Sharia* audit; and *Sharia* risk management.[1006] Although this framework is established in addition to the standard corporate governance arrangements, the guidelines emphasise that *Sharia* must be seen as the overarching principle governing all of the bank's activities.[1007]

In the interests of efficiency, the guidelines allow smaller institutions to outsource *Sharia* governance, but only if the arrangements are approved by the BNM. For the same reason, financial groups may establish a single SC to serve all of the institutions within the group.[1008] While this seems an entirely reasonable approach, it nevertheless highlights the tension between the need to impose rigorous standards and the need to ensure that Islamic banks remain competitive. Despite this, the guidelines impose more rigorous requirements than was previously the case. For example, rather than the more usual three members, the guidelines require that the SC has at least five members[1009] and they should only sit on one SC within any particular industry sector.[1010] Furthermore, these members, who must behave consistently with the requirements of professional ethics (principle 6), must be fit and

[1006] BNM, *Sharia Governance Framework for Islamic Financial Institutions* (2010) BNM/RH/GL 012-3, 1.3.
[1007] This is reinforced by the legal duties to ensure *Sharia* compliance under the Islamic Financial Services Act 2013, s 28.
[1008] BNM, *Sharia Governance Framework for Islamic Financial Institutions* (2010) BNM/RH/GL 012-3, 1.8-1.9.
[1009] *Ibid*, 2.3.
[1010] *Ibid*, 5.4.

proper persons to serve on the SC and the majority must be qualified in *Sharia*.[1011] Under principle 4, the SC members, and any other person involved in the *Sharia* governance framework, which includes the board of directors, must maintain their knowledge of *Sharia* and remain up to date with developments in Islamic finance.

As noted above, the internal SC is supported by suitably qualified *Sharia* officers, who are usually full-time employees of the bank and responsible for *Sharia* review, risk-management and research (principle 7). Where these functions are outsourced, the bank remains responsible to ensure that they are carried out effectively. The obligation to review *Sharia* practices has helped to fill a gap in *Sharia* governance that had previously focused almost exclusively on *ex ante Sharia* compliance.[1012] In addition to these functions, the *Sharia* officers may be engaged to support the internal *Sharia* audit, which must be carried out by auditors with adequate training in *Sharia*. The guidelines require the audit to be performed at least annually for critical areas of bank activity. Thus, under the BNM guidelines, supported by the statutory obligations imposed by the Islamic Financial Services Act 2013, Islamic banks must establish and maintain a comprehensive 'end-to-end' *Sharia* governance framework that manages the risk of *Sharia* non-compliance in all areas of banking activity and product development.[1013] Despite these arrangements, a 2010 survey highlighted that there still remains much room for improvement of *Sharia* governance in practice.[1014] Consistent with the survey, it has been further noted that the internal auditors

[1011] *Ibid*, Appendix 2. See also Islamic Financial Services Act 2013, s 29(2).
[1012] Amir Shaharuddin, 'Shariah Governance of Malaysian Islamic Banking Institutions' (2011) 14 *Jurnal Ekonom* 53, 55-56.
[1013] Surianom Miskam, Muhammad Amrullah Nasrul, 'Shariah Governance in Islamic Finance: The Effects of the Islamic Financial Services Act 2013' (Langkawi, Malaysia, 25-26 November 2013) *Proceedings of the World Conference on Integration of Knowledge* 455, 455-456 <http://worldconferences.net/proceedings/wcik2013/toc/index.html> accessed 26 November 2015.
[1014] Mohammad Faiz Azmi, *Sharia Audit: Industry Insights* (Price Waterhouse Coopers 2011).

currently tend to have a conventional finance background and may lack sufficient training in *Fiqh Muamalat* or *Usul Fiqh*.[1015]

Although *Sharia* governance is formalised through specific regulatory obligations, it remains distinct from corporate governance requirements (see figure 18). Thus, the relationship between corporate governance and *Sharia* governance is, as in the UK, one in which *Sharia* governance is implemented as an additional requirement. There is no attempt to construct a fully integrated system of Islamic governance and this is reflected in the three sets of guidelines produced by the BNM. There are corporate governance guidelines for conventional financial institutions,[1016] corporate governance guidelines for Islamic financial institutions,[1017] and separate *Sharia* governance guidelines.[1018]

[1015] Ahmad Faizal Abdul Aziz, 'Sharia Governance: Challenges Ahead' (2012) *MPRA Paper No 4772*, 14-15.
[1016] BNM, *Guidelines on Corporate Governance for Licensed Institutions* (amended, 2013) BNM/RH/GL 001-1.
[1017] BNM, *Guidelines on Corporate Governance for Licensed Islamic Banks* (amended, 2013) BNM/RH/GL 002-1
[1018] BNM, *Sharia Governance Framework for Islamic Financial Institutions* (2010) BNM/RH/GL 012-3.

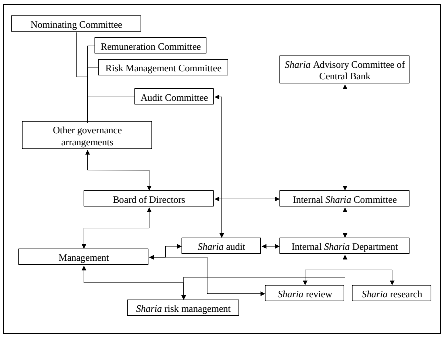

Figure 18: *Sharia* governance, Malaysia

As far as the corporate governance guidelines are concerned, the conventional and Islamic guidelines both rely on the same 14 principles of corporate governance. The key distinction lies in the references to compliance with *Sharia* in the guidelines for the Islamic financial institutions.[1019] Thus, one of the Board of Directors' functions is to establish a *Sharia* Committee along with appropriate policies, processes and infrastructure to ensure that there is a 'comprehensive and effective *Shariah* framework'.[1020] This creates a bridge between the corporate governance and *Sharia* governance arrangements, reinforced by the requirement for *Sharia* audit. *Sharia*

[1019] Tadashi Mizushima, 'Corporate Governance and Shariah Governance at Islamic Financial Institutions: Assessing from Current Practice in Malaysia' (2014) 22 *Reitaku Journal of Interdisciplinary Studies* 59, 70.
[1020] BNM, *Guidelines on Corporate Governance for Licensed Islamic Banks* (amended, 2013) BNM/RH/GL 002-1, 2.10(vi).

governance itself, however, remains an additional, but distinct obligation aimed at ensuring *Sharia* compliance.[1021]

This approach to corporate and *Sharia* governance reflects the development of Islamic finance. As in the UK, Islamic finance in Malaysia coexists with conventional finance. Islamic finance is delivered by wholly Islamic banks, but also previously through the Islamic windows of conventional banks. To maximise the availability of Islamic finance, this arrangement was encouraged by tax breaks offered to conventional banks with these Islamic windows.[1022] The Malaysian government's approach was to manage the growth of Islamic finance delivered by the private sector, with Islamic finance co-existing competitively with conventional finance. This is reflected in Rudnyckvj's observation that:

> The rhetoric of competition ... persists among many proponents of Islamic finance. Participants in my research often articulated the injunction that Islamic finance "must show that it can compete with conventional finance," a phrase reiterated by the country's leading officials.[1023]

While the Islamic windows structure was ended in 2004, with the BNM requiring conventional banks to deliver Islamic finance through distinct subsidiaries,[1024] conventional and Islamic finance 'remain mutually entwined' with the subsidiaries

[1021] Tadashi Mizushima, 'Corporate Governance and Shariah Governance at Islamic Financial Institutions: Assessing from Current Practice in Malaysia' (2014) 22 *Reitaku Journal of Interdisciplinary Studies* 59, 72-73.
[1022] Daromir Rudnyckyj, 'Islamic Finance and the Afterlives of Development in Malaysia' (2014) 37 *Political and Legal Anthropology Review* 69, 77.
[1023] Daromir Rudnyckyj, 'Islamic Finance and the Afterlives of Development in Malaysia' (2014) 37 *Political and Legal Anthropology Review* 69, 78.
[1024] BNM, 'The Islamic Financial System' in the Annual Report (2005) 156, 157 <http://www.bnm.gov.my/files/publication/ar/en/2005/cp06.pdf> accessed 25 November 2015; Baljeet Kaur Grewal, 'Constraints on Growth in Islamic Finance' (Amman, Jordan 2011) IFSB 4th Public Lecture on Financial Policy and Stability 19.

sometimes remaining financially dependent on their conventional "parents" to deal with issues of liquidity.[1025]

In introducing the financial blueprint for Malaysia up until 2020, the governor of the BNM noted that:

> progressive liberalisation of the domestic financial sector has contributed to the further diversification of the financial system and its competitiveness ... The next phase of transformation ... will further enhance the competitiveness and dynamism of the financial sector.[1026]

This approach, which relies on a highly competitive private sector and seeks to develop the global integration of the Malaysia within the international financial sector,[1027] imposes on Islamic finance the competitive and mimetic isomorphic pressures faced by any relatively nascent activity developing in the context of an environment shaped by an already established and successful alternative. Recognising the potential threats to Islamic finance, which is seen as a crucial part of Malaysia's international financial integration, the Blueprint also highlights the need to continue strengthening the regulatory framework and promote 'greater harmonisation in Shariah interpretations'.[1028] This goal may be advanced by the Malaysian-based Association of *Sharia* Advisors in Islamic Finance (ASAS), which was established in 2011,[1029] and is seeking to establish standards for *Sharia* scholars sitting as members of *Sharia* boards in an attempt to reduce the problem of

[1025] Daromir Rudnyckyj, 'Islamic Finance and the Afterlives of Development in Malaysia' (2014) 37 *Political and Legal Anthropology Review* 69, 79.
[1026] BNM, *Financial Sector Blueprint 2011-2020: Strengthening our future* (2011), 6.
[1027] *Ibid*, 9, 19.
[1028] *Ibid*, 16.
[1029] ASAS website <http://asas.my/> accessed 11 September 2016.

contradictory rulings and conflicts of interest.[1030] Such efforts, however, may be hindered by the structure of the regulatory system, with different bodies responsible for the banking (and *Takaful*) and Islamic Capital Market sectors. To resolve this, it has been suggested that Malaysia should establish a supreme SSB that would govern all sectors of Malaysian Islamic financial system.[1031] As noted earlier, this issue has, however, since been largely addressed by the Islamic Financial Services Act 2013, ss 152, 154, with the BNM and its SAC taking on the role of setting national standards.

The SAC provides an additional level of *Sharia* governance, which should increase standardisation of *Sharia* compliance rulings within Malaysia. It does not, however, mean that it improves standardisation globally. This is shown by the example of the controversial Malaysian versions of *Murabahah* and *Bai Bithaman Ajil Sukuk*, which were approved by the SAC and internal *Sharia* Committees in Malaysia, but were prohibited elsewhere.[1032] This divergence *occurred* despite some *Sharia* scholars sitting on boards in both Malaysia and in countries where the product was prohibited.[1033] The divergence between the *fatwas* in Malaysia and those elsewhere may reflect, at least in part, the Malaysian marriage of Islam and capitalism in its approach to the economy.[1034] The relevance of remaining competitive is further evidenced by the preference for debt-like financing through *Murabahah* and *Bai*

[1030] Bernardo Vizzcaino, 'Islamic finance body plans scholar accreditation, ethics code' (online, 15 August 2012) *Al-Arabiya* <http://english.alarabiya.net/articles/2012/08/15/232391.html> accessed 02 August 2015.
[1031] Rusni Hassan, Mohammad Azam Hussain, 'Scrutinizing the Malaysian Regulatory Framework on *Shari'ah* Advisors for Islamic Financial Institutions' (2013) 2 *Journal of Islamic Finance* 38, 42.
[1032] Hafizi ab Majid, Shahida Shahimi, Mohd Hafizuddin Syah Bangaan Abdullah, 'Sukuk defaults and Its Implication: A Case Study of Malaysian Capital Market' Paper Presented at 8th International Conference on Islamic Economics and Finance (Qatar, December 2011) 1, 10-11 <http://conference.qfis.edu.qa/app/media/267> accessed 25 November 2015.
[1033] Tadashi Mizushima, 'Corporate Governance and Shariah Governance at Islamic Financial Institutions: Assessing from Current Practice in Malaysia' (2014) 22 *Reitaku Journal of Interdisciplinary Studies* 59, 79.
[1034] Daromir Rudnyckyj, 'Islamic Finance and the Afterlives of Development in Malaysia' (2014) 37 *Political and Legal Anthropology Review* 69, 72, 75.

Bithaman Ajil rather than the more characteristically Islamic *Mudarabah* and *Musharakah*. For example, a study of the Bank Islam Malaysia (Berhad) showed an 81.2% reliance on debt-like financing compared to a 0.66% reliance on *Mudarabah* and a 3.53% reliance on *Musharakah*.[1035]

The relationship between conventional finance and Islamic finance is exacerbated by the historical lack of education and training available in Islamic finance, which meant that Islamic finance was an industry run on a day-to-day basis by conventional bankers who had converted to Islamic finance, bringing with them their conventional financial mindset.[1036] The reliance of the Islamic finance system on the framework of conventional finance still persists.[1037] Along with competition from conventional banks, this factor has been highlighted as one possible reason explaining the preference for debt-like products, which are more familiar to conventional finance.[1038] Such a problem may be alleviated through comprehensive training and education in Islamic finance, such as that provided by the International Centre for Education in Islamic Finance,[1039] but it is unlikely to completely divorce Islamic financial professionals from the influence of conventional economic theory. Nevertheless, the prospect of education in Islamic finance has, owing to the increasing demand for professionals in the area, now presented itself at elite business schools. The London Business School has, for example, considered introducing a

[1035] Abdus Samad, Norman D Gardner, Bradley J Cook, 'Islamic banking and Finance in Theory and Practice: The Experience of Malaysia and Bahrain' (2005) 22 *The American Journal of Islamic Social Sciences* 69, 78.
[1036] Dato' Mohd Razif Abd. Kadir, 'Responsibility Banking' (2009) 2 *ISRA Bulletin* 1, 2.
[1037] Ahmad Faizal Abdul Aziz, 'Sharia Governance: Challenges Ahead' (2012) *MPRA Paper No 4772*, 8.
[1038] Abdus Samad, Norman D Gardner, Bradley J Cook, 'Islamic banking and Finance in Theory and Practice: The Experience of Malaysia and Bahrain' (2005) 22 *The American Journal of Islamic Social Sciences* 69, 82-83.
[1039] Daromir Rudnyckyj, 'Islamic Finance and the Afterlives of Development in Malaysia' (2014) 37 *Political and Legal Anthropology Review* 69, 80.

London-based course as an executive programme in Islamic finance fundamentals.[1040] These moves towards formal education, examinations and, possibly, certified qualifications in Islamic finance principles could help standardise the practice of Islamic finance and resolve some of its tensions with conventional finance.

Despite some persisting reservations, the approach adopted in Malaysia appears to have created a robust and comprehensive system of *Sharia* Governance. Reliance on both statutory law and regulatory guidelines, this approach balances formal enforceability with flexibility and responsiveness to changing circumstances. This should result in reliable standardised rulings on *Sharia* compliance, at least on a national basis. In marrying Islamic finance with a liberal capitalist approach to the economy, the Malaysian approach does, however, maintain the competitive and mimetic isomorphic pressure on Islamic finance to develop products that behave like their conventional counterparts. Consistent with this, it has been noted that the *fatwas* in Malaysia tend to be more permissive than *fatwas* issued in less liberal environments.[1041] Thus, while the Malaysian approach provides a valuable model for the development of standardised *Sharia* governance, it leaves open a number of questions regarding: the influence of capitalism, particularly neoliberal capitalism, on Islamic finance; the proper goals of Islamic finance and how these may be better secured through regulation; the need for an integrated system of Islamic governance; and the need for standardisation on an international, as well as a national, level.

[1040] Jonathan Moules, 'Demand rises for education in Islamic finance' (2016), Financial Times.
[1041] Oliver Agha, 'Islamic Finance in the Gulf: A Practitioner's perspective' (2008) 1 *Berkeley Journal of Middle Eastern and Islamic Law* 179, 187-188.

5.1.3 The KSA

As in the UK, in the KSA there is a single regulatory approach applying to all banks.[1042] As such there is no formal regulatory framework governing *Sharia* compliance.[1043] Since the *Sharia* is incorporated within the Constitution of the KSA and forms the supreme source of law,[1044] it governs all aspects of life, including the commercial provision of Islamic finance. Formal governance, however, is left to the individual banks, operating under the influence of market pressures.[1045] There is no central *Sharia* board in the KSA, with each Islamic bank having its own board, guided by the standards of the Islamic Fiqh Academy.[1046] This is an international body established under the auspices of the Organisation of Islamic Cooperation (OIC), which has three objectives, including that of achieving:

> theoretical and practical unity of the Islamic Ummah by striving to have Man conform his conduct to the principles of the Islamic Sharia at the individual, social as well as international levels.[1047]

Since there is no formal *Sharia* governance framework, Islamic banks utilise *Sharia* boards as advisory bodies,[1048] with no set requirements for qualifications, for the

[1042] Inwon Song, Carel Oosthuizen, 'Islamic Banking Regulation and Supervision: Survey Results and Challenges' (2014) IMF Working Paper WP/14/220, 13.
[1043] Rihab Grassa, 'Shariah supervisory systems in Islamic finance institutions across the OIC member countries' (2015) 23 *Journal of Financial Regulation and Compliance* 135, 139; Ali Alshamrani, 'A Critical Evaluation of the Regulatory Framework for the Application of Islamic Financial Derivatives in the Kingdom of Saudi Arabia' (2014) 2 *Journal of Islamic Banking and Finance* 269, 292-293.
[1044] Basic Law of Governance 1992, articles 7 and 8.
[1045] Rihab Grassa, 'Shariah supervisory systems in Islamic finance institutions across the OIC member countries' (2015) 23 *Journal of Financial Regulation and Compliance* 135, 140.
[1046] Hichem Hamza, 'Sharia governance in Islamic banks: effectiveness and supervision model' (2013) 6 *International Journal of Islamic and Middle Eastern Finance and Management* 226, 232.
[1047] OIC, 'Subsidiary' <http://www.oic-oci.org/oicv2/page/?p_id=64&p_ref=33&lan=en> accessed 07 December 2015.
[1048] The individual bank may have a policy that makes decisions by the SB binding on its employees, with a penalty attached for any breach. See, eg, the *Sharia* policy of the Al Rhaji Bank: Al Rhaji Bank, 'Shariah Board' (2014) <http://www.alrajhi-capital.com/en/aboutus/Pages/shariahboard.aspx> accessed 08 December 2015.

composition of the *Sharia* board, for limits on multiple board membership, or for the duration of the appointment of *Sharia* board members.[1049] More generally, the corporate governance obligations of all banks in the KSA are overseen by the Saudi Arabian Monetary Agency (SAMA),[1050] which comprises the Central Bank and Supervisory Authority. Other financial institutions governed by the Capital Markets Authority.[1051] In a speech by Hamad Al-Sayari, the Governor of the SAMA, the importance of good corporate governance for financial stability was discussed. It is interesting to note that the focus was on risk management and the efficiency needed for competitiveness and profitability. In this regard the speech could have been made almost entirely in the context of conventional finance. The sole reference to Islamic finance consisted of noting that SAMA participates on the Islamic Financial Services Board (IFSB) and requires banks to follow the corporate governance guidelines issued by the IFSB.[1052] It should, however, be noted that SAMA makes no formal requirements that Islamic banks apply IFSB guidelines other than those relating to the Capital Adequacy Standard.[1053] The main corporate governance guidelines simply refer to the IFSB guidelines, but do not impose them as obligatory.[1054] Nevertheless, it appears from Al-Sayari's speech that there is an expectation that the IFSB guidelines will be relied upon.

[1049] Rihab Grassa, 'Shariah supervisory systems in Islamic finance institutions across the OIC member countries' (2015) 23 *Journal of Financial Regulation and Compliance* 135, 144.
[1050] Banking Control Law, Royal Decree No M/5, 11 June 1966.
[1051] Capital Market Law, Royal Decree No M/30, 31 July 2003; World Bank, *Corporate Governance Country Assessment: Kingdom of Saudi Arabia* (2009), 2.
[1052] Hamad Al-Sayari, 'Corporate governance for banks in the Kingdom of Saudi Arabia' (Institute of Banking, Riyadh 22-23 May 2007) Speech to the High-Level Roundtable Discussion for Bank Executives on Corporate Governance for Banks in Saudi Arabia.
[1053] SAMA, Basel II - SAMA's Detailed Guidance Document (2006), 160 <http://www.sama.gov.sa/> accessed 07 December 2015.
[1054] SAMA, *Principles of Corporate Governance for Banks Operating in Saudi Arabia* (First Update 2014), para 12 < http://www.sama.gov.sa> accessed 07 December 2015.

Corporate governance in the KSA is strongly influenced by the Anglo-American shareholder model that prioritises the maximisation of share value and the wealth of the owners.[1055] As such, it creates a very similar governance framework to the UK. Corporate governance forms the central framework, with provisions for *Sharia* governance established as an additional advisory service where the bank provides Islamic finance. The Board of Directors bears ultimate responsibility for ensuring compliance with the corporate governance guidelines.[1056] Under the 2006 guidelines issued by the IFSB, the bank, and hence the Board of Directors, must ensure that it:

> [has] in place an appropriate mechanism for obtaining rulings from *Shari'ah* scholars, applying *fatawa* and monitoring *Shari'ah* compliance in all aspects of their products, operations and activities.[1057]

The most recent guidance from the IFSB confirm that, while banks must have a robust and independent system of *Sharia* governance, it is for the individual supervisory authorities to determine the precise structure and conditions of the framework.[1058] Since SAMA is silent on the issue, it falls to the individual banks to determine an appropriate *Sharia* governance framework. Furthermore, as Lackmore notes, while both SAMA and the Capital Markets Authority:

> have the authority to implement the Islamic financial regulations proposed by the IFSB ... their responsibilities do not include

[1055] Yaser Fallatah, Denise Dickins, 'Corporate governance and firm performance and value in Saudi Arabia (2102) 6 *African Journal of Business Management* 10025, 10026.
[1056] SAMA, *Principles of Corporate Governance for Banks Operating in Saudi Arabia* (First Update 2014), para 35 (principle 3) < http://www.sama.gov.sa> accessed 07 December 2015.
[1057] IFSB, *Guiding Principles on Corporate Governance For Institutions Offering Only Islamic Financial Services* (2006), principle 3.
[1058] IFSB, *Core Principles for Islamic Finance Regulation (Banking Segment)* (2015) IFSB-17, CPIFR 16 <http://www.ifsb.org/published.php> accessed 07 December 2015.

> monitoring the sharia compliance of Islamic financial services and products offered by domestic banks.[1059]

This lack of engagement of the regulators in *Sharia* related activities 'allows for maximum innovation', but can also result in 'mixed messages' regarding *Sharia* compliance.[1060] While the lack of regulation imposes no formal limits on product innovation, in practice the lack of a formal *Sharia* governance framework and central *Sharia* board, may cause a lack of confidence in the Islamic financial system and discourage innovation. This can lead to problems regarding specific products, such as *sukuk* and Islamic derivatives.[1061]

While there is no formal *Sharia* compliance framework, all Islamic banks have their own *Sharia* boards, with members appointed by the boards of directors. The vast majority are *Sharia* scholars, but fewer have expertise in the financial side of things and banking experience is not required for selection. Because of this arrangement, there is a lack of standardisation, with inconsistent *fatwas* issued by the *Sharia* boards of different banks.[1062] Given that the KSA has a significant provision of Islamic finance through Islamic windows of conventional banks,[1063] this creates an environment that allows the institutional influences of conventional finance and

[1059] Bedi Gunter Lackman, 'The Six Key Countries Driving Global Islamic Finance Growth' (2104) 6 *Nomura Journal of Capital Markets* 1, 14.

[1060] Reem M Asaad, The Regulatory Framework of Islamic Banking in Saudi Arabia, (2007) Paper Presented at the 17th Saudi Economic Association Forum, Riyadh, 02-07 June 2007, 6, 9 <http://www.cibafi.org/ControlPanel/documents/library/pdf/a85.pdf> accessed 08 December 2015.

[1061] Abdullah Abudllatef A Al Elshikh, Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia' (2011) 5 *Law and Financial Markets* 183, 194; Ali Alshamrani, 'A Critical Evaluation of the Regulatory Framework for the Application of Islamic Financial Derivatives in the Kingdom of Saudi Arabia' (2014) 2 *Journal of Islamic Banking and Finance* 269.

[1062] Bedi Gunter Lackman, 'The Six Key Countries Driving Global Islamic Finance Growth' (2104) 6 *Nomura Journal of Capital Markets* 1, 14; See, eg, the example of the initial public offering of the Yanuba National Petroleum Company, which was deemed sharia compliant by some scholars, but not by others: Abdullah Abudllatef A Al Elshikh, Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia' (2011) 5 *Law and Financial Markets* 183, 194.

[1063] Inwon Song, Carel Oosthuizen, 'Islamic Banking Regulation and Supervision: Survey Results and Challenges' (2014) IMF Working Paper WP/14/220, 11.

capitalism to affect the development of Islamic financial services and products. The impact of these institutions will nevertheless depend on the individual banks and their *Sharia* boards, which - along with the methods of Islamic *fiqh* - may be a source of inconsistency.[1064] As the Oxford Business Group noted in its 2014 Report on the KSA:

> SAMA has chosen to operate a relatively more relaxed regulatory framework with respect to Sharia compliance than many of its neighbours, a decision which has resulted in a diverse market in terms of products and services ... [this] allows Islamic financial institutions to assess the compatibility of their offerings with the precepts of sharia themselves - a process which is normally undertaken by an internal sharia board. The degree to which institutions adhere to sharia therefore varies considerably across the sector, with some banks marketing themselves as strictly Islamic and others taking a more conventional tack.[1065]

It should, however, be remembered that the KSA is a conservative Islamic country, which will provide a counter balance to the pressures of competitive capitalism.

5.2 The interview study exploring attitudes to Islamic finance

5.2.1 Method

The method was discussed in detail in section 1.6.2.2, but a brief summary here may be helpful. The study, which received ethical approval from the University of Westminster's Research Ethics Committee, comprised a semi-structured interview study of twenty participants. These participants were identified through a purposive

[1064] Ali Alshamrani, 'A Critical Evaluation of the Regulatory Framework for the Application of Islamic Financial Derivatives in the Kingdom of Saudi Arabia' (2014) 2 *Journal of Islamic Banking and Finance* 269, 298-299.
[1065] Oxford Business Group, *The Report: Saudi Arabia* (Oxford Business Group 2014), 108.

sampling method based on the inclusive criteria of: a professional role in Islamic finance; and experience of Islamic finance in the UK. the KSA or Malaysia. These interviews were conducted in person or by Skype, lasting for a maximum of one hour. The interviews were conducted in English or Arabic, recorded, translated into English where necessary, and transcribed. The transcripts were then subject to an interpretative analysis following McCracken's five stage method aimed at identifying 'patterns of intertheme consistency and contradiction'.[1066]

5.2.2 Demographic details

Of the twenty interviewees, three were female and seventeen were male. Five of the interviewees were based in Malaysia, eight were based in the UK and seven were from the KSA.[1067] The interviewees from Malaysia comprised: two *Sharia* advisors who hold academic posts and sit on a number of SCs, including the SAC of the BNM; a researcher at the International Shari'ah Research Academy for Islamic Finance (ISRA); a chief financial officer for an Islamic bank; and an academic from the International Islamic University. The interviewees from the UK were: three leading Islamic finance lawyers; four leading academics, including one with a background as an Islamic finance professional in the KSA and one who acted as a consultant to, *inter alia*, the IFSB and the Central Bank of Qatar; and an Islamic finance professional with experience working in Islamic finance for conventional and Islamic banks. The interviewees from the KSA were: three academics; an Islamic finance consultant who had previously been banking professional; a professional managing administrative and technical support for an *Sharia* board; a professional with a background in economics currently working for SAMA; a lawyer with a wide

[1066] Grant McCracken, *The Long Interview* (Sage 1988), 42, 43-46.
[1067] The study involved 20 interviewees of whome 17 were male and 3 female. 5 interviewees were from Malaysia, 8 were from the UK and 7 were from the USA.

range of experience in Islamic finance, including acting as a member of *Sharia* boards and also as an arbitrator for Islamic finance disputes;

5.2.3 The interpretative analysis of the interviews

In analysing the interviews it became clear that, while there was not a complete consensus, there were nevertheless a number of common themes and associated tensions (figure 19) that coursed through the responses. The discussion will begin with a generalised description of the amalgamated themes and concepts identified from the analysis of the transcripts. This will be followed by a critical consideration of the key themes and concepts more specifically. This discussion will be structured around the three sections of the interview: Islamic finance and its relationship with conventional finance; current *Sharia* governance; and reforming *Sharia* governance.

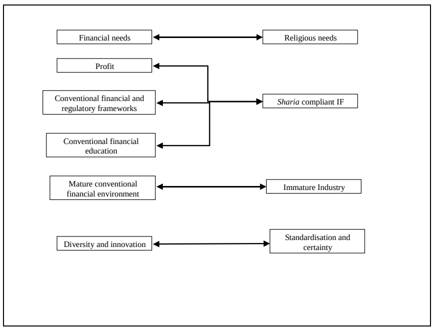

Figure 19: Themes and Tensions Identified from Interview Responses

The amalgamated thesis that may be abstracted from the interview responses is unsurprisingly founded on *Sharia* compliance as the central characteristic of Islamic finance, distinguishing it essentially from conventional finance. Thus, Islamic finance is faith based, ethical finance, subject to divine restrictions imposed by Allah. 'Based on real economic activities',[1068] 'money is not a commodity', but simply a 'medium of exchange'.[1069] While profit is acceptable, it can not be made through the exploitation or oppression of other, which explains the characteristic prohibitions of *riba*, *gharar* and *maysir*. It is unimportant who provides Islamic finance (Muslim or non-Mulsim, conventional bank or dedicated Islamic bank), as long as it is *Sharia* compliant and meets people's financial needs in a way that is socially just and consistent with the *Maqasid al-Sharia*. By providing financial opportunities to both rich and poor, Islamic finance should be an alternative to conventional finance that uses money productively, benefits society and avoids making 'profit at the price of the people'.[1070] To ensure that Islamic finance fulfils these goals it should be regulated by an 'end-to-end' system that has integrity, and is both trustworthy and transparent.[1071] National regulation is important, but some attention needs to be given at an international level to cross-border transactions, standardised guidelines, and a professional association for *Sharia* scholars.

In part one of the interview, the focus was on the nature and delivery of Islamic finance. Here the responses clearly indicated that the four core features of Islamic finance are: compliance with *Sharia*; 'participatory finance' based on risk sharing

[1068] Interviewee 2 (female researcher for ISRA, Malaysia). Interviewees 12 (male academic, UK), 13 (male academic, UK) and 14 (male lawyer, UK with experience of working in Middle East) made similar points.
[1069] Interviewee 8 (male Islamic finance professional, UK). Interviewee 17 (male academic, KSA) made a similar point
[1070] Interviewee 2.
[1071] Interviewee 1 (female academic and *Sharia* advisor on SAC of Malaysian Central Bank); interviewee 2,

rather than risk transfer;[1072] socially responsible and just investments that benefit society; and the productive use of money through trade in the "real" economy. It was seen as important to provide for Muslims an alternative to conventional finance, that meets both their financial and religious needs. These goals provide a crucial tension between profit and the constraints imposed by the need for *Sharia* compliance. For example, while interviewees 18 (male academic, KSA) and 19 (male Islamic finance professional, KSA) emphasised that Islamic banking is a commercial enterprise rather than a charity, interviewee 18 also explained that: ' banking should have moral side, to focus only on profit without moral view is useless'. This tension became something of a recurring theme, particularly in relation to the problem that Islamic finance has in the context of economic and regulatory frameworks designed specifically for conventional financial products and service.

In discussing the relationship between Islamic and conventional products, for example, Interviewee 5 (female lawyer, UK) explained:

> When we look at what a conventional instrument offers and then we try and deploy Islamic principles to effectively come up with an Islamic economic equivalent of that and the reason for that is because the entire economic framework is based on conventional models.

Interviewees 1, 2, 8, 14, 15 (male legally qualified Sharia scholar/advisor, KSA) and 16 (male professional providing administrative and technical *Sharia* support, KSA) all explicitly noted the problem of Islamic finance having to operate within a conventional regulatory framework. Interviewee 14, for example, noted that:

[1072] Interviewee 7 (male academic, UK). Interviewees 11 (male lawyer, UK) and 17 made a similar point.

> it goes back to the environment that Islamic financial sector has had to operate in and it is operating in a conventional economic space and that affects the perceptions of everyone in it, even subconsciously some times, so the bankers have come from conventional banking background. Consumers, even I would say Muslim consumers, I think they see what conventional banks do.

Thus, as interviewee 2 explained, regulation designed for conventional finance has 'forced the Islamic finance to eventually end up doing something just like conventional' and resulted in products that transfer risk rather than relying on the more characteristically Islamic model of risk sharing. Using the example of *sukuk* in Japan,[1073] Interviewee 1 similarly suggested that the conventional regulatory framework favours debt-based financial products and services over those that are equity-based and can make it difficult for Islamic finance to fit standard regulatory classifications.

Another theme that came through was that, it was generally accepted that Islamic financial products were modelled on conventional equivalents,[1074] with Islamic equity financing remaining distinct. This was not necessarily seen as a bad thing, provided that the products remained *Sharia* compliant.[1075] *Sharia* compliance is the

[1073] See, Elffie Chew, Liau Y-Sing, 'Japan Lacking Sukuk Rules Spurs Malaysia Debuts: Islamic Finance' (Online, 10 June 2014) *Bloomberg Business* <http://www.bloomberg.com/news/articles/2014-06-09/japan-lacking-sukuk-rules-spurs-malaysia-debuts-islamic-finance> accessed 11 September 2016. This looks likely to change: Takahiko Wada, Bernardo Vizcaino, 'Japan's FSA explores opening Market to Islamic finance (Online, 26 February 2015) *Reuters* <http://www.reuters.com/article/islam-financing-japan-idUSL5N0W03Z420150226> accessed 11 September 2016.

[1074] The exception was interviewee 20 (male Islamic finance professional, Malaysia), who expressed the view that Islamic finance products did not copy conventional finance.

[1075] Interviewee 3 (male *Sharia* advisor and academic, Malaysia); interviewee 4 (male academic, Malaysia).

'bottom line'.[1076] One particular problem, however, was noted by interviewees 4 and 12. Interviewee 4 explained that:[1077]

> basically what people should be concerned about is ... the pricing of some of these products -- pricing you use the conventional system -- the conventional system I think that is weird because they are still benchmarking against the interest rates.

For interviewee 12 this was a 'major issue' and a future challenge for Islamic finance to: 'come up with the rent, you know, with an index, that reflects the *ijara* rate and doesn't reflect the interest rates'.

Three interconnected reasons were advanced to explain the mimicry, or "Islamisation" of conventional finance.[1078] The first was that both Islamic and conventional finance had to meet similar financial needs.[1079] A second explanation was that the regulatory and economic frameworks were based on conventional finance and these necessarily affected the development of Islamic financial products.[1080] The third reason, was that the skill set of banking professionals and the framework of banks are conventional, which means that banking professionals are more comfortable with debt-based rather than equity-based financing.[1081]

These explanations suggest three possible forces affecting the development of Islamic financial products. First, there is a competitive, demand-based force with the

[1076] Interviewee 3.
[1077] Interviewee 4,
[1078] The phrase 'Islamise it' was used by interviewee 3.
[1079] Interviewee 1; interviewee 12, interviewee 13.
[1080] Interviewee2; interviewee 5; interviewee 10 (male regulatory professional (economist), KSA); interviewee 14; interviewee 15; interviewee 16.
[1081] Interviewee 6 (male academic with professional background, currently UK, previously KSA); interviewee 14.

financial needs of customers influencing the nature of the products. As interviewee 6 explained:

> On the demand side, there are forces also working which compel Islamic banks to basically offer the similar products very close to conventional because they are used to these products;

and

> It is that people, when they go to banks, they expect services which are similar to conventional banks.

Given its long history and well established products and services, it is likely that customer demand will be shaped by conventional finance and this then creates a pressure to provide an Islamic equivalent. As interviewee 19 commented:

> Islamic finance is only 30 years, which is in its infancy period ... It is in its infancy period and you want to compete with others that had been 200 to 300 years already? So that they will do, they will just copy a contract ... And then they will just change the label and unfortunately they will claim that it is Islamic.

In other words, conventional finance is far better established than Islamic finance and has shaped customer expectations, which then act on those providing Islamic finance and create a pressure to provide similar products and services. While not a direct influence, this is nevertheless the consequence of the institutional logics of the neoliberal capitalism that underlies conventional finance.

Second, the regulatory and economic frameworks impose a direct pressure that requires products to fit into particular established categories. This direct force also carries with it an ideological rationale. While the 2007 global financial crisis may have caused some tempering, regulatory and economic policies nevertheless remain essentially capitalist and neoliberal in nature. Furthermore, as discussed in chapter three, Islamic finance grew up during the period that saw neoliberal capitalism ascend. Thus, during a crucial stage of its early development, Islamic finance was indirectly subject to the logics of neoliberal capitalism through its impact on conventional regulatory and economic frameworks.

Third, as a young industry, Islamic finance necessarily had to rely on professionals educated under a conventional financial model. As interviewee 8 noted, Islamic finance is 'dominated by people who come from conventional backgrounds'. Although there may not be anything wrong with 'the industry leveraging of the expertise of non-Muslims and conventional bankers who may or may not be Muslim', it may nevertheless be a problem, since 'these people don't necessarily have a very clear understanding of the end customer'. A related point was made by interviewee 14, who commented:[1082]

> Many of them come from the conventional banking background, so the issue is how much do they really know about Islamic finance. I do not just mean the products ... but is there a real understanding of this *Maqasid of Sharia*.

Furthermore, those professionals coming from a conventional background:[1083]

> don't really care how they design a product or for whom they are designing a product. They just want to make money and that I think is the fundamental problem with the industry.

[1082] A similar point was also made by interviewee 19.
[1083] Interviewee 8.

These expressions of concern highlight the impact of a reliance on conventional finance, both educationally and professionally. As a consequence of this reliance, the norms and behavioural scripts of conventional finance, as shaped by the logics of neoliberal capitalism, are likely to impact on the development of Islamic finance frameworks, products and services. Where one's background is conventional finance then the starting point for innovation is likely to be conventional finance. However, this is not necessarily fatal to the further development of Islamic finance as, despite their differences in design, the starting point of many conventional investment banking products and *Sharia*compliant is their common focus on equity-linked financing.

An additional theme expressed by a number of interviewees was the characterisation of Islamic finance as a young, nascent industry, which connects the development of Islamic financial products and services to the issue of competition. Interviewee 3, for example, stated:

> you have to be fair with Islamic finance because Islamic finance -- I mean if you think Dubai Islamic bank as the first institutional Islamic Bank -- I mean it is just about 40 years back ... we are still new, we are still developing.

Building on this theme of development in the context of an established conventional economic framework, Interviewee 5 commented that:

> we take something that is Islamic and we try and put it into a box that is conventional, because the entire external framework is conventional it would be too difficult to create effectively a new

> world of -- a new economy entirely from the beginning ... There needs to be a process of adoption and change we can't do it in instantly.

Drawing the connection between a young industry trying to grow within the environment of the already well established industry of conventional finance and the need to be competitive, Interviewee 4 explained:

> it needs to compete because it is relatively new in the financial environment so for you to be outstanding, you must stand out or for you to be able to stand out you must be outstanding, so you must come up with innovative products.

The youth of Islamic finance has at least two consequences: the need to establish a foothold through competition with existing financial services; and the need to rely on existing expertise and knowledge. These two factors both create opportunities for the norms and behavioural scripts of conventional finance to influence and shape the development of Islamic finance. Interviewee 19 explicitly drew a connection between the 'infancy' of Islamic finance and its need to compete with the more mature and established conventional finance, which created an incentive to: 'just copy a contract ... change the label and unfortunately they will claim that it is Islamic'.

While competition with conventional finance may be the source of mimetic isomorphism,[1084] generally, the interviewees saw competition as a good thing. Interviewee 1, for example, explained that it 'makes you strive to give your best' and

[1084] Interviewee 15 noted: 'The bottom line is the customer, or at least the vast majority of the customers will come to Islamic bank if they get the same terms and conditions, pretty much the same, but if there are major differences, they will just quit'.

interviewee 10 pointed out that competition with conventional finance drives innovation and creates opportunities for the two industries to learn from each other:

> that creates an incentive for scholars to go for opinions that they might have not gone for had there been no competition with the conventional Bank because they see that there is need for that and they want to develop this.

This competition was seen as essentially driven by the norms of a competitive market environment[1085] populated with 'price conscious' customers,[1086] who are 'looking at dollars and cents'.[1087] As interviewee 12 explained, Islamic finance 'has to compete at the same level of profitability, efficiency, and effectiveness ... Islam is an entrepreneurial finance'.

Contrary to most of the views expressed, a minority of interviewees were not convinced that Islamic finance needed to compete.[1088] Interviewee 19 suggested that Islamic and conventional finance could co-exist as co-operative partners in a 'win-win game'. Interviewee 17 expressed the view that there was a demand from Muslims for Islamic finance 'to replace' rather than compete with conventional finance. However, this may be construed as the ultimate effect of successful competition with conventional finance. Interviewee 20 similarly explained that Islamic finance was targeting Muslims as 'people who would take the Islamic financing even if it is more costly'. Still, this is not to say that Islamic finance would nto compete with conventional finance; on the contrary, Islamic finance, here, competes directly with conventional finance, not on price, but on compliance with

[1085] Interviewee 3.
[1086] Interviewee 5.
[1087] Interviewee 1.
[1088] Interviewees 8, 17, 19 and 20.

Sharia principles. Interviewee 8 suggested that there may be no need to compete with conventional finance generally since the market for Islamic finance was different, although he accepted that there may be a need to compete in the market for ethical finance. It should be noted, however, that he did not claim there was no competition between conventional and Islamic finance, only that he was 'not sure they need to compete'. Both interviewees 1 and 6 also noted that IF served different consumer groups, which impacted on the need to compete. Interviewee 6 broke down the market for Islamic finance into three consumer groups: the devout Muslim; the pragmatic Muslim; and those for whom religion is not a factor. The devout Muslim will chose Islamic finance regardless, while the third group will generally opt for conventional finance. Pragmatic Muslims, however, will chose Islamic finance only if it offers the same service and returns as conventional finance.

It is this group of pragmatic Muslims that drives the competition between Islamic and conventional finance. This competition is seen as necessary for the success of Islamic finance,[1089] affecting the choices made by banks, who choose to develop 'less risky' options,[1090] and prefer risk transference to risk sharing.[1091] This profit driven competition[1092] requires the banks to:[1093]

> look at where the cash flows are so if there is Islamic money available for particular types of investments, people will structure the deals to attract that that cash.

[1089] Interviewee 9, male, academic, KSA.
[1090] Interviewee 1,
[1091] Interviewee 2.
[1092] Interviewee 9.
[1093] Interviewee 5.

The pressure from customer demand encourages the banks to develop services and products that are 'similar to conventional' products and services.[1094] Similarly, interviewee 3 explained that competition affects the development of Islamic financial products:

> because they have to provide and they have to keep up with the pace of the market -- you see -- what is the need of the people, what is the need of the market.

There are, then, a number of themes that have emerged from the first part of the interviews, that help to explain the relationship between Islamic and conventional finance. These themes may be combined to form a claim about that relationship. This claim, which relies both on the themes identified in the interviews and the analysis of Islamic finance developed in the earlier chapters, is that:

> *Islamic finance is a young industry that has necessarily had to rely on the expertise and knowledge base of conventional finance. It has grown up within the restrictions of regulatory and economic frameworks that are essentially conventional in nature. It has had to compete with conventional finance to establish its place in the market. All of these factors have combined to shape the development of Islamic financial services and products. These have inevitably been influenced by the neoliberal capitalist logics that have dominated conventional finance for the last 40 years, which spans the birth and growth of modern Islamic finance. Islamic finance should aspire to fulfilling the broader goals of*

[1094] Interviewee 6. Interviewees 11 and 13 made similar points.

ethical finance though social justice and benefiting the community. The 'bottom line', however, remains the constraint that Islamic financial products and services must be at least technically Sharia-compliant.

This claim leads into part two of the interviews, which explores the interviewees' attitudes towards the current approaches to *Sharia* governance in the UK, Malaysia and the KSA.

There was a general agreement that *Sharia* governance was a critical aspect of Islamic finance. It was seen as necessary or obligatory,[1095] and 'the most important aspect of *Sharia* compliance'.[1096] This is consistent with the idea that *Sharia* compliance 'is the very underpinning',[1097] or 'heart of Islamic finance',[1098] and 'the core of what is acceptable'.[1099] Indeed, interviewee 17 explained that, without Sharia compliance 'there is no justification for Islamic finance'. There may, however, be a mismatch, since interviewee 8 complained that *Sharia* compliance is 'not being given the respect it deserves'. He explained that:

> conventional bankers dominate ... they tend to see it as a bit of a compliance department where you just get to tick the boxes.

Where Muslims are simply seen as a potential market for financial products, and where Islamic finance is simply seen as a means of increasing profit by meeting the demand from that market, then the religious significance of *Sharia* compliance may take second place to efficiency and competitiveness. Taking a permissive approach

[1095] Interviewee 1; interviewee 4; interviewee 7.
[1096] Interviewee 10.
[1097] Interviewee 13.
[1098] Interviewee 1.
[1099] Interviewee 5. Interviewee 11 made a similar point.

to *Sharia* compliance and focusing on form rather than substance may provide the bank with a competitive edge and leave the ordinary Muslim customer vulnerable to a breach of their trust that the product is genuinely *Sharia* compliant.[1100] As interviewee 9 pointed out:

> even banks complain from competition aspect as some banks enjoy flexibility to offer more products and the client goes to these banks.

The issue of whether *Sharia* governance should focus on compliance in a formal technical rather than a substantive spiritual sense was adverted to by Interviewee 14, who noted that:

> there is, I think, a debate going on, form over substance, I mean it is a very formalistic, legalistic in a *Sharia* context approach ... it boils down to the direction of Islamic finance, where it needs to go.

For Interviewee 13, while the Islamic products may have avoided offending Islam by satisfying 'the letter of the law', the requirement for *Sharia* compliance 'hasn't gone far enough' with a failure to satisfy the 'substantive' requirement that the products be 'really in keeping with Islamic principles'. According to Interviewee 15, this formalistic approach to *Sharia* compliance had burdened Islamic finance with 'a very serious credibility challenge'. For Interviewee 15, the problem is that:

> a little bit of manoeuvring here and there has changed that something which was accord of harm in Allah... has suddenly become a blessing from Allah and his prophet

[1100] Interviewee 17.

This was made possible, he explained, because in the context of *Sharia* governance: 'there is no consistency, there is no basis, foundational basis'. As Interviewee 18 explained:

> it is a big problem, If you said I'm an Islamic bank and I have compliance, whether weak or strong, ok, compliance with what ? with *Sharia* board, *Fatwas* (legal opinions) or the principle of Islamic Finance (*Sharia* aims).

Although there was a general agreement that *Sharia* governance was necessary, there were some different opinions on the most appropriate regulatory framework. Some form of regulation was seen as important for confidence and growth of the industry.[1101] Interviewee 6 explained that *Sharia* compliance 'depend[s] on the regulatory regime' and, without adequate regulation 'it will be market driven and sometimes market driven products will be at the cost of *Sharia* compliance'. In institutional terms, this suggests that good regulation can counter the isomorphic pressures imposed by the need to be competitive in an otherwise liberal capitalist market. The influence of regulation may be both directly through the explicit rules, but also through its impact on the culture within the industry. As interviewee 1 noted, the risk of *Sharia* non-compliance depends on regulation and governance: 'better governance framework ... better culture of compliance'.

Interviewee 7 also recognised the competitive pressure on banks, who are 'always pushing the boundaries' of what is acceptable. While interviewee 7 saw regulation as sovereign issue for the individual nation, he also emphasised that it was important at

[1101] Interviewee 2. Interviewee 19 made a similar point.

both the national and organisational levels. At a national level, most of the interviewees identified the Malaysian model (see above) as the best example of *Sharia* governance within a national regulatory framework. Only interviewees 9 and 10, both from the KSA, disagreed. While suggesting that Islamic finance did need national regulation, they were both against the Malaysian approach of a central *Sharia* board. At an international level, the problem of cross-border transactions was identified and associated with a lack of any international regulatory framework.[1102] Interviewee 5 pointed out that current regulation was 'ad hoc', noting that the AAOIFI and IFSB 'are extremely helpful', but lack 'industry wide compliance'. Interviewee 8 also emphasised the importance of the AAOIFI and the IFSB for helping to 'homogenise' rulings.

While a degree of standardisation was seen as valuable, particularly in relation to the procedural aspect of *Sharia* governance, one theme that emerged from the interviews was the tension between standardisation and diversity. This tension was, for example, evident in the response of interviewee 8, who stated:

> I think that the diversity is helpful for innovation, so at this point in time, I am not keen on standardization because it actually stifles innovation ... although I do believe that you know we do need regular discussion and forums and organizations like AAOIFI and IFSB to homogenize rulings across the world. So we need to have the freedom to develop new products and also need to have a framework by which we are all accountable to. So, I think it is helpful to have both.

[1102] Interviewee 4.

The tension was also expressed by interviewee 13, who explained that it:

> is a bit of a fine balance ... Enabling enough diversity, enough flexibility in decisions of what is *Sharia* compatible so that diversity of the law is respected, but on the other hand establishing enough of the framework so that in fact the industry is allowed to flourish by virtue of the certainty that the framework provides.

In general, diversity of *fatwas* is seen as a permissible part of *Sharia*,[1103] a characteristic part of the nature of Islamic jurisprudence, 'one of the beauties of our faith',[1104] and something to be celebrated.[1105] Diversity 'gives richness and options',[1106] leads to debate and progress, which are signs of a healthy industry,[1107] and is good for innovation and competition.[1108] Diversity is, however, an issue where it is deregulated or where regulation exists, but lacks the foundations of clear and principled standards.[1109]

Both interviewees 9 and 6 drew the association between *fatwas* and law, arguing that both needed uniformity and certainty. Interviewee 6 explained that *fatwas*, like law, should be uniform at the national level, since they have a real impact on people's money and are 'not an academic exercise'.[1110] Interviewee 9 suggested that diversity was desirable in the context of research, but 'within the organisation stage this is a disaster as laws are not to be legislated on probabilities or possibilities'. As both

[1103] Interviewees 3, 12, 14, 17, 19.
[1104] Interviewee 8.
[1105] Interviewee 4.
[1106] Interviewee 1.
[1107] Interviewee 7.
[1108] Interviewees 8, 16, 20.
[1109] Interviewees 12, 15.
[1110] Interviewee 18 similarly suggested that business required the certainty of a single opinion.

interviewee 2 and 9 explicitly identified, too much diversity can lead to *Sharia* arbitrage and *fatwa* shopping.

Interviewee 7 commented that:

> I do not think personally there is much of *fatwa* shopping ... they want to comply and they want a credible system, so I do not think in practice clients do that.

The problem of *fatwa* shopping, however, was recognised by the majority of the interviewees.[1111] A distinction was drawn between 'benign' *fatwa* shopping and *fatwa* shopping in the negative sense.[1112] Benign *fatwa* shopping is where the *Sharia* board considers a range of opinions and opts for the one that best meets the needs of all the stakeholders, even if it is a minority view. *Fatwa* shopping in the negative sense, where the bank shops around for a *Sharia* scholar who will give the opinion that best suits its commercial need,[1113] was seen as a serious issue,[1114] unethical,[1115] *haram*,[1116] and 'a dirty practice ... [that] happens amongst people who have hijacked the industry to make money out of it'.[1117] The rationality of this was highlighted by a comment made by interviewee 10. This interviewee, who has a background in economics and works for SAMA - a conventional finance regulatory body - suggested that:

> [if I was a banker with] the opportunity to cherry pick scholars, I would be the happiest person on earth because I can cherry pick people who will provide me with the freedom of having the biggest suite of products that I could have.

[1111] Interviewee 13 stated that he had not seen it in practice.
[1112] Interviewees1, 4, 13.
[1113] Interviewee 16.
[1114] Interviewee 2, suggesting that the Goldman Sachs *sukuk* was an example.
[1115] Interviewee 9.
[1116] Interviewee 19.
[1117] Interviewee 8.

This rationale was given substance by the anecdotal experience of Interviewee 20, who explained:

> I can give you a more clear example which has came lately ... our HR has been called by a local bank here saying we are considering to recruit for our *Sharia* board the person who is currently serving in your *Sharia* and how conservative he is. That was a clear question.

The general view of the interviewees was that regulation was required to limit the options for *fatwa* shopping. This included the suggestion that part of the problem was caused by some *Sharia* scholars issuing *fatwas* without really understanding the product.[1118] While *Sharia* scholars were generally seen as trustworthy and deserving respect for their opinions, it was also suggested that in some cases the *Sharia* scholars were limited to understanding the legal form, but not the impact of the product,[1119] or that they were being presented with inadequate information and were over-pressed.[1120] This was seen as being an issue for regulation, to ensure that only appropriately qualified scholars are appointed to *Sharia* boards, but also as a professional issue requiring a national, or international,[1121] professional association for *Sharia* scholars.[1122]

Relatedly, the issue of conflicts of interest on *Sharia* boards arose. Some interviewees felt that the commissions and salaries provided to the members of *Sharia* boards militated against the consistent application of the principles to

[1118] Interviewee 3.
[1119] Interviewee 3.
[1120] Interviewee 2.
[1121] Interviewee 4.
[1122] Interviewee 3, referring to the Malaysian Association of *Sharia* Advisors, which has a Code of Conduct. Interviewee 14 also suggested a professional body for *Sharia* scholars.

instruments for which authorisation was sought. While reputational concerns of board members may work to reduce the likelihood of granting approvals for the sake of commissions, thiese concerns are unlikely to apply uniformly across the market.

The suggestion that there should be an international, or at least a national, professional association for *Sharia* scholars connects to the third part of the interview, which was focused on how *Sharia* governance should be reformed or developed. Here there was general agreement that any formal regulation should be nationally based. International or regional *Sharia* boards were generally not seen as viable or feasible. Rather than attempting formal international regulation, the theme that emerged from the interviews was for some form of international body to issue guidelines and standards, but that, for reasons of sovereignty,[1123] it should be for national regulators to implement and enforce those that are appropriate given the particular context of the relevant country. The AAOIFI was seen as one possibility, but the current framework would need to be developed to ensure standards are regulatory driven rather than market driven.[1124] It was also acknowledged that currently there was an issue with the lack of implementation of guidelines and standards issued by the AAOIFI.[1125] Indeed, as interviewee 15 noted: 'Even AAOIFI standards ... Are not followed by the members of the AAOIFI'. In addition to enhancing the role of AAOIFI, a greater role was also envisaged for the OIC *Fiqh* Academy, which could push for international regulation, or establish an influential international committee of *Sharia* Scholars.

[1123] Interviewee 17.
[1124] Interviewee 3; interviewee 6.
[1125] Interviewee 2.

On a national level, as noted earlier, the Malaysian model of specific regulation for Islamic finance, along with a central *Sharia* committee was generally seen as the best way forward, possibly harmonised through a Model Law.[1126] The two interviewees from the KSA, however, were firmly against a central *Sharia* committee. Interviewee 9 explained:

> We do not want a Higher *Sharia* Board, as we may expect an undesired rejection of a product as a result of difference of opinions. We want standards issues by Central Banks, so that transactions would not be delayed for months.

On a national level, both external and self-regulation were seen as important.[1127] Any such system should be consistent, transparent, credible and robust.[1128] It should focus on substance rather than just the form of Islamic financial products and services.[1129] It should, furthermore, provide a clearly defined framework of responsibility and accountability[1130] that restricts the opportunities for conflicts of interest.[1131] Again the tension between diversity and standardisation emerged as a theme, with interviewees emphasising the need for general standards that contain sufficient flexibility to allow the diversity necessary for competition and choice.[1132] In this regard, and again highlighting both the issue of the youth of the industry and the tension between diversity and compliance, interviewee 1 suggested that flexibility and diversity was important to allow Islamic finance to become established, but 'when all situations become better, we should now strive for narrowing diversity'.

[1126] Interviewees 13, 16, 18.
[1127] Interviewee 1. Interviewee 11 also emphasised the need for external regulation.
[1128] Interviewees 5, 7, 12, 16.
[1129] Interviewees 12, 15.
[1130] Interviewees 12, 14, 20.
[1131] Interviewees 11, 20.
[1132] Interviewee 1; interviewee 9.

5.2.4 Summary of the findings from the analysis of the interviews

A number of themes emerged from the interviews. These included: the tension between the need to make a profit and the need to ensure *Sharia* compliance; the problem for Islamic finance in fitting into established conventional economic and regulatory frameworks; that customer and market demand, combined with the existing frameworks and the need to rely on conventional financial structures and expertise, created a pressure that resulted in Islamic financial products and services being modelled on conventional financial equivalents; that competition is an inevitable driving force, helping to shape the development of Islamic finance; that *Sharia* compliance was fundamental and required *Sharia* governance within a national regulatory framework; that there was a tension between the need for diversity and standardisation, which should be recognised by the regulatory framework; and that existing international bodies should be developed to improve the implementation of international standards and guidelines, but that any enforcement should be at the national level.

One additional theme that should be emphasised is that Islamic finance, in its current form, is a young industry in the process of establishing itself and defining its identity. It cannot, however, remain a 'nascent' industry forever. If Islamic finance is to mature into the industry it should be, with a strong identity as a genuine ethical alternative to conventional finance, then it needs to focus its attention on *Sharia* governance within a broader regulatory framework. Islamic finance should also serve the wider goals of Islam, the goals of social justice and community benefit that may be characterised as the spirit of *Sharia*. How far Islamic finance succeeds in defining itself in these terms, as consistently both technically *Sharia* compliant and ethically motivated, will depend to a large extent on the development of an appropriate regulatory structure to counter the neoliberal capitalist scripts that treat money as a valuable intrinsic end in itself. This, however, requires the industry to decide on how it should be regulated and, where relevant, to lobby for change in national law to support that necessary regulatory framework.

5.3 Conclusion

The chapter began with an explication of the existing approaches to *Sharia* governance in the UK, Malaysia and the KSA. This served two purposes. First, it built on the more theoretical discussion of *Sharia* governance in chapter four. Second, it provided the context for the interviews. These initial vignettes identified a generally supportive environment in all three jurisdictions, but with quite different regulatory approaches. While *Sharia* governance was left to the individual institutions in both the UK and the KSA, Malaysia has established a rigorous regulatory structure based on regulation through the Central Bank, and the standardisation of *fatwas* through the central *Sharia* Advisory Committee.

Having provided the background context for the qualitative interview study, the second part of the chapter focused on the analysis of the interviews. It would perhaps be unduly repetitive to repeat the conclusion to that study here. Rather, it is more relevant to note that the themes identified in those interviews will feed into the discussion of regulatory reform that provides the focus for the subsequent chapter. That discussion will build on the analysis of the interviews presented in this chapter. It will integrate the themes identified into a wider debate regarding the options for reform, also taking into account the analyses of earlier chapters. This will allow the strengths and weaknesses of the options to be considered, and a recommendation made for the future development of *Sharia* governance and the regulation of Islamic finance.

Chapter Six: Islamic Finance and the Future of Sharia *Governance*

In this thesis, the *Sharia* governance of Islamic finance has been explored. From an analysis of the literature it is apparent that there are two essential concerns with Islamic finance. First there is the issue of inconsistent *fatwas* that results from a diversity of opinion and a lack of standardised and formal approach to *Sharia* governance. This can lead to *Sharia* arbitrage and *fatwa* shopping. The second, and related, issue is the criticism that Islamic financial products are *Sharia* compliant only in form and not in spirit. This has resulted in products that are technically compliant, but are not seen as characteristically "Islamic", bearing little relation to the *Maqasid al-Sharia*. Both of these concerns were also apparent in the interview responses discussed in chapter five.

Relying on the methodological approach of new institutionalism, it was argued that, when combined with Islamic *fiqh*, which allows for a diversity of opinion, these two concerns resulted from the competitive, normative and mimetic isomorphic influence of conventional finance and the institutional logics of neoliberal capitalism. One of the major themes that emerged from the interviews was that Islamic finance was still a new industry. This characterisation of Islamic finance as a nascent industry trying to find its feet in a competitive and capitalist global environment dominated by conventional finance was presented as an apologetic explanation for the current state of Islamic finance and *Sharia* governance. This is not to suggest that the interviewees saw Islamic finance as being in a bad way. All of the interviewees were very positive about the development of Islamic finance over the 40 years of its modern renaissance. It was, however, clear that they all acknowledged the two *Sharia* compliance issues noted above and saw room for improvement in the regulation and *Sharia* governance of Islamic finance.

There are, then, two aspects of the current approach to Islamic financial products and services that may benefit from reforming *Sharia* Governance. These are: an increase in reliability through the standardisation of the process, which may also have the benefit of reducing human resource demands;[1133] and an improvement in the Islamic quality of the products and services through a greater focus on compliance with the spirit of *Sharia* as well as its formal elements. In this chapter, the question of how *Sharia* governance might be reformed to achieve these goals will be addressed. This involves engaging with *Sharia* governance at three different levels: the level of the firm; the national level; and the international level. A complete solution that provides a comprehensive and coherent framework for *Sharia* governance must engage with all of these levels. For each level there are a number of options that may be combined to construct just such a framework. First, the features of an ideal regulatory system of *Sharia* governance will be discussed. This will include consideration of the institutional relevance of regulation. Second, the options available at each of the three levels will be examined. The final stage will be to explore how these options might be combined to produce a comprehensive framework that is capable of providing a globally standardised approach to *Sharia* governance.

As a final point in this introductory section it should be noted that reforming *Sharia* governance is not simply about a structural solution that standardises the process. While this is an important part of the reforms, it is also important to address the

[1133] Volker Nienhaus, 'Human Resource Management of Islamic Banks: Responses to Conceptual and Technical Challenges' in Simon Archer, Rifaat Ahmed Abdel Karim (eds), *Islamic Finance: The New Regulatory Challenge* (e-book 2nd ed, Wiley 2013), § 3.2.

institutional influence of any regulatory system. As noted above, one of the concerns for Islamic finance is the ongoing influence of the institutional logics of neoliberal capitalism. The interaction between the logics of neoliberal capitalism with those of *Islam* and the *Sharia* create a number of tensions that have shaped the structures, products and services of Islamic finance resulting in a 'conventionalisation of Islamic banking and finance'.[1134] As was readily apparent from the interview responses, these tensions include: the need to generate a profit and the need to ensure *Sharia* compliance; the need to compete with conventional finance within existing economic and regulatory frameworks specifically developed for conventional rather than Islamic finance; the need to rely on conventional finance expertise while trying to develop a genuinely Islamic alternative; the distinction between compliance in form and compliance in spirit; and the need for both diversity and standardisation.

In seeking to manage these tensions, reform of *Sharia* governance should be concerned both with the structure of the framework and also with its potential for its institutional logics to reinforce Islamic norms as the dominant cultural force driving Islamic finance. Properly designed, a comprehensive and coherent *Sharia* governance framework should enhance the ability of Islamic finance to resist the institutional influences of conventional finance and neoliberal capitalism, with its very different attitudes to money, interest and social justice. As Mizushima has noted:

> *Shariah* governance is one of the cornerstones that will determine how successful Islamic finance will be in the years to come. It is in *Shariah* governance that we will find the issue of whether Islamic

[1134] Humayon Dar (ed), Global Islamic Finance Report 2012 (2012), 44 <http://gifr.net/gifr_2012.htm> accessed 01 February 2016.

> finance is really Islamic (in terms of its achievement of social justice) or just a copy of Wall Street products with Islamic wrappings.[1135]

At present, as Song et al have noted, 'there is yet no internationally generally accepted legal, regulatory, and supervisory framework dealing with Islamic banking'.[1136] If Islamic Finance is to develop from a nascent to a mature alternative to conventional finance, it needs a coherent and comprehensive framework for *Sharia* governance to ensure public confidence in the very feature that truly distinguishes Islamic from conventional finance.

6.1 The features of an ideal regulatory system of *Sharia* governance

A prerequisite for any effective system of regulation is that the regulatory objectives are clear.[1137] In the context of *Sharia* governance, the need to ensure *Sharia* compliance is, at least superficially, a clear goal that can be used to as a focus for the design of an appropriate system of regulation. The apparent clarity of this objective, however, conceals two underlying issues, both of which were apparent in the interview responses discussed in chapter five. First, is the tension between standardisation and diversity.

While some degree of standardisation is seen as beneficial, diversity of *fatwas* is also considered important for the innovation necessary for the development of Islamic finance and its ability to survive in a competitive environment. Furthermore, the freedom to issue diverse *fatwas* is seen as entirely consistent with Islamic *fiqh*.

[1135] Tadashi Mizushima, 'Corporate Governance and Shariah Governance at Islamic Financial Institutions: Assessing from Current Practice in Malaysia' (2014) 22 *Reitaku Journal of Interdisciplinary Studies* 59, 83.
[1136] Inwon Song, Carel Oosthuizen, 'Islamic Banking Regulation and Supervision: Survey Results and Challenges' (2014) IMF Working Paper WP/14/220, 8.
[1137] Robert Baldwin, Julia Black, 'Really Responsive Regulation' (2008) 71 *Modern Law Review* 59.

Interviewee 8, for example, commented that 'one of the beauty of our faith ... [is the] freedom of flexibility'. Interviewee 5, a lawyer specialising in Islamic finance, explained that *fatwas* are:

> like legal opinions. We as a law firm can issue an opinion. It is quite possible for another firm to take a different view and providing we can justify our view and they can justify their view. In a way, it's up to the client to decide what works for them.

She went on to acknowledge that inconsistent legal opinions can be resolved by the judgment of the court while:

> It's very difficult with the *fatwa* to have a final arbitration as to what is acceptable or not.

This, however, was not 'the end of the world'. Rather:

> It is OK to have a range of interpretation and values. Then the customer decides what is acceptable.

Although interviewee 5 suggests that it is difficult to subject *fatwas* to a final arbitration, this may be a reflection of her location in the UK, which does not recognise *Sharia* law as a national legal system under the Rome Convention on the Law Applicable to Contractual Obligations, as implemented by the Contracts (Applicable Law) Act 1990.[1138] As was discussed in chapter five, however, Malaysia has enacted the Central Bank of Malaysia Act 2009, which provides the central SAC with the authority to resolve any differences of opinion regarding *Sharia* compliance. Under s 56, both courts and arbitrators must refer *Sharia* issues to the SAC for resolution, which is then binding under s 57. This suggests that there are at least two

[1138] *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2004] EWCA Civ 19; [2004] 1 WLR 1784, [40].

options for a regulatory system: the restriction of diversity through a central *Sharia* board with the same authority afforded to the Malaysian SAC; or the acceptance of diversity coupled with an obligation of transparency with regard to any *fatwas* issued, including reference to and explanation of, any differences of opinion. These solutions will be returned to later.

The second underlying issue that must be determined if the regulatory objectives are to be clear, is the question of whether *Sharia* governance should aim simply for technical compliance or for the more demanding requirement of ensuring that the products and services are consistent with the spirit of *Sharia* reflected in Islam's approach to the nature of money, social justice and community benefit. As was discussed in chapter five, it was apparent from the interview responses that technical compliance is the "bottom line". It was seen as better to have technically compliant Islamic finance to meet the basic religious needs of Muslim clients, than to provide no alternative to conventional finance. Imperfect Islamic finance is better than nothing.[1139] This was particularly so given the relative youth of Islamic finance as an industry trying to compete for a foothold in the global world of conventional finance. It was also apparent, however, that it would be better for Islamic finance to aim for genuinely Islamic finance, which is not simply about the prohibition of interest, but 'is about the real economy and ... the nature of money'.[1140] For example, in discussing Islamic finance in Malaysia, interviewee 2 commented:

> when we first started the Islamic finance and banking in Malaysia it was very much into giving an alternative to the consumers that ... is not interest based banking -- you know its Islamic banking. We are

[1139] Abdul Karim Aldohni, 'The Emergence of Islamic Banking in the UK: A Comparative Study with Muslim Countries' (2008) 22 *Arab Law Quarterly* 180, 186.
[1140] Interviewee 8.

done with that period. Now we are moving towards -- not only we say that this is *Halal* banking but it must be *halal* and *tayyib*.[1141]

It not simply a matter of technical *Sharia* compliance, of ticking boxes,[1142] rather it is about the product as a whole and:

> [its] impact ... [on] the economy... [and] the environment ... [and]society, to this many things that is affected by this banking and finance ... what we are trying to push forward in Islamic finance is a socially responsible investment ok. Not only we produce product that is in *Sharia* compliance, but it makes sure that it has -- it gives benefit

In a similar vein, interviewee 3 suggested that:

> we have to go beyond the legality of the product that we are proposing – into looking at the impact of the instrument that we are offering people that people can say, "oh yes it is different between the Islamic and also the conventional".

It is therefore important to look at what motivates moral compliance with *Sharia* principles. In Islamic theoology, the model of interest is rejected because it serves to objectify time as a material entity from which rents can be extracted through interest.[1143] Thus the underlying moral concern with Islam's prohibition of *riba* is with the conception of time as a godr from God, whose commodification would be seen as incompatible with *Sharia* principles.

More broadly, practitioners of Islamic finance seek to "*align themselves morally with corporate social responsibility and socially responsible investing movements in the way they expect to receive profit on investments while at the same time improving upon moral imperatives, such as building community and fostering healthy business practices*".[1144]

[1141] While *halal* refers to the permitted, *tayyib* goes beyond this and refers to the good, wholesome, fair and lawful.
[1142] Interviewee 12.
[1143] Wilson, Rodney, 'Islamic Finance' (1997), FT Financial Publishing, London.
[1144] Karen Hunt Ahmed, Islamic banking and Finance: Moral beliefs and business practices at work (2009), De Paul University.

Beyond the need for clear objectives, a good system of regulation should be coordinated, coherent, efficient and effective.[1145] While it is certainly important for regulation to be efficient and cost-effective, this does not mean that the quality of any *Sharia* compliance regulatory framework can be fully determined by its ability to maximise wealth. Because of its religious and moral significance, *Sharia* compliance cannot be fully reduced to an economic value. It is, therefore, important to consider other benchmarks of good regulation to guide the design of a suitable framework. Efficiency is an important factor, but wealth maximisation should be secondary to protecting the moral and religious integrity of Islamic finance.

A significant issue for *Sharia* governance is, that in countries like the UK and the KSA, the arrangements are *ad hoc* and left as a matter of self-regulation for the individual firms with little, if any, central oversight. This lack of any coherent coordination is one aspect of the regulation of *Sharia* compliance that could be improved through the standardisation of national frameworks, backed by international coordination. The lack of any central oversight and administration also creates a problem of accountability. In the absence of any external regulatory framework, accountability is essentially a matter for the individual firm. This is particularly problematic given the tension between profit and *Sharia* compliance that is inherent to Islamic finance operating within the context of an environment dominated by conventional finance and neoliberal capitalism.

Accountability is an important component of Baldwin et al's five criteria for assessing the quality of the regulatory framework:

[1145] Robert Baldwin, Julia Black, 'Really Responsive Regulation' (2008) 71 *Modern Law Review* 59, 59, 71.

- legitimisation of the regulatory framework by legislative authority;
- appropriate system of accountability;
- 'fair, accessible, and open' procedures;
- sufficiently expert regulators; and
- efficiency.[1146]

The need for accountability is also emphasised by the UK Better Regulation Task Force, which included it as one of its five key regulatory principles.[1147] As already noted, an *ad hoc* system of self regulation tends to lack adequate accountability and this was an issue highlighted by some of the interviewees.[1148] The approach taken in Malaysia, however, of ensuring central oversight of *Sharia* governance, by the Central Bank and the SAC (see chapter five) provides a better system of accountability. The strength of the Malaysian system was acknowledged by most of the interviewees, although two of the interviewees (9 and 10) from the KSA were against a central *Sharia* board. It should be noted that centralised external regulation does not require a central *Sharia* board. A distinction may be drawn between a standardised framework comprised of prescribed structures and processes, and standardised *fatwas*. While the latter may require a central *Sharia* board, this is not true of the former.

Another advantage of the Malaysian approach over the UK and KSA approaches is that the *Sharia* governance framework is backed by legislative authority. Supporting *Sharia* governance through legislation legitimises the framework's structure and processes. This follows because the legislation carries with it the legitimacy of the

[1146] Robert Baldwin, Martin Cave, Martin Lodge, *Understanding Regulation* (Oxford University Press, 2nd ed 2011), 27.
[1147] Better Regulation Task Force, *Principles of Good Regulation* (2003), 1.
[1148] Interviewees 5, 12.

nation's government. Furthermore, legislation can also provide for formal legal sanctions, which may be valuable where other less formal regulatory interventions fail to resolve an issue, or where the breach is particularly serious. Although providing legitimacy and additional sanctions, the value of putting *Sharia* governance on a statutory basis will depend on both the content of the legislation and on how it is implemented. Here Baldwin et al's criteria, and the five Better Regulation principles (proportionality; accountability; consistency; transparency; and targeting)[1149] should be used as a guide to ensure a robust, but fair system of accountability, facilitating consistency and transparency, and allowing an appropriately targeted, proportionate response to any regulatory issues. Under this approach, regulation should be based on clear, consistent and coherent standards, with a transparent process and clearly explained, publicly accessible regulatory decisions made by an accountable regulatory body, with appropriately targeted responses that prioritise educational over punitive measures.[1150]

6.2 The regulatory approach

While *Sharia* governance should be legitimised and formalised through legislation, the trend has been to rely more on new forms of governance. These utilise soft law and less formal mechanisms, such as benchmarking, communication and regulatory frameworks, with regulatory responses implemented through 'mutual learning, arguing and persuasion, and nonlegal sanctioning methods, such as naming and shaming'.[1151] Responsive regulation,[1152] for example, will utilise education and persuasion as initial tactics. It is only where these approaches fail to achieve the

[1149] Better Regulation Task Force, *Principles of Good Regulation* (2003), 1.
[1150] *Ibid*, 4-6.
[1151] Florian Saurwein, 'Regulatory Choice for Alternative Modes of Regulation: How Context Matters' (2011) 22 *Law & Policy* 334, 336.
[1152] Ian Ayres, John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press 1992).

desired response that compliance strategies are replaced by increasingly punitive measures. This 'enforcement pyramid', which allows for both the escalation and de-escalation of responses provides for a range of enforcement measures that can be used to both support and appropriately enforce self-regulation.[1153] This regulatory process allows the regulator to move up or down a scale of enforcement measures depending on the response and compliance of the firm. It is, therefore, sensitive to the need to vary regulatory measures depending on the degree of cooperation. It may, however, if rigidly applied, result in a system that is unable to respond quickly enough to a rapidly escalating situation of risk. Furthermore, the context of a competitive environment and the cultural differences between firms may require a more targeted approach that is sensitive to the institutional logics that affect compliance with regulatory requirements.[1154]

One of the central strengths of responsive regulation is that it enables a collaborative relationship between the regulated and the regulators.[1155] This is contingent on the cooperation of the regulated, but where that fails it also allows for traditional enforcement mechanisms. Its approach of active listening, relationship building, support and mutual learning is consistent with the Islamic governance principles of *shura* (consultation) and *khilafah* (vicegerency), which emphasises trust and engagement. In so doing, it supports a framework that can be effectively mediated by cooperation between external regulators, internal self-regulators and the other stakeholders, including the managers, other employees and, through representatives

[1153] Ian Ayres, 'Responsive regulation: A co-author's appreciation' (2013) 7 *Regulation & Governance* 145.
[1154] Robert Baldwin, Julia Black, 'Really Responsive Regulation' (2008) 71 *Modern Law Review* 59, 62-63.
[1155] John Braithwaite, 'The Essence of Responsive Regulation' (2011) 44 *UBC Law Review* 475.

or public interest groups,[1156] the Islamic community more widely. By initially relying on mechanisms of support and soft enforcement, such as argument and persuasion, the philosophy of responsive regulation begins from a position of trust that should help to create a positive culture that treats the managers and self-regulatory actors as stewards acting in the interests of all the stakeholders. It only treats the regulated as self-interested agents where trust has been broken and the supportive relationship has been damaged by the attitude and behaviour of the regulated.[1157]

As a 'public interest orientated' system sensitive to the politics of neoliberalism, responsive regulation provides a nuanced approach that bridges state, non-state and self-regulation.[1158] Based essentially in restorative justice, but willing to engage with the rational self-interested agent through enforceable deterrents and the incompetent actor through 'incapacitation',[1159] responsive regulation provides a suitable initial basis for a comprehensive and coherent regulatory framework that can manage the risk of *Sharia* non-compliance in a way that could allow international standardisation that is sensitive to the national context. Its focus on public interest and community participation in the regulatory dynamic is consistent with the ideal of Islamic finance as a socially just industry that benefits the community as a whole. Furthermore, it could also be implemented in a way that is consistent with the institution of *hisbah* by giving ordinary Muslims 'a platform for social action'.[1160]

[1156] Christine Parker, 'Twenty years of responsive regulation: an appreciation and appraisal' (2013) 7 *Regulation & Governance* 2, 5.
[1157] John Braithwaite, 'The Essence of Responsive Regulation' (2011) 44 *UBC Law Review* 475, 484-486.
[1158] Christine Parker, 'Twenty years of responsive regulation: an appreciation and appraisal' (2013) 7 *Regulation & Governance* 2, 3,7.
[1159] John Braithwaite, 'The Essence of Responsive Regulation' (2011) 44 *UBC Law Review* 475, 486.
[1160] Abdussalam Mahmoud Abu-Tapanjeh, 'Corporate governance from the Islamic perspective: A comparative analysis with the OECD principles' (2009) 20 *Critical Perspectives on Accounting* 556, 564.

Although it has been suggested that responsive regulation provides a strong basis for international standardisation, it was originally intended as a regulatory approach at the national, rather than the transnational level. At a national level, domestic regulatory bodies backed by national law can readily provide the enforcement mechanisms and powers required by the enforcement pyramid of responsive regulation. At the international level, such enforceability is more challenging. There are, however, different options available for adapting responsive regulation for a transnational role, which may include reliance on intergovernmental organisations (IGOs) and transnational standard setting bodies.[1161] These options will be considered later when discussing the three levels of a comprehensive regulatory framework.

Responsive regulation has been chosen as the foundation for a regulatory framework managing the risk of *Sharia* noncompliance because, as discussed above, it appears to provide a good fit with both an Islamic approach to governance (see chapter 4) and with the regulatory goal of securing genuine and transparent diversity that provides the necessary information and guidance that allows consumers to choose the most suitable product that range from the "Islamically acceptable" *Sharia* compliant to "Islamically good" products that are socially just, benefit the community and embody the spirit of *Sharia* and the *maqasid*. While not providing the core foundation, the framework structure may nevertheless be usefully supplemented by aspects of "smart regulation", particularly those that complement or reinforce the approach of responsive regulation.

[1161] Kenneth W Abbott, Duncan Snidal, 'Taking responsive regulation transnational: Strategies for international organizations' (2013) 7 *Regulation & Governance* 95.

Smart regulation advocates a flexible balance of market and non-market solutions, using a combination of strategies and relying on both public and private regulatory mechanisms.[1162] The aim is to build on existing regulation to improve efficiency by utilising a full and complementary range of regulatory instruments, including economic, direct legal and self-regulatory, to capitalise on the strengths of each individual approach while minimising the weaknesses.[1163] In particular, smart regulation usefully emphasises the need for a cooperative complementarity between public and private regulatory bodies, especially where there is a transnational element.[1164] This should help to avoid unnecessary duplication and conflicting messages.

6.3 Regulation and institutional logics

Building further on the approach of responsive regulation is Baldwin and Black's "really responsive regulation", which emphasises the need for regulation to account for and engage with the institutional influences that guide the behaviour of individuals within the firm. As they explain:

> Responsive regulation presupposes that regulatees do in fact respond to the pressures imposed by regulators through the sanctioning pyramid. Corporate behaviour, however is often driven not by regulatory pressure but by the culture prevailing in the sector or by the far more pressing forces of competition.[1165]

[1162] Neil Gunningham, Peter Grabosky, Darren Sinclair, *Smart Regulation: Designing Environmental Policy* (Clarendon Press 1998), 10.
[1163] Neil Gunningham, Peter Grabosky, Darren Sinclair, *Smart Regulation: Designing Environmental Policy* (Clarendon Press 1998), 14-15.
[1164] Judith Hanebury, 'Smart Regulation - Rhetoric or Reality?' (2006) 44 *Alberta Law Review* 33, 58-60.
[1165] Robert Baldwin, Julia Black, 'Really Responsive Regulation' (2008) 71 *Modern Law Review* 59, 63.

The thinking behind "really responsive regulation" is that regulators need to understand the interaction between rational thought and institutional logics, which include the tension between Islam and neoliberal capitalism, the pressure of competition, and the norms and scripts of regulation itself. This means employing a sensitivity to the culture and context of the industry, the culture of the individual firm, and the tensions that may exist between the attitude of the firm and its employees towards the regulatory system. It also means ensuring that the institutional logics of the regulatory approach are coherent and consistent with the underlying culture and values of the industry. Furthermore, the regulators must be capable of varying their approach in response to the firm's attitude and compliance with the regulatory regime.[1166] This requires a cycle of: detection, response, enforcement of response, assessing the effect of the response, and modifying the response accordingly.[1167]

While it is important for any regulatory system to be sensitive to the institutional logics that help to shape the firm's attitude and response to regulation, it is also important to appreciate that a well established system of regulation will itself feed into the logics of the regulated industry. Provided the regulatory system is designed to provide a clear, coherent and consistent set of values then it may, in the long term, be used to influence the taken-for-granted norms and behavioural scripts of the regulated firms,[1168] which should reduce the risk of *Sharia* non-compliance and limit the need for enforcement. This should, in the long term, reduce the costs of regulation and allow a greater focus on mechanisms of support rather than

[1166] Robert Baldwin, Julia Black, 'Really Responsive Regulation' (2008) 71 *Modern Law Review* 59, 61, 69-76.
[1167] Robert Baldwin, Julia Black, *A Review of Enforcement Measures* (Defra 2005).
[1168] Lawrence M Friedman, 'Legal Culture and Social Development' (1969) 4 *Law & Society Review* 29, 41.

enforcement. In other words, the regulatory system established to manage the risk of *Sharia* non-compliance should proactively aim to shape the culture of the industry.

Emphasising the importance of culture, Meidinger argues that any social system requiring collective action 'must be based on a set of cultural understandings ... [which] provide the interactional basis to organize and constrain regulation '.[1169] He goes on to explain that, within any regulatory community, 'shared understandings of acceptable behavior are most likely to develop where regulatory actors maintain ongoing, interdependent relationships'.[1170] This again highlights the importance of "really responsive regulation", which allows for a range of interactions that goes beyond simple enforcement of rules and standards. The use of supportive mechanisms of education, argument, persuasion and the positive reinforcement of desirable behaviour provides a set of tools well suited to creating positive institutional logics to reinforce the norms and values of *Sharia*.

Within Islamic finance, such an approach could utilise the trust and respect that exists for eminent *Sharia* scholars, which was clearly articulated by the interviewees in the study of attitudes toward Islamic finance discussed in the previous chapter. This might be facilitated by establishing a modern form of *hisbah* on a national or international level as part of a supportive international system of regulation that aims to reinforce the institutional norms of Islam and the *Sharia*, alongside oversight of compliance in a technical sense. This would provide a mechanism to ensure that Islamic financial products are technically compliant and so Islamically acceptable (*halal*), as well as providing mechanisms to encourage the development of products

[1169] Errol Meidinger, 'Regulatory Culture: A Theoretical Outline' (1987) 9 *Law & Policy* 355, 369.
[1170] *Ibid*, 367.

and services that are *tayyib* (desirable). This possible role for *hisbah* will be considered further in subsequent sections.

There remains one further insight that follows from the institutional approach of "really responsive regulation". As has already been discussed, Islamic finance does not just involve the delivery of *Sharia* compliant products and services by Islamic firms. A significant proportion of Islamic finance is delivered by conventional firms, through Islamic widows or subsidiary firms. From an institutional perspective, it might be speculated that the culture of these firms will differ from the culture of Islamic firms. Although it would need to be confirmed by further empirical study, some support for this concern is found in the responses of some for the interviewees.

Interviewee 8 commented that professionals from conventional finance prioritise profit over the consistency with Islamic principles. Interviewee 12 emphasised that anyone working in Islamic finance ought to 'believe in the product' and needed to 'embed the philosophy of the Sharia'. Interviewee 14 similarly raised doubts about whether conventional finance professionals working in Islamic finance had 'a real understanding of [the] Maqasid'. The concern behind these comments is also apparent in the suggestion made by Interviewee 11 that, ' it would not be a very sensible thing [for a conventional firm] to' offer Islamic financial products 'without some involvement of Muslim people or staff'. These comments all reflect a concern with the culture of conventional firms, with the consequential implication that the regulatory approach should be sensitive to the cultural differences. As Baldwin and Black note, really responsive regulation requires the regulator to be 'clear about the role of different individual logics in relation to the [regulatory tasks]'.[1171] In the present context this would, for example, require the regulator to appreciate that different approaches may be required where Islamic finance is provided by a conventional firm than where it is provided by an Islamic firm.

The cultural background of the individual professionals is also important. With Muslims already motivated by the *Sharia* as part of their faith, a regulatory approach that focuses on clarifying any mixed messages may be more effective than a punitive regime. While non-Muslims may readily be taught the technical requirements of Islamic finance, they lack the deeper understanding of Islam that comes from being brought up in the faith. While those norms and values may be taken for granted by Muslims, they are less likely to provide a reliable institutional influence on non-Muslims. Here the role of regulation is perhaps more complicated, to which the "really responsive" approach is well suited. A greater level of initial support may be required to encourage a commitment to the regulatory goals of *Sharia* governance, and the regulator must be aware that such commitment may be less likely for the non-Muslim than for the Muslim professional. This is particularly so in the context of a conventional firm whose goal is to exploit the Islamic finance market, where *Sharia* compliance is secondary to this primary aim.

The failed attempt by Goldman Sachs to enter the *sukuk* market in 2011 provides a useful illustration.[1172] This example was specifically noted by interviewees 2 and 4,

[1171] Robert Baldwin, Julia Black, 'Really Responsive Regulation' (2008) 71 *Modern Law Review* 59, 81.
[1172] Arachana Narayanan, Al-Zaqan Amer Hamzah, 'Goldman Sachs plans debut sukuk issue as Islamic finance goes mainstream' (Online, 4 September 2014) *Reuters* <http://uk.reuters.com/article/uk-goldman-sukuk-idUKKBN0GZ0PU20140904> accessed 01 February 2016.

with interviewee 2 raising it as a problem of *fatwa* shopping and interviewee 4 raising it is as an example of regulating cross-border transactions. The gist of the issue was that the *sukuk* relied on a controversial organised *tawarruq* structure.[1173] While some *Sharia* scholars were prepared to certify it as *Sharia* compliant, other Scholars argued that it was not, primarily because of the perception that Goldman Sachs were planning to use the issue as a way of raising money that would then be used for the normal business of non-compliant conventional finance, which would be *haram*. As noted by the interviewees, this raises issues of cross-border regulation as well as that of *fatwa* shopping, or 'getting the right *Sharia* advisor to sign off the product as *Sharia* compliant'.[1174] It also highlights that non-Muslims are not guided by the same religious convictions as Muslims and may see their obligations very differently, prompting them to push the boundaries of what is acceptable. Islamic finance, while being open to non-Muslims, imposes the same rights and duties regardless of the faith of the investors.[1175] In order to preserve the purity of Islamic finance, and the money it handles, it is important for the regulatory system to be sensitive to the institutional context of the regulated. This may, under a risk-based approach to regulation, also justify specifically targeting conventional firms entering the Islamic market.

As a final point, the institutional approach of "really responsive" regulation suggests that the regulatory approach will need to be sensitive to the nature of the country.[1176] The political and religious context of the country, its economic system and the

[1173] Paul Wouters, 'Goldman Sachs: Genuine or Ribawi Sukuk in the Making?' (16 February 2012) *Business Islamica Magazine* 34.
[1174] Interviewee 2.
[1175] Humayon Dar (ed), Global Islamic Finance Report 2012 (2012), 103 <http://gifr.net/gifr_2012.htm> accessed 01 February 2016.
[1176] Anton Eberhard, 'Matching regulatory design to country circumstances' (2007) *Gridlines*, Note No 23, 3.

existing regulatory structures will combine to provide the taken-for-granted norms and scripts that influence the behaviour and decisions taken by the managers of a firm based in that country. This may be complicated where the firm's employees come from different backgrounds and where the firm is a subsidiary of a company based in a different country. The cultural context of the country may, nevertheless, provide different logics of legitimacy and illegitimacy that influence the response to regulation,[1177] requiring an understanding of the influences that shape the response and the most appropriate approach to managing the risk of *Sharia* non-compliance.

6.4 The three levels of regulation: the firm; national; and international

In the preceding sections, the features of good regulation were considered and it was argued that a suitable regulatory system for *Sharia* compliance should be smart, responsive and sensitive to the institutional logics that influence the behaviour of the regulated. If this "really responsive" regulatory approach is to be effectively implemented it requires an appropriate structural framework that enables and facilitates *Sharia* governance. As previously discussed, one of the main goals is to standardise the governance structures and processes while still permitting innovation and diversity. While diversity and innovation are important, so too is the need for Islamic finance to establish itself as a genuinely Islamic alternative to conventional finance rather than just a variation on the theme. Technical compliance with *Sharia* remains the "bottom-line", but the aim of Islamic finance should be the *maqasid* as the spirit of *Sharia*. In order to prevent the permitted diversity from being

[1177] Vilmos F Misangyi, Gary R Weaver, Heather Elms, 'Ending Corruption: The Interplay Among Institutional Logics, Resources and Institutional Entrepreneurs' (2008) 33 *Academy of Management* Review 750.

manipulated to serve conventional financial interests, these governance structures must be capable of managing the possibility of *fatwa* shopping.[1178]

There are three structural levels that may be engaged, to a greater or lesser extent, in constructing a regulator framework. These are: the level of the individual firms; the level of the nation state; and the international level. While regulatory initiatives already exist at each of these levels, they are inconsistent and, at the international level at least, lacking the coherence of a unified, authoritative, voice. In order to instil maximum confidence in Islamic finance, its products and services, these inconsistent and patchy regulatory systems should be reformed into an internationally standardised approach. This requires an framework that connects and coordinates the regulatory and governance initiatives at each level.

6.4.1 *Sharia* governance at the level of the firm

At the level of firm, it is clear from both the literature and the interviews that *Sharia* boards or committees provide the gold standard for *Sharia* governance and a good starting place for developing a comprehensive standardised framework. As discussed in chapter four, however, there are a number of criticisms that need to be addressed. These include the problem of a lack of suitably qualified *Sharia* scholars, with some scholars sitting on multiple boards increasing the likelihood that their workload affects their ability to perform their governance role.[1179] As interviewee 14 noted, in the context of expanding the regulatory framework: 'if you are going to have another parallel set of people, I suppose then the question is if there is enough human capital available'. Further to the problem of a lack of suitably qualified *Sharia* scholars, there

[1178] Umar A Oseni, Abu Umar Faruq Ahmad, M Kabir Hassan, 'The Legal Implications of '*Fatwa* Shopping' in the Islamic Finance Industry: Problems, Perceptions and Prospects' (2016) 30 *Arab Law Quarterly* 107.
[1179] Interviewee 2.

are three conflicts of interest that potentially threaten the credibility of *Sharia* governance. These are; the conflict arising from multiple board memberships, especially where the *Sharia* scholar sits on bank *Sharia* boards while also participating in national or international regulation;[1180] the employment relationship between banks and the *Sharia* scholars that sit on their boards, especially where bonus payments are offered for fatwas;[1181] and, as interviewee 11 observed:

> a ... less obvious conflict ... is that the same people are involved in the structuring of the products at their setup stage and then further down the line, they are also the people who are signing off and if you like, auditing them, so in a sense they are marking their own work.

These types of issues are best managed through governance at a national or international level, which will be considered in due course. There is however, one further issue that should be addressed at firm level, although it may be supported by appropriate national governance. In chapter four, it was noted that *Sharia* governance tended to be managed as an additional type of governance, distinct from the structures and processes of the governance of other risks. There are two problems with this. First, there is a need for *Sharia* governance to engage with, and constrain, the institutional influences of conventional finance and neoliberal capitalism. This is likely to be more easily achieved if *Sharia* governance is not treated as an issue distinct from the other financial risks and concerns managed through the conventional governance structures and processes. Second, the risk of *Sharia* non-compliance might be affected by the approach of the firm to the other risks that face

[1180] Interviewee 12.
[1181] Interviewees 11, 12, 20.

the bank in its financial dealings. Equally, the management of *Sharia* compliance is also likely to impact on those other risks. Both of these may addressed by integrating *Sharia* governance with the general governance structures and processes.

An additional concern with the current approach to governance at the level of the firm, which was raised in chapter four, is the reliance on western approaches to governance. This is not a criticism of those approaches *per se*. Rather, the point is that the governance of Islamic finance should be consistent with Islamic values, which is better achieved through an Islamic model of governance rather than one, such as the shareholder model, that reflects conventional finance and neoliberal capitalism. As discussed in chapter four, an Islamic approach to governance should engage with all stakeholders, including a representative engagement with the Muslim community or *Ummah*, through the process of *shura*. This process, based on the conception of stakeholders as Allah's vicegerents, should aim to ensure that the bank's operations serve the *Maqasid al-Sharia*.[1182] In other words, its products and services should be designed to serve the goals of community benefit and social justice, albeit in a way that generates sufficient profit for the firm to remain competitively viable in its particular economic environment. Such an approach has the additional benefit, not of preventing *fatwa* shopping, but reducing the motivation to engage in the practice.

6.4.2 *Sharia* governance at the national level

A general theme that emerged from the interviews discussed in chapter five, was that some form of national regulatory oversight was necessary. Most of the interviewees

[1182] Zulkifli Hasan, 'Corporate Governance: Western and Islamic Perspectives' (2009) 5 *International Review of Business Research Papers* 277, 279.

considered the Malaysian model to be the best approach. As explained in chapter five, Malaysia provides a 'proactive',[1183] comprehensive national framework for *Sharia* governance, managed by the central bank of Negara Malaysia (BNM) and backed by statutes. The Islamic Financial Services Act 2013, for example, imposes formal legal duties and conditions to ensure compliance with the *Sharia*,[1184] and provides for a range of regulatory powers allowing investigation, enforcement and sanction of breaches of those duties.[1185] Enforcement measures include a range of administrative powers allowing the BNM to issue orders or directions requiring compliance, to require the person in breach to make a public statement, to mitigate any loss or to pay a monetary penalty.[1186] Where such measures fail, or are considered inappropriate, then the BNM may initiate civil proceedings.[1187] A failure, to comply with a court order that results from the civil action will have committed a criminal offence and, if convicted, may be imprisoned for up to 8 years and/or fined.[1188] Criminal offences are also directly available for breaches of the individual obligations such as the duty to comply with the *Sharia* under s 28. The regulatory framework provided for by this statute enables a range of responses to breaches of the Act, from administrative orders and fines, through civil court orders to criminal sanction. This establishes a pyramid of responses consistent with a responsive regulatory approach.

In addition to central oversight by the BNM, and the regulatory framework provided by statute, Malaysia has also established, under the auspices of the BNM, the central

[1183] Zulkifli Hasan, 'Regulatory Framework of Shari'ah Governance System in Malaysia, GCC Countries and the UK' (2010) 3 *Kyoto Bulletin of Islamic Area Studies* 82, 84.
[1184] Sections 28-38.
[1185] Sections 229-266.
[1186] Section 245.
[1187] Section 250.
[1188] Section 254.

Sharia Advisory Committee (SAC). While all of the interviewees were in favour of some form of central regulation of *Sharia* governance, two of the interviewees from the KSA were opposed to a central *Sharia* board. The reason for this opposition was the perception that a central *Sharia* board would stifle diversity and innovation, both of which were considered important by all of the interviewees. The likelihood of this will depend on the constitution of the board and, perhaps, the political context of the country. In particular, a central *Sharia* board could provide the national government with too much influence and the opportunity to advance their own particular agenda by appointing scholars for political reasons, rather than because of their expertise.[1189]

The tension between the possible advantages of a central *Sharia* board and the risk of government interference was recognised by interviewee 8, who commented:

> in general, I oppose the idea of government imposing the view of Islam on others because it is a decentralized religion, it does not have a pope. It does not have a, you know, central authority. We have scholars who can give us opinions and guide us, so I like the idea of having centralized *Sharia* boards in order to, let us say, move the industry forward quickly, but I don't know if the idea of dictating at a government level what is and is not Islam.

While these are potential dangers, the Malaysian experience shows that a central *Sharia* board can operate effectively without stifling diversity or triggering complaints of political interference. Indeed, despite his expressed concern, interviewee 8 subsequently stated: 'Malaysia has shown an excellent model and I think that is a good model to follow'.

[1189] A similar point was made by interviewee 7 in relation to the remuneration of *Sharia* scholars.

An additional national option is a professional regulatory body for *Sharia* scholars, responsible for the education, registration and professional regulation of *Sharia* scholars. While not precluding *fatwa* shopping, a professional body with disciplinary powers may reduce the opportunity for the practice. Such a body could be established and provided with authority by statute, along the lines of the General Medical Council, which provides such a service for doctors in the UK,[1190] or the Legal Service Board, which oversees the regulation of lawyers in England and Wales.[1191] While a national regulatory structure is necessary to effectively monitor and enforce standards, some of the bodies might operate more efficiently and effectively at an international level. Given the shortage of *Sharia* scholars and their global identity and transnational activity, it may be better to manage professional regulatory issues at an international rather than a national level. This would prevent the need for scholars to be registered in a number of different countries, with all of the issues of coordination that multiple registration requires. An international professional regulatory body would provide a single point of registration, harmonise professional standards and coordinate both the education and career structure for *Sharia* scholars working in the field of Islamic finance.

By maintaining a professional register of scholars as well as a code of professional ethics, a professional regulatory body would be able to assist the national regulatory bodies in managing those potential conflicts of interest noted previously. This could be achieved primarily through guidelines or regulations, the substantive details of which are beyond the scope of this thesis. One option worth noting however, would

[1190] The Medical Act 1983.
[1191] Legal Services Act 2007, ss 2-7.

be to follow the Malaysian lead and impose limits on board membership. This could be supported by also ensuring an adequate training programme to increase the human capital and reduce the need for multiple board membership. Furthermore, an appropriate code of professional ethics, monitored by the professional regulatory body, may encourage the development of a culture in which the potential for conflicts of interest will be more readily recognised and managed, rather than exploited.

A further option is a modernised *hisbah* body, providing a national ombudsman service, which could also be created by statute. In the UK, for example, the Financial Ombudsman service is a public body established under ss 225-227 of the Financial Services and Markets Act 2000. A modernised *hisbah* office could be established as part of the general Financial Ombudsman scheme or as a separate service. Combining the schemes would be more administratively efficient and would provide a single point of consumer contact. It may, however, be better from an institutional perspective to establish a *hisbah* office as a distinct service, which would help to maintain the distinction between conventional and *Islamic* finance. Although not impossible, instituting *hisbah* at the national level is likely to be problematic in non-Islamic countries such as the UK. The inherently religious nature of *hisbah* may be seen as inappropriate for Christian countries with secular politics. This would not preclude such an institution being set up privately as a non-profit organisation, but it would lack the authority of a statutory basis. Such an approach may lead to patchy and inconsistent regulation. This could be resolved by managing *hisbah* at an international level.

6.4.3 *Sharia* governance at international level

The international level of regulation is crucial to goal of a coordinated standardised regulatory framework. Specifically, there are two main reasons for establishing an international framework, rather than simply leaving the regulation and governance of *Sharia* compliance to the individual nations. First, a global approach will help to harmonise the regulatory structures and process.[1192] This will increase consistency and predictability, which should facilitate product innovation. Second, this increased consistency and predictability of regulatory approaches should also increase confidence in the Islamic finance products and services.

The structures that may be established at international level include: a standards setting body; an international *Sharia* board; an international professional body responsible for the education, registration and professional regulation of *Sharia* scholars; and an international *hisbah* body to maintain a network of ombudsmen. These are not mutually exclusive, but may be established in combination to create a deep, but coordinated, regulatory framework. Such a framework could either be established and legitimised by an international regulatory structure backed by treaty or a private international regulatory structure, enabled by an industry-wide voluntary agreement. International harmonisation and standardisation could be further enhanced by the drafting of a Model Law, which may then be used to establish a national framework that would be consistent with national frameworks in all countries adopting such a Model Law. Implementing these options, whether alone or in combination, would require a cooperation between governments and also between

[1192] Anton Eberhard, 'Matching regulatory design to country circumstances' (2007) *Gridlines*, Note No 23, 3.

public and private initiatives. This may be a difficult political process, but remains possible.

While there are no international treaties dealing specifically with *Sharia* governance, the Organisation of the Islamic Conference (OIC) is an IGO that has, through its Islamic *Fiqh* Academy (IFA) been involved in Islamic finance and *Sharia* compliance. The OIC, which was established in 1969, provides the 'collective voice of the Muslim world ... [and has the mandate to safeguard and protect the interests of the Muslin world in the spirit of promoting international peace and harmony'.[1193] As an IGO with a uniquely Islamic identity,[1194] the OIC could act as an international *Sharia* governance standards setter,[1195] either through the IFA or through a newly established Academy.

Although the OIC is mandated to speak collectively for Muslims, it generally only allows Muslim majority states to join, which perhaps limits its role in states where Muslims are in a minority.[1196] This would not prevent the Muslim community in those states from voluntarily accepting the IFA as a standard setter for *Sharia* governance of Islamic finance. If the IFA is to become the sole international authority, however, this would require the voluntary acceptance of a critical mass of

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[1193] M Ishan Qadir, M Salfur Rehman, 'Organization of Islamic Co-operation (OIC) and Prospects of Yemenia Conflict Resolution: Delusion or Plausible Reality' (2015) 22 *Journal of Political Studies* 367.
[1194] Victor Luis Gutierrez Catillo, Jonatan Cruz Angeles, 'Islam and International Organizations: The Organization of Islamic Cooperation' in Roberto Virzo, Ivan Ingravallo (eds), *Evolutions in the Law of International Organizations* (Brill Nijhoff 2015) 171, 176.
[1195] Christine Chinkin, 'International Organizations' in Peter Cane, Joanne Conaghan (eds), *The New Oxford Companion to Law* (Online ed, Oxford University Press 2009) <www.oxfordreference.com> accessed 01 February 2016.
[1196] Abdullah al-Ahsan, 'Political Discourse of the Organization of the Islamic Conference' in Ibrahim M Abu-Rabi (ed), *The Blackwell Companion to Contemporary Islamic Thought* (Online ed, Blackwell 2006) <www.blackwellreference.com> accessed 01 February 2016.

Islamic finance firms in non-Muslim countries to exert commercial pressure on other firms to also submit to any standards issued.

Regarding the possible role for the IFA, it is pertinent to note its Resolution 190 (20/5) on the Role of the *Fiqh* (jurisprudence) Academies in Rationalizing the Progress of Islamic Financial Institutions: Mechanisms and Formulas.[1197] In this Resolution, the IFA noted: the need for cooperation and coordination between the IFA and *Sharia* boards, and between the individual *Sharia* boards themselves; the need for the IFA to conduct research; and the need for the IFA to produce a comprehensive Islamic finance law. It also called on all Islamic financial institutions to adopt IFA resolutions, which should be communicated to them and made fully accessible to the public. This aspect of the resolution was not limited to Muslim countries, but non-Muslim countries were excluded when it called for 'continued dialogue with central banks and supervisory authorities'. Restricting such dialogue to Islamic countries is inadequate for global standardisation and raises concerns that the IFA, as part of the OIC, may not be the appropriate body to oversee a globally standardised governance framework. Rather, it may be better for it to remain a body that provides guidance on specific *Sharia* issues.

Apart from the IFA, two other international standards setting bodies warrant mention. These are the IFSB, established in Malaysia in 2002;[1198] and the AAOIFI, an independent not-for-profit organisation established in 1991 and based in

[1197] Anon, 'Resolution of OIC Fiqh Academy (related to Islamic Economic and Finance)' (2014) 22 *Islamic Economic Studies* 265, 269.
[1198] IFSB, 'Background' *Islamic Financial Services Board* <http://www.ifsb.org/background.php> accessed 01 February 2016.

Bahrain.[1199] While both organisations are engaged in standards setting, the AAOIFI takes more of a business perspective and the IFSB adopts more of a regulator's perspective of governance issues.[1200] The AAOIFI has the advantage that it includes most Islamic finance institutions as members, and many already adhere to its standards,[1201] but this adherence may be patchy or incomplete.[1202] Although a relatively new body, the IFSB has an international remit to provide guidelines on governance and risk management. Its role is recognised by both the IMF and the Bank for International Settlements.[1203] Both the IFSB and the AAOIFI produce guidelines for *Sharia* governance, although it is not the exclusive concern of either body. The AAOIFI, however, does have a dedicated *Sharia* board, which issues recognised standards.[1204]

While it is possible for the current situation to continue, with standards being set by the IFA, the IFSB and the AAOIFI. it would be better to establish a regulatory framework that relies on a single international standard setter.[1205] This would be more efficient, cheaper to maintain, and, because it would eliminate the risk of inconsistent or even contradictory standards, it would also provide a more coherent solution. Having said that, these bodies have already built up significant experience

[1199] AAOIFI, 'What We Do' *Accounting and Auditing Organization for Islamic Financial Institutions* <http://aaoifi.com/?lang=en> accessed 03 July 2016.
[1200] Volker Nienhaus, 'Human Resource Management of Islamic Banks: Responses to Conceptual and Technical Challenges' in Simon Archer, Rifaat Ahmed Abdel Karim (eds), *Islamic Finance: The New Regulatory Challenge* (e-book 2nd ed, Wiley 2013), § 3.2.
[1201] Rodney Wilson, *Legal, Regulatory and Governance Issues in Islamic Finance* (Edinburgh University Press 2012), 134.
[1202] Mahmood Ahmed, Maksuda Khatun, 'The Compliance with Shariah Governance System of AAOIFI: A Study on Islamic Banks Bangladesh' (2013) 9 *Journal of Islamic Economics, Banking and Finance* 177.
[1203] Rodney Wilson, *Legal, Regulatory and Governance Issues in Islamic Finance* (Edinburgh University Press 2012), 123.
[1204] *Ibid*, 228.
[1205] Nawal Kasim, Sheila Nu Nu Htay, Syed Ahmed Salman, 'Comparative Analysis on AAOIFI, IFSB and BNM Shari'ah Governance Guidelines' (2013) 4 *International Journal of Business and Social Science* 220, 227.

of standard setting, as well as a reputation. It would be wasteful if all three bodies were not, in some way, involved in the production of standards in the future. This could be achieved through a new body, established with the agreement and support of each of the existing standard setters, and including representatives from them on the board. Alternatively, with the agreement of the other two bodies, one of the existing bodies could take on the role. Based on the responses to the interviews discussed in chapter five, and the emphasis on its standard setting role found in the literature,[1206] the AAOIFI appears to be the favoured body to take on such a role.

The benefits for harmonisation and standardisation of international standard setting bodies is relatively clear. The value of an international *Sharia* board is, however, more controversial. Interviewee 10, for example, raised the problem of achieving a unanimous agreement on the compliance of particular products. While an international *Sharia* board could rely on majority decisions, such decisions could be rejected where the majority view conflicts with the view taken within a particular jurisdiction.[1207] An international *Sharia* board may be too great an infringement of the national sovereignty of Muslim countries. As such, it would be better to deal with the issue of a centralised, higher *Sharia* board at national level.

It was noted in chapter five, that there is currently a Malaysian-based Association of *Sharia* Advisors in Islamic Finance (ASAS), which already has the goal of gaining international recognition.[1208] The role of this association could be expanded so that it becomes part of an international regulatory framework as the professional body for

[1206] See, eg, Abdul Aziz Farid Saymeh, Harbi M Orieqat, 'The Global Financial Crisis: Is Islamic System a Possible Solution?' (2014) 5 *Interdisciplinary Journal of Contemporary Research in Business* 44, 46.
[1207] Interviewee 10.
[1208] ASAS website <http://asas.my/> accessed 13 February 2016.

Sharia scholars, with obligatory registration enforceable at a national level. It has already accepted a responsibility for education and professional development, for promoting professionalism and maintaining public confidence in Islamic finance. Along with a compulsory system of registration, it could also take on a disciplinary role, that would allow it to respond to lack of professionalism, breaches of trust and other unacceptable behaviour through a range of enforcement measures. These could include educational measures, supervisory measures, suspension, or even expulsion from the register.

Since there is no existing international *hisbah* institution, a new body would need to be established. This could be completely distinct to the already existing international bodies, or it could be set up under the auspices of a body such as the IFA. It may, however, be better to establish a new body that functions in a coordinated and cooperative way with the existing *Sharia* governance bodies. This would ensure that the new body was clear of any political baggage associated with existing bodies. Traditionally, *hisbah* has been a national concern, established to encourage good behaviour and discourage bad behaviour consistent with the religious duty imposed by *Sharia*.[1209] Over time, the institution has been fragmented, with the secular functions assigned to relevant government departments. With the notable exception of the KSA, the religious aspect of *hisbah* has largely been relegated to a secondary concern.[1210]

[1209] Ssuna Salim, Syahrul Faizaz Binti Abdullah, Kamarudin bin Ahmad, 'Wilayat Al-Hisba; A Means to Achieve Justice and Maintain High Ethical Standards in Societies' (2015) *6 Mediterranean Journal of Social Sciences* 201, 202; Azrin Ibrahim, 'Accountability (Hisbah) in Islamic Management: The Philosophy and Ethics behind its implementation' (2015) 5 *International Journal of Humanities and Social Science* 184, 184-185.
[1210] Ssuna Salim, Syahrul Faizaz Binti Abdullah, Kamarudin bin Ahmad, 'Wilayat Al-Hisba; A Means to Achieve Justice and Maintain High Ethical Standards in Societies' (2015) *6 Mediterranean Journal of Social Sciences* 201, 204.

In the context of the international regulation of *Sharia* governance, the holistic approach of traditional *hisbah* would need to be re-established if it is to fulfil its potential for providing a powerful reinforcement of the institutional logics of Islam and the *maqasid*. The aim behind such a body would be, through the provision of a network of national Islamic ombudsmen, to create bridge between the Muslim community and the organisations that provide Islamic finance. Grounded in Islamic values, the institution of *hisbah*, administered through a modern proactive ombudsman (*muhtasib*), could provide a valuable moral compass, reinforcing Islamic norms while also countering the institutional logics of neoliberal capitalism.[1211] Through a proactive approach, it may also investigate and deal with suspicions or complaints of *fatwa* shopping. It would, however, need to be funded and would also face problems of limited human capital. In order to fulfil the goals of *hisbah*, it would be necessary to engage the authority of *Sharia* scholars, who would need to play a significant role. This does not mean that the individual ombudsmen need to be *Sharia* scholars, but they do need to be of good character, well educated and proficient in both Islamic finance and *Sharia*.[1212] The need to involve both *Sharia* scholars and suitably qualified professionals may create staffing problems, which may be managed by initially establishing an international ombudsman service with a view to subsequently developing an internationally coordinated network of national ombudsmen.

[1211] Mohd Ab Malek bin Md Shah, Mohd Harun bin Shahudin, Sulaiman bin Mahzan, Rani Diana Othman, Jeniwaty Mohd Jody, 'The Institution of Hisbah: In the Purview of Its Significances and Development' (2015) 1 *Global Journal of Business and Social Science Review* 386, 394.
[1212] Ssuna Salim, Syahrul Faizaz Binti Abdullah, Kamarudin bin Ahmad, 'Wilayat Al-Hisba; A Means to Achieve Justice and Maintain High Ethical Standards in Societies' (2015) *6 Mediterranean Journal of Social Sciences* 201, 204.

Before turning to consider more specific details of a comprehensive *Sharia* governance framework, there is one further possible international initiative that warrants mention. In addition to establishing international bodies to harmonise and standardise the structures and process of *Sharia* governance, Islamic finance could follow the lead of international commercial arbitration and produce a Model Law.[1213] The advantage of a Model Law on *Sharia* Governance, which could be produced as part of an IFA project to create a comprehensive law on Islamic finance transactions (see Resolution 190), is that it provides a common point of reference while not encroaching on national sovereignty. A Model Law would allow individual nations to implement a *Sharia* governance framework that is sensitive to the political, constitutional, legal and social context of the particular country.[1214] Furthermore, even if not actually implemented, a Model Law would still provide a valuable resource for the development and review of a national *Sharia* governance system.

6.5 Towards a comprehensive *Sharia* governance framework

According to interviewee 5:

> one of the most fundamental questions that Islamic finance has to decide is, are there going to be one set of rules that apply to everybody so do we have a single governing body that decides what is acceptable or do we allow, as the Chinese a 1000 blooms to flower and let the customers decide what is acceptable to them. I think both options are a possibility but at the moment where we have effectively no single – we have no single approach. We haven't decided which one we want to go down.

[1213] See the UNCITRAL Model Law on International Commercial Arbitration 1985 (amended 2006) <http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1985Model_arbitration.html> accessed
[1214] Anton Eberhard, 'Matching regulatory design to country circumstances' (2007) *Gridlines*, Note No 23, 3.

In this section, it will be explained how a deep, but coordinated, comprehensive regulatory framework could be established for *Sharia* governance that charts a path between those two alternatives. The aims behind this framework are; to ensure *Sharia* compliance and maintain confidence in Islamic finance as a distinctly Islamic alternative to conventional finance; to maintain diversity and innovation while standardising governance structures and processes to prevent *fatwa* shopping and ensure consumer confidence; to help shape the identity of Islamic finance by actively reinforcing the institutional logics of Islam; and to create a framework that will improve and sustain *Sharia* governance into the future.

The goal is to produce a standardised approach that emphasises the substantive values of Islam and the *Sharia*,[1215] ensuring that any concern with the form of Islamic financial products is understood and assessed within the wider context of the *maqasid*. This is an ambitious proposal and one that will need further research to provide more detailed proposals for each of the individual components. Nevertheless, the framework suggested here is a plausible way to build on already existing structures to standardise *Sharia* governance, reduce the risk of *fatwa* shopping and shape a clear and distinct identity for Islamic finance.

The basic idea is to create a comprehensive, coherent and comprehensive regulatory framework that engages all three levels: the level of the firm; the national level; and the international level. Although these levels are distinct, they are connected, and should be organised, through the 'irreplaceable' role of the *Sharia* scholars, who 'do not simply embody, perform and mobilize Islamic values and expertise but also

[1215] See, Volker Nienhaus, 'Human Resource Management of Islamic Banks: Responses to Conceptual and Technical Challenges' in Simon Archer, Rifaat Ahmed Abdel Karim (eds), *Islamic Finance: The New Regulatory Challenge* (e-book 2nd ed, Wiley 2013), § 2.3.

wield formidable and often unquestionable religious authority'.[1216] Through that external authority, these scholars bring legitimacy to the firm and, as 'elite subaltern cosmopolitans ... [they are capable of] mobilizing wider geographies of faith that shape the governance of financial markets and the formation of Islamic financial consumers'.[1217] This means that the significance of their authority extends far beyond simply legitimising individual firms and their products and services. It also helps to form and reinforce the institutional logics that influence agency within the organisational field of Islamic finance. If *Sharia* governance is to effectively counter the undesirable elements of neoliberal capitalism it must mediate this though the *Sharia* scholars, who should be engaged at all levels of the framework.

At the level of the firm, *Sharia* scholars should retain their role as part of the *Sharia* board or committee. The constitution of these *Sharia* boards should be standardised, with some flexibility allowed to the individual banks. They should also be more fully integrated within the corporate governance structure of the firm. This is important to facilitate the reinforcement of Islamic norms and values within the firm. One way to ensure this integration would be to require managers from other parts of the firm to sit on the *Sharia* board. While they would not be engaged directly in issuing *fatwas*, they should be involved in discussing *Sharia* compliance and its monitoring within the firm. In particular, at least one member of the risk management committee should sit on the *Sharia* board. This integration should not, however, be one sided, and a *Sharia* scholar should also sit on the general risk management committee. By overlapping memberships, the institutional logics of Islam may be more readily

[1216] Jane Pollard, Michael Samers, 'Governing Islamic Finance: Territory Agency, and the making of Cosmopolitan Financial Geographies' (2013) 103 *Annals of the Association of American Geographers* 710, 712-713.
[1217] *Ibid*, 714.

disseminated throughout the firm, becoming part of the firm's culture. Furthermore, such an approach recognises the relationship between the risk of *Sharia* compliance and the other risks faced by the bank, which may facilitate a coordinated approach to governance.

As a minimum, each *Sharia* board should have two *Sharia* scholars and one apprentice *Sharia* scholar. The apprentice *Sharia* scholar would be a new role created to ensure that the number of suitable *Sharia* scholars will be maintained at a level adequate to meet the regulatory needs of the profession. They would be employed by the bank as a permanent member of staff with professional responsibilities as *Sharia* officers, but they would also be provided with professional training and postgraduate education in *Sharia* as applied to economics and finance. As the name suggests, this would be in part through an apprenticeship with one of the *Sharia* scholars and in part through attendance of recognised postgraduate courses.

The importance of the role of *Sharia* scholars, and the trust placed in their judgment, highlights the need to ensure that they are a fit and proper person. This means that they should be a person of good character, a devout Muslim of unquestionable faith and suitably qualified in both *Sharia* and Islamic finance and economics. Furthermore, there should be some active regulation limiting the number of *Sharia* boards that any single scholar may sit on. This could be a fixed number, as per the approach in Malaysia, or it could be managed less rigidly by requiring approval of all appointments by an international regulatory body, which would most appropriately be an international professional regulatory body that maintains a register of all *Sharia* scholars. As noted above, this could be taken on by ASAS.

The existence, composition, staffing and activity of *Sharia* boards should be proactively regulated at national level. The importance of national regulation was a clear theme that emerged from the interviews discussed in chapter five, with the Malaysian approach identified as a good model. This model includes a regulatory framework, backed by legislation and overseen by the central bank and the central SAC. Legislation provides regulation with both legitimacy and robust mechanisms for enforcement.[1218] As such, it would be helpful if all national regulatory oversight was formally established through legislation, which could be based on an internationally agreed Model Law (see above). This could be managed through existing financial regulatory structures, although the regulators would need a sufficient understanding of both *Sharia* and Islamic finance.

Whether there should be a central *Sharia* board, as in the Malaysian model, is a matter that may best be decided on a national basis. The main issue, as expressed by interviewees 9 and 10, is the restrictive impact that a central board might have on innovation and diversity. This could be minimised by a central board with a remit restricted to 'that of the final instance for the clarification of doubtful cases and in dispute settlement'.[1219] While there is value in this role, such a structure has a limited role in standardisation and harmonisation of the structures and processes of *Sharia* governance.

[1218] Robert Baldwin, Martin Cave, Martin Lodge, *Understanding Regulation* (Oxford University Press, 2nd ed 2011), 27.
[1219] Volker Nienhaus, 'Human Resource Management of Islamic Banks: Responses to Conceptual and Technical Challenges' in Simon Archer, Rifaat Ahmed Abdel Karim (eds), *Islamic Finance: The New Regulatory Challenge* (e-book 2nd ed, Wiley 2013), § 4.2.

Rather than risk restricting diversity and innovation through a central *Sharia* board, an alternative option would be to require transparency regarding the *Sharia* compliance of a product, or service. Ensuring the accessibility and transparency of *Sharia* compliance certification, which is consistent with the requirements of good regulation, may also help to further the goals of balancing the tension between diversification and standardisation, and shaping the identity of Islamic finance. If effectively implemented, an accessible and transparent system of *Sharia* governance would reduce the risk of *fatwa* shopping, empower consumers and facilitate diversity, while ensuring that all products are, at least, technically compliant with *Sharia*. It is important to remember that Islam and the *Sharia* are not simply about the permissible (*halal*) and the forbidden (*haram*). While the obligations of Islam are important, the devout should aspire to live a life that is good, pure and ethical (*tayyib*) rather than simply permissible. Consistent with this, *Sharia* governance should be aimed not just at the *halal* financial products and services, but also towards identifying and promoting *tayyib* products and services, which are those that account for social justice and generally benefit the community rather than simply the profit margins of the bank. In publishing *fatwas*, the *Sharia* scholars should make use of both of these labels. Providing these judgments are clear and accessible, backed by reasons and relevant evidence supporting the label, then consumers can choose how "Islamic" their investment should be, balancing their own beliefs with their financial needs.

This framework, of *Sharia* boards at the level of the firm, subject to central regulation at national level should be backed by a standard setting body, a professional regulatory body for *Sharia* scholars, and a specialised international *hisbah* organisation specific to Islamic finance. This should create a multi-layered, coordinated framework that facilitates the standardisation and harmonisation of *Sharia* governance while not precluding fully transparent diversity and innovation. Although it will take time to fully develop, an international network of national *hisbah* ombudsmen should help to provide a bridge across all three levels as well as a conduit to engage the Muslim community in shaping the future development of Islamic finance.

Connecting these different elements of regulation into a coherent, cooperative framework should enable the development of an appropriate regulatory culture that will serve to reinforce the institutional logics of Islam and counter any conflicting messages that derive from conventional finance and neoliberal capitalism. Because regulatory culture is influenced by the background institutional logics that derive from the country's culture, social structure, law and regulatory tradition,[1220] the regulatory framework supporting *Sharia* governance must facilitate a proactive, institutionally sensitive approach that serves to reinforce Islamic norms and values. As has already been argued, this will be enabled by an integrated and Islamic approach to governance that counters the 'hidden struggle for Shari'a compliance between scholars and managers',[1221] and encourages a convergence of objectives to facilitate a more cooperative relationship. Under this Islamic approach, which relies on a modified stakeholder model, the managers should be seen as stewards, fulfilling their role as Allah's vicegerents (*khilafah*).

[1220] Errol Meidinger, 'Regulatory Culture: A Theoretical Outline' (1987) 9 *Law & Policy* 355, 369-374.
[1221] Shakir Ullah, Ian A Harwood, Dima Jamali, '"Fatwa Repositioning": The Hidden Struggle for Shari'a Compliance Within Islamic Financial Institutions' (2016) *Journal of Business Ethics*, doi:10.1007/s10551-016-3090-1.

Consistent with the obligations of *khilafah*, the firm's managers should be trusted to act in the interests of all stakeholders, which include not just the shareholders, employers and customers, but also the whole Muslim community. Similarly, the *Sharia* scholars should be trusted to safeguard the faith-based interests of the *Ummah* by ensuring *Sharia* compliance. Recognising, however, the imperfections of human agents and the profit-based objectives motivating the managers,[1222] that trust must be supported by smart and "really responsive" regulation. Highlighting the importance of the relationship between the regulator and the regulated, this style of regulation varies its approach depending on the both the institutional logics influencing the regulated actors and their attitude towards the regulatory intervention. The ideal relationship is one of trust and cooperation, with both the regulated and the regulator appreciating the shared goal of *Sharia* compliance as a minimum. This relationship can be supported by regulatory mechanisms that rely on *shura* and effect the *hisbah* approach to responsibility and self-development.

Hisbah is aimed at safeguarding the faith-based interests of the *Ummah*, which includes the welfare of the community, the fulfilment of religious, obligations, the encouragement of good moral behaviour and the discouragement of bad behaviour.[1223] It involves both the monitoring of behaviour and responding to transgression in a way that involves both internal (self) and external regulation and is based on five underlying principles, which are: the watchful eye of Allah; trustworthiness; personal responsibility; abstaining from bad behaviour; and

[1222] *Ibid*.
[1223] Fauzan Saleh, 'The Institution of *Hisbah*: Its Roles in Nurturing Fair and Just Economic System In Islam' (2009) Paper presented at National Conference on Islamic Economics, University Malaya, 10-11 February 2009.

proportionality in response to any transgressions.[1224] Although the idea that we are all monitored by Allah is a non-secular principle and so inappropriate for an international body engaging with the delivery of Islamic finance in secular jurisdictions, the emphasis on trust, responsibility, and proportionality are all consistent with responsive regulation. Furthermore, the aim of *hisbah* to encourage sincerity,[1225] commitment to the values of Islam and self-discipline through self-regulation and development reinforces that consistency.

[1224] Azrin Ibrahim, 'Accountability (Hisbah) in Islamic Management: The Philosophy and Ethics behind its implementation' (2015) 5 *International Journal of Humanities and Social Science* 184, 188-189.
[1225] *Ibid*, 188.

6.6 Conclusion

This chapter responds to the arguments developed in the preceding chapters. Those chapters were devoted to analysing the need for reform of *Sharia* governance. Specifically they addressed the question of whether *Sharia* governance should be standardised. The analysis suggested that reform was indeed necessary to address two particular issues: the risk of *Sharia* non-compliance; and the limited focus of *Sharia* governance on technical compliance rather than on the *maqasid* and the spirit of *Sharia*. In this chapter, a regulatory framework has been developed (figure 20). This framework should both reduce the risk of *Sharia* non compliance and help to refocus Islamic finance on the goal of providing an Islamic alternative to conventional finance that embodies the spirit of Islam and provides products and services that are not only *halal*, but are also *tayyib*. With appropriate substantive standards, the framework should also reduce the risk of *fatwa* shopping that is the downside of allowing diversity.

The framework presented here relies on the coordination of multi-layered structures and processes as part of a coherent, comprehensive and standardised regulatory approach to *Sharia* governance. This standardisation is limited to the regulatory structures and processes that support the certification of products and services as *Sharia* compliant. The aim is to achieve a balance between the reliability of standardisation and the value of diversity. Lying behind this balance is the obligation to make *Sharia* compliance information comprehensive, transparent and accessible, which allows consumers to decide on whether they are comfortable with *halal* products or would prefer to invest in the *tayyib*.

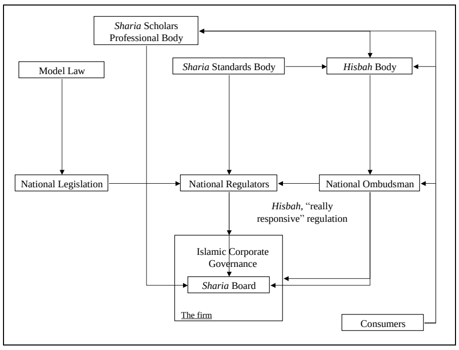

Figure 20: Multi-layered Regulatory Framework for *Sharia* Governance

While an approach that favours technical compliance is not eliminated, the proposed framework and regulatory approach should help to encourage the development of *tayyib* products and services that should shape a more distinctly Islamic identity for Islamic finance. To that end, it has been argued that *Sharia* governance should be integrated as part of an Islamic approach to governance generally. This Islamic approach relies on a modified stakeholder model that emphasises the both the faith-based and other interests of the Muslim community. Rather than treating the managers as self-regarding agents, the Islamic approach relies on stewardship theory that recognises the managers as Allah's vicegerents. This model utilises *shura* as the primary governance and regulatory mechanism and, through the *hisbah* methodology of encouraging trustworthy personal responsibility and the development of self-discipline, engages with "really responsive" regulation.

The standardised structure proposed here is built on the integral role of *Sharia* scholars. It relies on self regulation through the *Sharia* board as part of an integrated Islamic system of governance. At national level, legislation, which may be based on an internationally agreed Model Law, should provide for the rules that ensure that firms take a standard approach to *Sharia* governance, and this should be enforced by national regulators. A central *Sharia* board was seen as something that should be left to the discretion of the individual nation. At international level, there should be a single, authoritative body that sets the standards for *Sharia* governance. There should also be a single international professional regulatory body that maintains a registry of *Sharia* scholars, manages their professional education and deals with any disciplinary issues. Both of these could be implemented through existing bodies such as the AAOIFI and ASAS. While the option of an international *Sharia* board was rejected, there should additionally be an international *hisbah* body that should ultimately coordinate a network of national ombudsmen.

This framework should provide a system of regulation that achieves the standardisation of the structures and process of *Sharia* governance. It should also enhance the institutional influence of *Sharia* governance as part of a regulatory process. This in turn will encourage the development of products and services that are *tayyib*, enhancing the Islamic nature of Islamic finance. It will, however, require international cooperation, motivation and funding. As Archer and Karim comment:

> One major challenge to governments and legislative authorities is ... to equip the supervisory and regulatory bodies concerned with

> Islamic finance with the authority and the means to perform their functions effectively.[1226]

Beyond the need to involve governments, the framework proposed here requires Islamic finance to build on existing bodies and establish a new *hisbah* body. Pressure should also be put on governments to support these international initiates by increasing their legitimacy and authority through treaty. The need for national and international cooperation between private and public bodies provides a very practical barrier to the implementation of the framework, but it at least provides a starting place for the process of standardising *Sharia* governance in a way that will enhance the Islamic nature of Islamic finance as a distinct alternative to conventional finance.

[1226] Simon Archer, Rifaat Ahmed Abdel Karim, 'Concluding Remarks' in Simon Archer, Rifaat Ahmed Abdel Karim (eds), *Islamic Finance: The New Regulatory Challenge* (e-book 2nd ed, Wiley 2013), § 4.

Chapter 7: Conclusion

As defined in Section 1.5, Islamic finance is a system of finance offering products and services that are consistent with the Islamic *Sharia*. Importantly, it provides an alternative to conventional finance, which is based on the secular ideology of capitalism. Conventional finance values money as an end in itself and is built on the foundations of debt and interest allowing the creation of money through credit (Section 2.2.1.3). By comparison, Islamic finance values money as a means to an end, as a commercial tool that cannot be divorced from the resources and services that exist in the real world, rather than in the virtual world of credit, debt and interest (Section 3.3.1.1). The need for all Islamic financial transactions to be visibly connected to real assets is reflected in the principle that money cannot be used to make money. This principle, which derives from the prohibition of *riba* required by the *Sharia*, precludes Islamic finance from charging interest. As per Chapter 3 Section 3 The prohibition of *riba* is perhaps the most well known feature of Islamic finance, but also important are the prohibitions of *maysir* and *gharar*. Islamic finance is also prohibited from involvement with goods or services, such as alcohol and pornography, that are *haram*. Alongside these prohibitions, the other defining feature of Islamic finance is the obligation to pay *zakat*.

As a bare minimum, Islamic banks must respect these obligations and ensure that its products and services comply with the *Sharia*. The importance of compliance is twofold. First, and foremost, it is an obligation owed to Allah by the providers of Islamic finance. Following the *Sharia* is a condition of Islam and governs all aspects of Muslim life, including the commercial provision of finance. Humans, as the vicegerents of Allah, are entrusted with all the resources of earth, but this trust imposes a duty to use those resources wisely and consistently with *Sharia*. This reason for compliance is, of course, most relevant where Islamic finance is provided by Muslims. Islamic finance may, however, be provided by conventional financial institutions. This creates a potential disconnection between Islamic finance and Islamic values, which was adverted to by a number of those interviewed as part of the study discussed in chapter five. It was generally accepted that, provided Islamic and conventional funds were properly segregated, there was no fundamental issue with Islamic finance being delivered by non-Islamic conventional firms. As disscused in Cahpter 6 section 3, Interviewee 11, however, cautioned that 'it would not be ... very sensible' for a conventional firm to offer Islamic finance without involving Muslim staff. Furthermore, interviewees 8, 9, 12, 14, and 19 all emphasised the need for non-Muslims to understand and believe in the philosophy behind Islamic finance.

The impact of this potential disconnection between those providing Islamic finance and the Islamic values embodied by the *Sharia* may be limited to some extent by the second reason for ensuring compliance. This reason emphasises the need for compliance, not because the providers have a duty to act consistently with the *Sharia*, but because it is important for consumer confidence. Muslims constitute the primary market for Islamic finance and, while the principle of necessity allows them to use non-Islamic finance where there is no viable alternative, devout Muslim consumers would prefer to utilise *Sharia* compliant Islamic finance. This creates the demand for Islamic finance and the expectation that any financial products and services will be consistent with *Sharia*. The failure to meet that expectation will breach the trust that the Muslim consumer invests when using Islamic finance and risks undermining confidence in the provider and possibly the industry as a whole.

The importance of ensuring *Sharia* compliance, which derives both from the obligations imposed on the providers and the demand and expectations of the consumer, means that the risk of non-compliance is a serious issue. The need to manage the risk has been clearly recognised by the industry, which has created a risk-management strategy centred on *Sharia* governance (Section 4.4.2). The system of *Sharia* governance is paradigmatically based on the use of *Sharia* boards or committees comprised of *Sharia* scholars. These scholars, usually assisted by *Sharia* officers, advise the banks on *Sharia* compliance, issue *fatwas* certifying Islamic financial products as *Sharia* compliant, and provide some degree of oversight of the development and delivery of the products and services. Given that *Sharia* compliance is essential to the nature of Islamic finance and provides the 'justification for the Islamic finance',[1227] it is no surprise that an effective *Sharia* governance framework is also seen as fundamental.[1228] This raises the question of whether the current system of *Sharia* governance is sufficiently effective.

The question of the effectiveness of *Sharia* governance lies behind the specific research question addressed by this thesis. That question asked how should the system be reformed to improve *Sharia* governance through standardisation, so ensuring that Islamic finance provides a genuinely Islamic alternative to conventional finance. It was prompted by the recognition that the existing approaches varied from country to country, resulting in diverse and inconsistent

[1227] Interviewee 17.
[1228] Interviewees 1, 2, 4, 7, 11, 13, 17.

fatwas. While the issue of standardisation is not new, the existing debate on the issue lacks sufficient depth and has yet to be resolved by the development of plausible approach to reforming the system of *Sharia* governance. As noted in chapter one, the need for a workable scheme or model of standardisation that might be pragmatically applied to improve global *Sharia* governance provided the motivation behind this research.

The question of how *Sharia* governance should be reformed through standardisation comprises three constituent elements. They are: the existing problems affecting the current delivery of Sharia governance; the possible solutions; and the preferred solution. These three elements provided the framework for the main part of the argument that was constructed to address the research question. Before the research question could be addressed directly, however, it was important to provide some necessary context for the issues facing Islamic finance and *Sharia* governance. This thesis has, therefore, also considered the socio-political context of delivering Islamic finance in a global financial environment dominated by capitalism and conventional finance. A limitation of study is the sample used which includes only three countries out of 75 Muslims countries. The study findings maybe only relevant to the sample countries as other countries may have different set of financial and sharia regulations. The research methodology used is also a limitation to this study. This is because interviewees only provide the views or opinions of the questions asked as part of the research investigation.

The structure of the thesis was organised around the need to consider how best to reform *Sharia* governance given that Islamic finance must be delivered in the global context of the capitalist structures and processes of conventional finance. In order to provide a solution that is sensitive to this context, it was considered important to appreciate the social, cultural and ideological tensions facing Islamic finance, its provision and its regulation. In order to meet that need and address those tensions, new institutional theory was used as the foundations for the research methodology. The theoretical commitments of this methodological approach were discussed in section 1.6.1. While accepting the relevance of individual agency to the possibility of change, new institutional theory provides two crucial insights that are particularly useful for understanding the issues facing Islamic finance and *Sharia* governance. First, it highlights the importance of the taken-for-granted cultural and ideological scripts and norms that constitute an institution and guide behaviour. Second, it emphasises the relevance of legitimacy as a motivational force, driving the processes of coercive, mimetic and normative isomorphism. Along with the isomorphism driven by the force of competition, these processes serve to explain why firms within particular organisational fields develop in a way that means they tend to resemble each other.

For this thesis, the importance of appreciating the institutional isomorphic forces that guide behaviour, and so shape the development of firms and other organised groups, is twofold. First, it provides insights into why Islamic finance has developed in the particular way that it has to become the industry in its current state. The insights gained from an institutional perspective allow the identification and characterisation of the institutional influences operating on Islamic finance. Second, if the present state of the industry and its regulation is the result of the institutional influences affecting its development, then any future change must reinforce the institutions that will help to effect the desired change, while also countering the influence of institutions that are likely to cause resistance to the desired change. From a regulatory perspective, the relevance of institutions to *Sharia* governance and standardisation is that the governance must be sensitive to the conflicting institutional logics that affect the behaviour of firms and the individuals working within the industry. By reinforcing the norms and scripts of desired institutions and by countering the norms and scripts of undesired competing institutions, an enlightened system of regulation can utilise the process of isomorphism to further the goal of standardisation, without the need to coercively enforce standards.

While new institutional theory provides the dominant theory, chapter one also discussed the relevance of other methodological approaches that were utilised to supplement and enhance the institutional approach. In particular, the relevance of risk in the context of a risk society was considered, with the conclusion that risks not constrained by national borders required a cosmopolitan analysis engaging with the issue on multiple levels, including the sub-national, national, regional and global levels.[1229] This is particularly important for systemic risks, where the threat extends beyond individual firms to create a danger for the system as whole and justifies multi-layered systemic regulation engaging with each level of the system.[1230] The relevance of risk to this thesis lies both in its role as a discourse that intersects with institutions and an institutional analysis, and in its role as a motivational factor for establishing regulation.

[1229] See section 1.6.1.3.
[1230] See the text at n 146.

Given that the focus of this thesis is on *Sharia* governance, engaging with regulatory theory and paradigms is unavoidable.. For the purposes of the thesis, regulation has been defined as: ' the sustained and focused attempt to alter the behaviour of others according to defined standards or purposes'.[1231]

New governance was adopted as a term to refer to a specific approach to regulation that focuses on transparency, iterative participation, incentivisation, and the integration of private and public regulatory elements.[1232]

The relevance of this understanding of both regulation and governance is that, by emphasising the need for regulation that goes beyond the traditional "command and control" state-based regulation to provide a more nuanced approach, it complements the insights of both new institutional theory and the risk society.

Apart from explicating the methodological commitments of the research presented in this thesis, chapter one also provided some background context, setting out the historical context of Islamic finance. It explained that, although the modern interest in Islamic finance originated in the 1940s, it was not really until the latter half of the 1970s that Islamic finance took off. Its development accompanied the creation of new Muslim states and was driven by a dissatisfaction with conventional finance and a desire for an Islamic alternative that would provide financial products and services consistent with the principles and rules of *Sharia*. The industry, then, is still comparatively young when contrasted to the more firmly established conventional

[1231] Julia Black, *Critical Reflections on Regulation* (Centre for Analysis of Risk and Regulation, London School of Economics 2002), 20. See text at n 170 for full definition.
[1232] See text at n 176.

finance. The relative youth of Islamic finance is an important feature when trying to understand the way the industry has developed. Indeed, as discussed in chapter five, a number of the interviewees raised this point as an apologetic explanation for the current issues facing Islamic finance. For them, Islamic finance was still a nascent industry, struggling to find its feet within an economic framework predicated on the goals and principles of conventional finance. Given this constraint, it is understandable that the identity of Islamic finance remains unsettled.

As was discussed in chapter one, one of the issues facing Islamic finance in its search for a settled identity, is the competing motivations that drive the development of the industry.[1233] In particular, the question of whether the goal of Islamic finance should simply be to provide a financial service that complies with the technical requirements of the *Sharia*, or whether it should more fully embrace the spirit of *Sharia* and its ethical goals expressed by the *maqasid al-Sharia*. Compounded by the need to build the industry in the competitive arena of conventional finance, the tension between these two motivations is reflected in the criticism that Islamic finance has focused too much on technical compliance, resulting in products that are Islamic in name and form, but are conventional in spirit. Again, this issue was apparent in the interviewees' responses discussed in section 5.2.3. The mirroring of conventional financial products and services raises questions about the nature and goals of Islamic finance that highlights the role of *Sharia* governance.

One of the major issues facing Islamic finance and its governance is the diversity and inconsistency of the *fatwas* certifying products and services as *Sharia* compliant.

[1233] See section 1.5.2

How far this is a real problem for the industry depends on the cause of that diversity and inconsistency. There are perhaps three main causal factors that contribute to this: the competitive pressure to satisfy the demand for products and services that provide the same economic advantages as those provided by conventional finance; the diversity of interpretation of *Sharia* allowed by Islamic *fiqh* and reflected in the existence of different schools of Islamic jurisprudence (*Madhhabs*);[1234] and the lack of standardisation of *Sharia* governance. The problem, particularly with inconsistency, is the risk of *Sharia* non-compliance. Apart from the implications that it has from the faith-based perspective of the devout Muslim, the risk of *Sharia* non-compliance, where it materialises or is seen as particularly high, may undermine confidence in Islamic finance. This is particularly problematic because of the risk that a loss of confidence in a particular product or firm may spread to infect the whole system highlighting the systemic nature of the risk of *Sharia* non-compliance.

It is the risk of *Sharia* non-compliance, and the consequential danger that Islamic finance will suffer from a systemic loss of confidence in its ability to deliver a "genuinely" Islamic alternative to conventional finance, that provides the motivation for the research question addressed by this thesis. The research question, as noted above, asks how best to standardise *Sharia* governance so as to minimise the risk of *Sharia* non-compliance and deliver genuinely Islamic products and services. In order to answer that question, it was first important to elucidate and explicate the extent of any problem caused by a lack of standardisation. This in turn required an analysis of Islamic finance, the risk of Sharia non-compliance and the limitations of the current approach to *Sharia* governance.

[1234] See section 3.2.4.

From this methodological perspective of new institutional theory, the starting point was to identify the institutional influences shaping the development of Islamic finance. Given that Islamic finance developed in an already established economic environment dominated by conventional finance, it was first necessary to understand the institutional context of that environment. That context was explored in chapter two, which had three aims. The first of these was to examine the concept of a financial system, allowing the construction of the core model concept through the elucidation of an underlying theory and the core attribute-values. That model is set out in chapter two and it would be unduly repetitious to set it out in full again here.[1235] For present purposes it is sufficient to note the underlying theory that explains the core attributes of the concept. It was argued, then, that the theory of the concept of a financial system is:

> *A complex socio-cultural system comprising a relational network of interdependent roles coordinated to facilitate the flow of money within the community served by that system.*

It should be noted that the core concept of a financial system does not include regulation. Since a financial system is capable of existing without it, regulation is a peripheral attribute. Although not a core attribute, regulation nevertheless plays an important role in ensuring that the financial system meets the needs of the economy. Similarly, central banks were not characterised as part of a core concept, but it was noted that they play important roles as financial policy makers and regulators, helping to preserve financial stability and manage liquidity.

[1235] See section 2.1.5.

The second aim of the chapter two was to briefly examine the nature of conventional banking. The point was to provide an understanding of conventional banking both as a context for, and as a contrast to, Islamic banking. To more fully understand conventional finance, the third aim of the chapter was to explicate the institutional influences that shaped the recent development of conventional financial systems. This examination of the institutional influences that shape conventional finance is important because Islamic finance did not develop as a fully independent system, isolated from any external influences. Rather, Islamic finance was situated within the financial environment dominated by conventional finance. The consequence of this is that Islamic finance was necessarily exposed both to conventional finance as an institution in its own right, and to the societal institutions that act on conventional finance as an organisational field.

The institutional analysis that comprised the second half of chapter two focused particularly on neoliberal capitalism. This dominant ideology grew out of Anglo-American politics from the 1970s onwards, encouraged by the policies of Thatcher's government in the UK and Reagan's presidency in the US. These policies encouraged deregulation and aggressively competitive financial innovation in a relentless pursuit of profit and growth. This innovation resulted in ever more risky products such as subprime mortgages bundled into CDOs, over-the-counter derivatives, and synthetic-CDOs. Along with the growth of the shadow banking system which is relatively untouched by financial regulation, these innovations destabilised the financial systems that relied on them, eventually resulting in the global financial crisis of 2007/2008.

The behavioural scripts and norms legitimised by neoliberal capitalism characterise money as an intrinsically valuable end in itself and the primary goal of conventional finance.[1236]

For the banks, the implication of neoliberal capitalism is emphasised by Milton Friedman's claim that increasing profit is '[the] only ... social responsibility of business'.[1237] This view of money and the role of business became increasingly embedded as institutional norms as neoliberalism became more firmly established. Importantly, the growth of Islamic finance from the mid 1970s onwards, broadly coincided with the growth of neoliberalism, which created the backdrop for Islamic banks as they strove to establish themselves in the global environment of conventional finance.

In chapter three, the discussion focuses on the nature of Islamic finance. This chapter had three main aims. The first aim was to explicate the theoretical nature of Islamic finance and its dependence on *Sharia*. The second aim was to explain Islamic finance in practice, considering both Islamic banks and the financial products and services they offer. The third aim was to explore the institutional influences that have affected the development of Islamic finance, and in particular the interaction between the institutions of Islam and neoliberal capitalism.

[1236] See section 2.2.1.3.
[1237] Quoting from his own book, Capitalism and freedom: Milton Friedman, 'The Social Responsibility of Business to Increase its Profits' (13 September 1970) *The New York Times Magazine* 32-33, 122-124.

Relying on the concept of a financial system characterised in chapter two, the underlying explanatory theory of Islamic finance was identified as:

> *A complex socio-cultural system comprising a relational network of interdependent roles, guided by the tenets of Islam and coordinated to facilitate the flow of money in a way that is consistent with Sharia.*

This theory recognises Islam as the dominant institution shaping Islamic finance. In theory, since *Sharia* is a pervasive guide for life as a Muslim, Islam should be the sole institution. Given, however, that it must exist within the global economic context of conventional finance and neoliberal capitalism, Islamic finance in practice must contend with the inevitable impact of those institutions on its norms and behavioural scripts. This means that behaviours of Islamic banks and those working in them will be influenced by the logics of both Islam and neoliberal capitalism. Where these conflict, this will muddy the purity of the Islamic discourse.

Perhaps the key distinction between the institutions of Islam and neoliberal capitalism is their contrasting view of money. While neoliberal capitalism uses money as a measure of success, Islam measures success through *falah*.[1238] Measuring success through the accumulation of money means that neoliberal capitalism affords money an inherent value that makes it an end in itself. By contrast, Islam characterises money as a means to an end.[1239] All Muslims are Allah's vicegerents, with an obligation to make effective use of the resources made available on earth. Money is simply a tool, whose instrumental value lies in its ability to maximise the efficient use of those resources, but, divorced from the tangible assets

[1238] See section 3.2.3.
[1239] See section 3.3.1.1.

of the real economy, money loses its worth. For Islam, money cannot be used to make money,[1240] which means that interest is prohibited as *riba*.

The problem that the prohibition of *riba* creates for Islamic finance derives from its need to establish itself as nascent industry and to develop within the competitive environment of a global economic framework designed around conventional finance and its essential reliance on interest as the main source of profit and growth. There are then, a number of pressures on Islamic finance.[1241] To begin with, Islamic finance is a relatively young industry that must find its way within an environment shaped by conventional finance and neoliberal capitalism. The regulatory framework is designed for conventional finance, consumer demand is for products and services that perform like conventional finance, and the development and delivery of Islamic finance must rely on professionals with a background in conventional finance. This exposes Islamic finance to the conflicting institutional influences of neoliberal capitalism while requiring it to compete against conventional financial firms and forcing it to stand on the uneven ground of conventional financial regulation.

The conflict between Islam and neoliberal capitalism, then, is also subject to the pressures of competition, which may act to resolve any tension in favour of the norms of conventional finance. While *Sharia* compliance is the bottom line, the influence of neoliberal capitalism within the context of a competitive financial environment results in a mimetic and competitive isomorphism that encourages the development of financial products that use Islamic components, but which are fundamentally based on conventional products. These products may be technically

[1240] See the discussion of the interview responses in section 5.2.3.
[1241] *Ibid*.

compliant with the formal requirements of *Sharia*, but they are inconsistent with its spirit and the *maqasid al-Sharia*.

The opportunity for developing technically compliant products that mimic conventional financial products is exacerbated by the diversity of interpretation inherent to *Sharia* and Islamic *fiqh*. In the absence of a single authoritative ruling on the *Sharia* compliance of Islamic financial products and services, banks are free to "shop" for the most favourable *fatwa*. While the practice of *fatwa* shopping will not necessarily result in products that are not *Sharia* compliant, when coupled with the financial rewards for scholars willing to issue a favourable *fatwa*, it does increase the likelihood that compliance will focus on the formal, technical aspects of *Sharia* rather its spirit. The competitive pressure on Islamic banks, combined with the legitimising influence of neoliberal norms and the focus on technical *Sharia* compliance, may encourage the banks to develop products that test the boundaries of *Sharia* compliance, increasing the risk that a favourable *fatwa* will be issued only to be later challenged by other scholars. Given that *Sharia* compliance is the justification for, and foundation of, Islamic finance,[1242] the marketing of products as Islamic that are subsequently determined to be non-compliant may result in a loss of confidence in Islamic finance as a genuinely Islamic alternative to conventional finance. This risk may be compounded by any dissatisfaction with the focus on technical compliance rather than on the spirit of *Sharia* expressed through the *maqasid al-Sharia*.

[1242] See the discussion of the interview responses in section 5.2.3.

In an less regulated industry, the task of ensuring *Sharia* compliance would be the responsibility of the board of directors, who would be subject only to their own conscience and market forces. Given the fundamental importance of *Sharia* compliance, the invisible hand approach has been rejected in favour of a more formal approach to *Sharia* governance. Following the examination of the nature of Islamic finance and its institutional tensions in chapter three, the governance of *Sharia* compliance was addressed in chapter four. The focus of this chapter was to analyse *Sharia* governance as a type of corporate governance situated in the context of risk management and the competing institutional logics of Islam and neoliberal capitalism.

Through an initial analysis of risk as an institutionalised discourse, it was argued that, from a conventional non-secular approach, all risks can be reduced to an economic value. From an Islamic perspective, however, the risk of *Sharia* non compliance cannot be treated simply as a financial risk, emphasising the importance of prevention and making an effective system of *Sharia* governance essential to Islamic finance.[1243] The standard approach to *Sharia* governance is through the employment of *Sharia* scholars who sit on a *Sharia* supervisory board or committee as part of a bank's corporate governance system. While some countries, such as Malaysia, provide central regulatory oversight, in many cases *Sharia* governance is a matter for the bank and its board of directors.

One of the problems with this approach is it treats *Sharia* governance simply as an additional component of a value-laden system of corporate governance, based on a

[1243] See section 4.1.1.

secular conventional approach that carries with it the institutional norms and scripts of neoliberal capitalism. Rather than utilising western corporate governance with the addition of *Sharia* governance, it was argued that Islamic banks should develop a more integrated approach that incorporates *Sharia* governance within an holistic system of Islamic corporate governance. This Islamic corporate governance might employ a modified stakeholder model based on Islamic principles of *tawhid*, *khilafah* and *shura*, engaging, through a system of representation, all Muslims as stakeholders.[1244]

Other problems faced by the current approach to *Sharia* governance include:[1245] the potential conflicts of interest created by the direct employment relationship between the banks and the *Sharia* scholars sitting on the *Sharia* board; the problem caused by *Sharia* scholars sitting on multiple boards, which creates a power base of elite scholars, again raising concerns of the potential for conflicts of interest caused by the mutual dependence of the banks and the scholars; the issue of scholars sitting on multiple boards may also, through pressure of time, prevent the scholars from affording sufficient attention to their duties owed to each of the individual boards; the issue of multiple board membership also highlights the potential for conflict of interest caused by elite *Sharia* scholars sitting on both the *Sharia* boards of individual banks and on central regulatory *Sharia* boards, standard setting bodies or Islamic rating agencies. These problems are exacerbated by a global shortage of *Sharia* scholars who possess sufficient expertise in both the disciplines of *Sharia* and economics. All of these problems encourage an approach that focuses on formal

[1244] See section 4.4.1.
[1245] See section 4.4.2.

technical compliance rather than the deeper level of engagement required to assess compliance with the *maqasid al-Sharia*.

Beyond the problems caused by a shortage of adequately qualified scholars, multiple board membership and the mutually dependent relationship between the banks and the *Sharia* scholars, *Sharia* governance faces two further problems. First, is the problem of the lack of transparency caused by opaquely technical *fatwas* that make it difficult for those *fatwas* to be subject to external assessment. Second, there is the problem of inconsistent *fatwas*, which threatens to undermine the credibility of Islamic finance. As already noted, this latter problem provides the central motivation behind the argument presented in this thesis, which is that *Sharia* governance should be standardised.

All of these problems are exacerbated by the context of Islamic finance as a young industry exposed to the competing institutional influences of Islam and neoliberal capitalism.[1246] To counter the logics of neoliberal capitalism it is argued that *Sharia* governance should be part of an integrated system of Islamic corporate governance. If such an approach is to be successful on a global scale then it needs to be standardised in order to avoid *fatwa* shopping as a way of avoiding the scrutiny of a more rigorous system of *Sharia* governance. A lack of standardisation permits the coexistence of *Sharia* boards operating at different levels of *Sharia* supervision. This provides banks with the opportunity to seek to obtain a competitive financial advantage by utilising a less rigorous standard of *Sharia* governance. As such, a standardised approach is necessary, both to ensure a high standard of *Sharia*

[1246] See section 4.4.3.

governance is implemented across the board, as well as to ensure that firms face a level regulatory playing field.[1247]

Establishing a rigorous standardised system of *Sharia* compliance governance, especially for cross border transactions,[1248] is crucial to the long term growth and stability of the industry.[1249] The question is, how best to achieve that goal. Before considering any proposal for standardisation, it is first important to clarify precisely what is being standardised. The two main options are standardisation of *Sharia* governance and standardisation of *fatwas*. Direct standardisation of *fatwas* may be advantageous for the industry through a reduction in transactional and information costs. There is, however, a tension between the benefits of standardisation and diversity inherent to *Sharia* and Islamic *fiqh*. This tension was apparent in the interview responses discussed in section 5.2.3. Although not of a unanimous voice, the general impression gained from the responses is that such diversity should not be stifled, which reflects the counterargument that standardisation of Islamic finance 'would detract from the development of its principles'.[1250]

While most of the interviewees regarded the diversity allowed by *Sharia* as an important Islamic aspect of Islamic finance, interviewee 18 stated that:

> I have a certain view regarding the diversity of *Sharia*, there is a mercy on that, but in business, there should be no mercy, there should be one opinion.

[1247] Interviewee 20 expressed a preference for central regulation to enable 'the regulations that gives a fair playing field to everybody'.
[1248] Rahmat Hakim, 'Harmonization of *Shariah* Rulings in Islamic Finance: An Analysis' (2013) 7 *Ijtihad* 267, 276.
[1249] Bedi Gunter Lackman, 'The Six Key Countries Driving Global Islamic Finance Growth' (2104) 6 *Nomura Journal of Capital Markets* 1, 14.
[1250] Rahail Ali, Mustafa Kamal, 'Standardising Islamic Financing: Possibility or Pipe Dream?' (2009) 10 *Business Law International* 19.

This view forcefully emphasises the importance of the business context[1251]. This context was also recognised by interviewee 6 who observed that the issue of diversity and standardisation was 'not an academic exercise', but concerned people's money. Interviewee 13, however, reflecting the tension apparent in most of the interview responses, stated that:

> [it] is a bit of a fine balance ... Enabling enough diversity, enough flexibility in decisions of what is *Sharia* compatible so that diversity of the law is respected, but on the other hand establishing enough of the framework so that in fact the industry is allowed to flourish by virtue of the certainty that the framework provides.

Rather than stifling diversity through the direct standardisation of *fatwas*, a balance between diversity and standardisation may best be achieved by standardisation of *Sharia* governance. Provided it is applied across the whole industry, a sufficiently rigorous system of *Sharia* governance can permit diversity, while restricting the opportunity for the undue testing of the boundaries of *Sharia* compliance. This should allow choice and innovation while maintaining confidence in Islamic finance as an industry that provides a genuinely Islamic alternative to conventional finance. A standardised approach that implements *Sharia* governance as part of an integrated system of Islamic corporate governance will also help to counter the influence of neoliberal capitalism, which should reduce the pressure to copy conventional financial products. Over time, the reinforcement of Islamic norms through governance and regulation should, though the normative isomorphism of professionalism and the coercive isomorphism of legitimacy, indirectly encourage

[1251] See section 1.6.2.2.

harmonisation of *fatwas*. Furthermore, as noted above, a standardised approach to *Sharia* governance will provide a relatively level playing field for all providers of Islamic finance and avoid the exploitation of inconsistency to achieve a competitive advantage.

The proposed approach to *Sharia* governance was developed in chapter six of the thesis and built on both the theoretical analysis presented in chapters three and four and on the qualitative empirical study discussed in chapter five. In the qualitative study, 20 experts in Islamic finance from Saudi Arabia, Malaysia, and the UK were interviewed with the aim of identifying their attitudes regarding Islamic finance and *Sharia* governance. An analysis of their responses was able to identify a number of relevant themes that usefully complemented the earlier theoretical analysis and provided insights that influenced the subsequent proposal.

In short, the relevant themes are:

1. the youth of the industry as an apology for any issues with Islamic financial products and *Sharia* governance;
2. the tension between making a profit and *Sharia* compliance;
4. the difficulties faced by Islamic finance in trying to operate within established conventional economic and regulatory frameworks;
6. the competitive, normative and mimetic isomorphic pressure on Islamic finance to mirror conventional financial products and services;
7. the fundamental nature of *Sharia* compliance, which required at least a national regulatory framework, with the Malaysian approach identified as the best current model; the tension between the value of diversity and the need

for standardisation, which should be recognised and accounted for by any regulatory framework; and

8. that international bodies should be further developed to enhance the implementation of global standards, but that any enforcement should remain a national issue.

7.1 Implicative Futures

While it may be reasonable to characterise Islamic finance as a young industry by comparison to conventional finance, it is now some forty years since the industry began expanding to become a significant provider of financial services on the global stage. The problems of becoming firmly established and the need to provide a competitive service, compounded by the lack of suitably qualified professionals and *Sharia* scholars, explains and arguably excuses the reliance on conventional finance for the development of Islamic products and services. If, however, Islamic finance is to provide a genuinely Islamic alternative to conventional finance, and to retain the confidence of the Muslim consumer, then it needs to look to the future. First, the industry needs to settle on a clear identity by deciding on whether Islamic finance simply means formal technical *Sharia* compliance, with the emphasis on the prohibition of *riba*, *gharar*, *maysir*, or whether it means compliance with the wider goals of the *maqasid al-Sharia*. A third alternative would be to transparently provide both types of products and services, allowing the consumer to choose. Second, the industry needs to develop a coherent comprehensive system of regulation that allows *Sharia* governance to be standardised without completely precluding diversity.

In chapter six the regulatory options were explored, allowing a proposal to be developed for a standardised approach to *Sharia* governance. The proposed regulatory framework addresses both the risk of *Sharia* non-compliance and the problem of the undue focus on technical compliance, rather than compliance with the spirit of *Sharia*. The aim is to preserve diversity by transparently offering both *halal* and *tayyib* products and services, while enhancing confidence in Islamic finance through a standardised, robust system of governance. Such an approach recognises the value in diversity. It also acknowledges that firms delivering Islamic finance do not all operate in identical cultural, political and legal contexts. In some contexts, it may not be feasible for Islamic finance firms to operate as commercial ventures unless they provide products and services that go no further than satisfying a technical *Sharia* compliance. As Aldhoni notes, the Holy *Qur'an* (64:16) allows that a limited consistency with *Sharia* is better than nothing.[1252] The important condition is that *Sharia* compliance is transparent, making it clear to the consumer whether the product is *tayyib*, or simply *halal*.

The proposed framework is multi-layered, engaging with *Sharia* governance at the level of the firm, the national level and the international level. At the level of the firm, the proposal maintains the current reliance on *Sharia* supervisory boards or committees, but argues that their role should be more fully integrated within the corporate governance of the firm rather than provided as an additional, distinct element. Furthermore, governance of Islamic banks should be based on an Islamic, modified stakeholder conception of governance, which should help to reinforce the norms and scripts of Islam. This approach, which relies on both *shura* and the *hisbah*

[1252] Abdul Karim Aldohni, 'The Emergence of Islamic Banking in the UK: A Comparative Study with Muslim Countries' (2008) 22 *Arab Law Quarterly* 180, 186.

methodology of encouraging trustworthy personal responsibility and the development of self-discipline, engages with a "really responsive" regulatory framework established at the national level.

At the national level, the proposal suggested that national law, which might usefully be harmonised through an internationally agreed Model Law, should require a standardised approach to *Sharia* governance enforced by national regulators. The national framework could, as in the Malaysian system, include a central *Sharia* board, but this was not seen as an essential element and should be left to the individual nations to decide.

At the international level, the proposal recommends that a single, authoritative body should set standards for *Sharia* governance. There should also be an international professional regulatory body to maintain a registry of *Sharia* scholars, manage the professional education of *Sharia* scholars and deal with disciplinary issues. It was acknowledged that both of these could be implemented through existing bodies, but would require greater coordination and the cooperation of the industry. To support these bodies, the proposal further recommended the establishment of an international *hisbah* body, which, in the long term, would be responsible for coordinating a network of national ombudsmen.

While the proposed framework should enhance both the standardisation of *Sharia* governance and the Islamic identity of Islamic finance, there are a number of issues that would need to be resolved in order to implement it effectively. This includes the cost of such a system, both in terms of the financial expense and in terms of the additional demands on human resources. The lack of suitably qualified individuals for *Sharia* governance is already a recognised issue and is something that can only be dealt with through the establishment of adequate educational programmes and time. This may require the proposed framework to be implemented gradually, in stages, but should not prevent it from eventually being established.

Implementing the framework will also require the cooperation of the industry and national governments. Islamic finance is, however, a valuable industry. While it has a clear economic value, Islamic finance also has an immeasurable religious and ethical value, providing Muslims with financial services that enhance their lives as Allah's vicegerents on earth, and offering non-Muslims an ethical alternative to conventional finance. Although securing the cooperation necessary to implement the proposed framework is unlikely to be straightforward, the advantages of a standardised approach to governance that enhances the Islamic quality of Islamic finance, increases consumer choice, and reinforces consumer confidence in Islamic finance, make implementation worthwhile. Additional research is required into the practicalities of implementing such a framework, including its costs. The proposal, however, provides a good starting point and could be taken forward by an international committee of influential and authoritative experts in Islamic finance and *Sharia* governance.

Appendix: The Semi-Structured Interview

Section 1: The development of Islamic finance

1. Briefly, What is Islamic Finance? And how different it is from Conventional Finance?
2. What do you think are the goals of Islamic finance (try to name up to five)?
3. Why do you think these goals are identifiable with Islamic finance?
    a. What do you think are the most important goals for organisations that provide Islamic finance (up to 5)?
    b. Are these goals affected by the nature of the organisation, for example are the goals different for Islamic banks and Conventional banks that offer Islamic finance alongside a conventional service?
4. Do any issues arise from conventional and Islamic finance being offered by the same organisations? What are these issues?
5. Do any issues arise from Islamic finance being offered by non-Muslim organisations? What are these issues?
6. What differences, if any, are there between Islamic finance as offered in Muslim countries when compared to non-Muslim countries? (Reference the three countries of interest: Saudi Arabia; Malaysia; and the UK).
    a. What, if any, are the particular issues that face organisations delivering Islamic finance in: Muslim countries such as the KSA; Countries with a majority Muslim population (Malaysia); Countries with a minority Muslim population (UK)?

7. Do you think Islamic financial instruments have tended to be modelled on conventional financial instruments? If yes, why has this happened?

    a. How would you describe the relationship between Islamic and conventional finance?

8. Does Islamic finance need to compete with conventional finance? If yes: How far does that competition influence the development of Islamic financial instruments?

9. Are there any differences in the Islamic financial instruments developed in Muslim countries from those developed in non-Muslim countries? (Reference the three countries of interest: Saudi Arabia; Malaysia; and the UK). If yes: Would you explain the nature of any differences and why you think they arose.

    a. Who are the target clients for Islamic finance? Has this changed over time as Islamic finance has developed? How has it changed?

    b. How do you think the 2007 global financial crisis has affected Islamic finance, both on its own terms and with regard to its relationship with conventional finance?

Section 2: The current challenges facing Islamic finance regarding *Sharia* governance

10. Do you think Sharia compliance is a particular issue for Islamic finance? Would you explain why you think that?

    a. What are the current arrangements for Sharia governance?

11. What do you think of the current governance arrangements for managing the risk of Sharia non-compliance?

a. What issues do you think are particularly relevant to Sharia board members?

b. How far are these issues affected by the country in which the board is situated?

12. Do you think the risk of *Sharia* non-compliance is affected by the nature of the country in which the financial instruments are innovated and developed? (Suggest Kingdom of Saudi Arabia, Malaysia and UK as countries for comparison). If yes: Would you explain why you think that?

a. What do you think are the most important factors that influence the risk of Sharia non-compliance?

13. What are your views on the issue of the diversity of *Sharia* rulings regarding *Sharia* compliance?

a. What do you think is the legal status of the *Fatwas* issued in regard to Islamic financial products?

b. In your opinion, what sort of issues arise from this legal status

14. Do you know what is meant by *Fatwa* shopping?Have you ever come across *Fatwa* shopping, either in theory or in practice? What are your views on this issue (of *Fatwa* shopping)?

a. Are there any financial instruments that you feel are problematic with regard to Sharia compliance? Would you name the ones that you believe are most problematic? Why do you think they are problematic?

b. What do you think are the possible consequences of a product initially passed as Sharia compliant subsequently being ruled as non-compliant? Which of these consequences do you think are most likely?

Section 3: The possible solutions to those challenges

15. How do you think Sharia compliance should be regulated? Why do you think that?
16. Is there a need for reform of the current approach to Sharia governance? What reform is required? Why do you think that?
17. What do you think of specific possible solutions? International Sharia board (Backed by treaty; Backed by voluntary co-operation); Regional Sharia boards; Model Law governing national Sharia boards.

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