Developing Islamic Financial Markets.
Reifying the Status Quo of Global Finance?*

ABSTRACT

Islamic finance is one of the fastest growing segments of international financial markets and at first glance, its ideals are appealing. Deriving its core principles from the Koran and the jurisprudential body of knowledge known as the Shariah, the objective of Islamic finance is to install a more equitable financial and economic order that at the same time is transaction-friendly, organised around religious principles. Thus, Islam could be seen as a foundation for the inclusion of the ethical and moral dimensions of economics and markets. This coincides with an increasingly affluent Muslim middle class, a rise in oil-income, and a reorientation towards cultural-religious values. As a consequence, over the last few decades increasing efforts have been undertaken to structure Shariah-compliant financial products, to develop and institutionalise Islamic capital markets and above all, to make Islamic finance acceptable (and thus investable) to the mainstream. This paper investigates whether Islamic finance can offer an ethical alternative to the existing international financial system or whether it rather serves to reify the status quo of global finance. In doing so, it takes a closer look at the knowledge base from which Islamic financial products are constructed and assessed and at the emerging international regulatory framework for Islamic financial markets. From this, it derives the conclusion that there is a real possibility that instead of creating a more equitable economic order, the currently emerging regulatory structure of Islamic finance will actually serve to reproduce, to legitimise, and thus to reify existing financial structures.

Key words:

Islamic finance; religious economics; financial regulation; epistemic authority; Shariah compliance; legitimacy

* Lena Rethel, Department of Politics and International Studies, University of Warwick, Coventry, CV4 7AL, United Kingdom, email: L.Rethel@warwick.ac.uk. Please do not quote or circulate without author’s permission.
Developing Islamic Financial Markets. Reifying the *Status Quo* of Global Finance?
 Islamic finance is one of the fastest growing segments of international financial markets and at first glance, its ideals are appealing. Deriving its core principles from the Koran and the jurisprudential body of knowledge which is known as the Shariah, the objective of Islamic finance is to install a more equitable financial and economic order that at the same time is transaction-friendly, organised around religious principles. Thus, Islam could be seen as a foundation for the inclusion of the ethical and moral dimensions of economics and markets. This coincides with an increasingly affluent Muslim middle class, a rise in oil-income, and a reorientation towards cultural-religious values. As a consequence, over the last few decades increasing efforts have been undertaken to structure Shariah-compliant financial products, to develop and institutionalise Islamic capital markets and above all, to make Islamic finance acceptable (and thus investable) to the mainstream. This paper investigates the question whether Islamic finance can offer an ethical alternative to the existing international financial system or whether it rather serves to reify the status quo of global finance. In doing so, it will take a closer look at the knowledge base from which Islamic financial products are constructed and assessed and at the emerging international regulatory framework for international Islamic financial markets. From this, it derives the conclusion that there is a real possibility that instead of creating a more equitable economic order, the currently emerging regulatory structure of Islamic finance will actually serve to reproduce, to legitimise, and thus to reify existing inequitable financial structures.

The paper is organised as follows. The next section discusses the ethical and moral dimensions of capital markets and how these can be related to what are identified as the core principles of Islamic finance. Section 2 gives an overview of the rise of Islamic finance over the last decades and critically discusses the major drivers of these developments. In section 3, problems that are confronted in attempting to create and regulate a mainstream-capable Islamic financial system will be discussed. Section 4 summarises key points and concludes with an outlook on the possible futures of Islamic finance and its potential role as a site of resistance.

1 Ethical Foundations of Capital Markets and the Core Principles of Islamic Finance
The basic allocative function of capital markets is to match capital supply with capital demand. This is modelled in the market clearing mechanism of classical and neoclassical economic theory, where the price of capital, the interest rate, effectuates an equilibrium between capital demand and supply. As such, markets are conceived as rational, not moral
entities. They are depicted as following objective principles that can be scientifically established. The focus rests on the economic and financial aspects of transactions. Yet, this view neglects the fundamentally distributive aspect of (capital) markets and their ethical, moral and social dimensions. As such, it can be argued that a much more reflective approach is required than can be offered by the framework of secular neoclassical economics which builds on Pareto’s principles of efficiency as its underlying theory of economic justice but has long evaded a more thorough engagement with these principles and economic justice more generally (see also Buchanan 1985). However, contesting the absence (of an explicit articulation) of the ethical and social dimensions of markets is a key theme of much of the more critically inclined political economy literature (see e.g. De Goede 2005; Watson 2005). Yet, it is often hard to see to what extent these criticisms can, or even should, be translated into financial practice (Kessler 2007).

Interestingly, there exists little reference to other value systems that actively embrace the ethical, moral and social dimensions of the market. As such, the political economy literature, which often engages directly with a certain, secular or post-Enlightenment view of economics, reproduces its secular ontology. Frequently, more religiously oriented and/or cultural considerations and interpretations are not seen as legitimate spheres of analysis. For example, apart from an interest in hawala networks and ‘terrorist finance’ after September 11, so-called Islamic finance has escaped the attention of political economy approaches to finance (De Goede 2003; Warde 2007). This position is untenable. An IPE which claims that a different world order is possible should become more curious about alternative value systems. Such an agenda could also support current efforts to expand, yes, truly ‘globalise IPE’ by looking beyond its narrow focus on mainly advanced, mainly Western political economies (Phillips 2005).

In contrast to conventional financial practice based on the principles of neoclassical economic theory, Islamic finance is fundamentally concerned with and very articulate about embedded elements of morality/ethics. It derives its basic principles from the Koran, Islam’s holy book, which Muslims believe has been imparted to mankind by Allah, and the jurisprudential body of knowledge which is referred to as the Shariah. A fundamental tenet of Islamic jurisprudence is that everything which is not clearly prohibited is permissible (IOSCO 2004, p. 6). The four major prohibited elements in Islamic finance are riba (unjustified increase; narrowly interpreted as the paying or receiving of interest), maisir (gambling), gharar
(making profit from someone else’s uncertainty), and the production and sale of haram (forbidden) goods and services. These will be explained in turn.

The prohibition of interest is often seen as the *sine qua non* of Islamic economic and financial philosophy (Kuran 1995, p. 157). As Venardos (2006, p. 57) explains, “[m]aking money from money is not Islamically acceptable. From an Islamic point of view money is only a medium of exchange, a way of defining the value of a thing; it has no value in itself and therefore should not be allowed to give rise to more money simply by being put in a bank or lent to someone else at a fixed interest rate. The human effort, initiative and risk involved in a productive venture are more important than the money used to finance it. Muslim jurists consider money as potential capital rather than capital, meaning that money becomes capital only when it is invested in business. […] In Islam, money represents purchasing power which is considered to be the only proper use of money. This purchasing power (money) cannot be used to make more purchasing power (money) without undergoing the intermediate step of it being used for the purchase of goods and services.” More generally, there are three closely related reasons to justify the prohibition of riba in Islamic finance. According to an Islamic world view, it is “unfair, it is exploitative, and it is unproductive” (Warde 2000, p. 63).

Because of its zero-sum character as one party gains from the other party’s loss, all forms of gambling are forbidden. Furthermore, gambling contains elements of uncertainty as the outcome of a gamble by definition cannot be ascertained *a priori*. The prohibition of profiting from uncertainty is meant to prevent the taking of excessive risk and the entering into a commercial venture without sufficient knowledge (Venardos 2006, p. 54). In an exchange, this applies to situations where for instance the quality of the goods cannot be established or where goods cannot immediately be delivered (e.g. short-selling). However, minor uncertainties are tolerated. The underlying rationale is that one party should not unfairly benefit from the other party’s ignorance.

Furthermore, the prohibition of financing sinful products and activities is meant to give Islamic financial products a morally embedded character. While in conventional economics, the production of and trade in goods and services is conceptualised as only being subjected to demand and supply and thus the price mechanism, Islamic economic philosophy clearly identifies a number of products and activities which are not socially desirable and thus forbidden. Among these are alcohol, pork-related products, pornography, gambling,
prostitution and activities engaging in riba, maisir and/or gharar such as conventional banking and insurance. Thus, the market mechanism is complemented by a ‘moral filter’ of what is socially desirable (Rice 1999, p. 346). These prohibitions have to be seen in the wider context of Islamic economic philosophy which contains strong elements of redistribution (as e.g. through zakat, mandatory alms-giving by individuals and firms), the idea of participatory economic growth and risk-sharing as the basis of a more equitable development, together with a certain materiality or transactions focus as expressed in the sanctity of contracts and property rights. These principles and provisions give Islamic financial instruments and services a distinct character. The remainder of this section briefly outlines how Islamic finance compares with conventional finance in the areas of banking, equity finance and debt finance by discussing some of the major Islamic financing techniques.

Conventional commercial banks take deposits and make loans. The main source of bank profits lies here in the interest rate differential as interest rates on deposits are usually lower than those on loans. The absence of interest in Islamic finance leads to different models of deposit taking. Deposits are taken either as demand deposits for safekeeping or as investment deposits. In the former case, a 100% reserve should be held as deposits are assumed to be placed as amanat (safekeeping) and thus considered as always belonging to the depositor (Venardos 2006, pp. 99-100). The bank might charge a fee for this service. In the latter case, funds are placed in profit (and loss) sharing investment accounts (PSIAs). Here, no reserve holdings are required as the deposits are not guaranteed. They are used to finance investment projects and depositors share both the profits and the losses of the venture. Thus, depositors turn into shareholders, equity financiers. Bank lending to consumers usually takes the form of murabaha, as a sale with an agreed upon profit.

In sharing risks and profits, equity finance is by nature participatory and mostly Shariah compliant. The two most frequently used instruments/contracts in equity finance are mudharabah (profit sharing) and musharakah (profit and loss sharing partnership). In the former, an investor (e.g. Islamic bank, fund, etc.) provides finance to an entrepreneur. Both investor and entrepreneur are entitled to the profits arising from the enterprise which are shared according to a predetermined ratio. However, in case of failure of the business (if this is not due to the entrepreneur’s negligence) only the investor bears the loss. The latter type of contract refers to a partnership where each partner shares in the profits and losses of the venture according to their capital contribution.
As such, most conventional equity finance is Shariah compliant, apart from stocks that finance enterprises engaged in sinful activities (e.g. casinos/gambling, breweries/alcohol, conventional banks/riba). Similarly, enterprises that finance themselves through debt and as such pay interest (engage in riba) are forbidden investments. However, in cases where the income from non-halal activities is negligible, some interpretations allow for the application of a cleansing mechanism “to purify investments that are tainted by prohibited activities”, by making a charitable contribution that covers the share of profit made through non-halal activities (e.g. drug concerns that use pork gelatine in pills or hotels that also serve pork products and alcohol in their restaurants) (IOSCO 2004, p. 30).

The matter gets more complicated when it comes to loan capital as Islamic finance rejects the conventional debtor-creditor relationship in which risk is only asymmetrically shared. Prohibiting any return on a debt, lending is not considered a legitimate profitable activity. As Venardos (2006, p. 44) summarises, according to the Shariah “[a]ll wealth creation should result from a partnership between the investor and the user of capital in which rewards and risks are shared. Returns on invested capital should be earned rather than predetermined.” Thus, the conventional creditor-debtor relationship is rejected in favour of a notion of profit-sharing or stakeholder relationships. According to Islamic financial principles, only one type of loan is permissible, qard hassan (literally: good loan), an interest-free loan where the investor is not at all allowed to benefit, neither directly nor indirectly, from the lending relationship. In all other cases, lenders (be it depositors, banks or portfolio investors) must share in the profits or losses incurred by the business venture, unlike conventional loans where the borrower has to repay principal and interest independently of the success of her project (Venardos 2006, p.56). At the core is here the banning of the risk-free accumulation of capital and the concentration of wealth in the hands of only a few. Lenders enter a partnership “on the basis of economic viability and profitability of a project – not on the basis of the creditworthiness of the borrower” (Al-Harran 1995, p. xii, emphasis added). Furthermore, Islamic financial philosophy provides for a suspension of repayments in case the borrower experiences financial difficulties as stated in Verse 280 of the Surah Al-Baqarah, “[a]nd if the debtor is in a hard time [has no money], then grant him time till it is easy for him to repay, but if you remit it by way of charity, that is better for you.”
More controversial is the issuance of Islamic bonds or *sukuk*. The word *sukuk* derives from the Arabic word for cheque, *sakk* (plural: *sukuk*) and refers to Islamic certificates or contracts (in this it is similar to conventional bonds). However, “[s]ukus differ from traditional fixed income in that technically they do not pay interest […]. Instead, investors are compensated through a cash stream typically generated from assets placed in special purpose vehicles” (FT 2007a). In this, they are profit-sharing instruments. Most importantly, there exists a specific contract of exchange (IOSCO 2004, p. 35). The rationale here is “to link the return of an Islamic contract to productivity and the quality of the project, thereby ensuring a more equitable distribution of wealth” (El Qorchi 2005, p. 46).

To sum up, the rationale of Islamic investment is markedly different from that of conventional finance. It rests on a moral/ethical base and the overarching goal is to achieve a socially embedded financial system that includes - if not actively promotes - ethical and moral dimensions. Yet, how has it fared empirically? The next section will look at the rise and spread of Islamic finance over the last four decades. It will identify key drivers of the resurgence of Islamic finance.

**2 The Rise and Spread of Modern Islamic Finance**

The emergence of modern Islamic finance is usually dated back to the establishment of a small rural savings bank in Egypt in 1963. However, it was only from the late 1970s onwards that Islamic banking gained pace. The first country to adopt Islamic finance at a national level was Pakistan. Over a period from 1979 to the mid-1980s, steps were undertaken to organise the financial system on an interest free basis, leading to a complete elimination of interest in domestic operations by 1985 (Siddiqui 1988). Post-revolution Iran swiftly followed and enacted a new banking law in 1983 which led to the abolition of interest by 1985. The Sudan was the third country that Islamised its financial system in this period. In addition, public and private Islamic banks were founded all across the Muslim world. In 1974, one year after the imposition of the oil embargo, the Islamic Development Bank (IDB) was established as a multilateral development bank “to foster economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of the Shariah” (Article 1, IDB Articles of Agreement). This development is often seen as a catalyst for the further incorporation of Islamic banks (IOSCO 2004, p. 18). A year later in 1975, the first fully-fledged private Islamic bank, Dubai Islamic Bank, was founded (see table 1 for an overview of the establishment of Islamic banks). By the mid-
1980s, Islamic assets under management were estimated to be around USD 5 billion (Iqbal 1997, p. 42).

<table>
<thead>
<tr>
<th>Year first bank established</th>
<th>Country</th>
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<tr>
<td>1975</td>
<td>United Arab Emirates</td>
</tr>
<tr>
<td>1977</td>
<td>Egypt, Kuwait</td>
</tr>
<tr>
<td>1978</td>
<td>Jordan</td>
</tr>
<tr>
<td>1979</td>
<td>Bahrain</td>
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<tr>
<td>1982</td>
<td>Qatar</td>
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<tr>
<td>1983</td>
<td>Malaysia, Tunisia</td>
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<tr>
<td>1985</td>
<td>Turkey</td>
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<tr>
<td>1988</td>
<td>Saudi Arabia</td>
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Islamic finance experienced a new impetus from the mid-1990s onwards when established Western banks became increasingly attracted to the growing market and major global actors stepped in. For example, Citibank opened its first Islamic subsidiary in Bahrain in 1996. In 1998, HSBC established its global Islamic banking division, HSBC Amanah. In addition, more and more conventional banks opened Islamic ‘windows’. A few years later, specialised Islamic financial institutions began to emerge in Western, non-Muslim countries. For example, the Birmingham-based Islamic Bank of Britain was created in 2004 and the London-based European Islamic Investment Bank in 2006.

As equity finance is to a large extent Shariah compliant, little effort has been undertaken to create separate Islamic stock markets. However, recent years have seen the increasing salience of Islamic debt markets, in particular through the widespread issuance of sukuk. What started out in the 1980s in countries such as Malaysia as a niche market, dominated by government paper, has since then become a big international market for corporate and sovereign sukuk. Shell Malaysia, a big multinational corporation decided to issue sukuk in 1990. Yet, it took another decade for sukuk issuance to take off as Middle Eastern Shariah scholars especially were sceptical about its compliance with Islamic financial principles (AWSJ 2007). Over the last decade, the global sukuk market has experienced exponential growth from USD 340 million in 2000 to more than USD 80 billion by the end of July 2007 (FT 2007a; Gulfnews 2007). Furthermore, sukuk are becoming increasingly accepted as regular debt instruments. Large secular international financial institutions have used them to raise funds. Similarly, companies from non-Muslim countries as well as sovereign and sub-sovereign borrowers seem to be keen to tap the Islamic capital market. The UK has just set
up a working group to study the feasibility of becoming a sovereign issuer of sukuk (HM Treasury 2007). Given the relatively early stage of economic development of many countries with sizable Muslim populations, a big potential is seen for project finance via sukuk (Zeti 2007a). Currently, institutions offering Islamic financial services are very conservatively estimated to outnumber 300 worldwide, to manage more than USD 300 billion in assets and to operate in nearly 50 of the Worldbank’s member countries (Standard & Poor’s 2006, p. 5).12

The reasons for the resurgence of Islamic economics and finance over the last decades are many and can only be briefly touched upon here. Many developments in the emergence of Islamic financial markets have arisen within a specific historical context as the (Muslim) world passed through a series of crucial junctures. However, it appears that the development of Islamic financial markets is largely driven by political and socio-economic factors, and only to a far lesser extent by purely ethical motives.

The emergence of Islamic finance is closely linked to political and economic developments in the 1970s and early 1980s, most importantly the rise of pan-Islamism and the energy crises of the 1970s and early 1980s (Warde 2000). Not only did these crises, for the first time in its modern history, generate vast sources of funds for the Middle East that were seeking investment, but they also stood for an increasing political assertiveness of the Islamic world against ‘the West’.13 Kuran (1995, pp. 169-170) points out that the intellectual movement of Islamic economics should not be seen so much as being meant “to galvanize a radical shift in economic thought or to unleash a revolution in economic practices [but as a reassertion of] Islam’s importance as a source of guidance and inspiration, and to reaffirm its relevance to modern life. [...]Its influence has stemmed less from its substance than from the cultural statement it delivers”. In a similar vein, Vogel and Hayes (1998, p. 21) note, that “the surge in Islamic banking and finance is part of the much larger phenomenon of Islamic reassertion”. Islamic finance is often taken as a precedent of Islam’s capability to regulate further aspects of everyday modern life (Henry and Wilson 2004, p. 2).

The First Gulf War brought about a reversal in fortune for many Middle Eastern countries. Coupled with sinking oil prices in the early 1990s, it depleted currency reserves and led to increased international borrowing, and thus dependence, by Saudi Arabia and other Gulf states at a time of heightened interference by Western powers in the region’s political and
economic affairs. Thus, later efforts to develop the region’s capital markets can also be seen as an attempt to reduce foreign dependence by being able to generate and manage funds domestically and regionally. The increasing oil prices over the last few years again led to growing oil wealth with demand for suitable investments soaring in the Gulf region and beyond. This coincides with increasing efforts to reverse capital flight from the region to OECD countries by improving the domestic financial infrastructure (Siddiqui 2005).

However, the size of funds being held by Muslims and seeking investment according to Islamic principles did not only soar in the Middle East. Increasingly, strong demand for Shariah-compliant financial services and transactions is coming from immigrant and non-immigrant Muslims in other parts of the world, caused by the emergence of an increasingly affluent Muslim middle class (DeLorenzo 2005). The socio-economic conditions of many Muslims have improved in countries such as the UK and the US, but also on a broader level in countries that are in the transition from developing to middle income countries such as Malaysia. This emerging Muslim middle class represents a set of consumers who, if they have the choice, express a decided preference for Islamic products (DeLorenzo 2005).

Another impetus for the development of Islamic financial markets has been the changing geopolitical environment since the September 11th, 2001 attacks on New York and Washington, followed by the launch of the ‘War on Terror’. Not only did the subsequent actions of the US and their allies lead to increasing disenchantment in the Muslim world with the West, but stringent US anti-terrorist finance and money laundering regulations as well as the often arbitrary persecution of Islamic financial institutions and funds further alienated Muslim investors who had parked their funds in the US (Henry and Wilson 2004; De Goede 2003; see Warde 2007 for a thorough assessment of the financial `war on terror’). Finance was the first front in the war on terror. The almost equation of Islamic banking with terrorist finance in the minds of policymakers following 9/11 led to an, at least in the early stages, very indiscriminate clamp down on Islamic funds and institutions, many of which were later quietly exonerated.

These developments triggered a reversal of capital flight and (Middle Eastern) Muslims withdrew their funds to place them in a now politically safer environment.14 However, there was also a more constructive side-effect to the financial war on terror. To counter claims equating Islamic finance with terrorism and to comply with new US and international anti-
terrorist and anti-money laundering regulation, efforts were undertaken to step up the regulation of Islamic finance and to make Islamic financial markets more transparent. Thus, Islamic finance experienced a big push towards further institutionalisation in the wake of the 9/11 attacks.

To sum up, major drivers in the development of Islamic financial markets are the increase in funds through oil income and the improving socio-economic conditions of large segments of a growing Muslim population, coupled with an increasing reorientation towards religious-cultural values, as well as political factors, most importantly the war on terrorist finance. The contribution of a more responsible investment culture should also not be neglected. However, it is difficult to assess its quantitative impact. No reliable data exists indicating to what extent Islamic investments are motivated by religious and ethical considerations. Yet, a comparable trend has occurred in conventional finance with the rise of socially responsible investments. Here, growth rates are tremendous. In the US alone, the amount of assets invested under socially responsible investment strategies is currently estimated to approach USD 2.3 trillion (Social Investment Forum 2006). Less tangible motivations surely play a role in the rise of Islamic finance. Kuran (1995, pp. 168-9) for example argues that it is driven by a need to cope with modernisation, and identifies trust and guilt as key motivations. A wide-held perception, especially in countries that have been hit by financial crises such as Malaysia, is that Islamic finance - through its embeddedness in real economic activity - is more stable and thus less crisis-prone (Zeti 2007b).

Islamic finance has arrived at a crossroads. The question is whether the moral, ethical and social orientation of Islamic finance can be maintained in the face of its increasing institutionalisation and integration with global financial markets. The next section will attempt to address this question by looking at the emerging regulatory structure for Islamic finance.

3 The Emerging International Regulatory Framework for Islamic Finance
The rise of assets invested according to Islamic principles has been accompanied by an increasing institutionalisation of regulatory structures for international Islamic finance both on the private (self-)regulatory and public regulatory level. Islamic finance tends to be more internationally oriented than conventional finance “[a]s Shariah is about universal, divinely inspired principles rather than national laws” (Wilson 2007, no pagination). However,
divergences in Islamic jurisprudence (there are five major schools of Islamic law) make it inherently difficult to develop common standards and best practices. Furthermore, in many countries, Islamic finance, being a latecomer, has to find its place alongside existing conventional structures (Warde 2000).

Two major legitimising elements and important sources of private epistemic authority in the world of global finance are indices (performance measures for stocks) and ratings (of the creditworthiness of financial instruments and entities). They both create visibility, credibility and thus investability for financial products. This is important for Islamic capital markets and instruments even more so than for many conventional instruments as firstly, they are emerging and thus had only a limited time span to be tested and to build a reputation, and secondly, their ‘guilt of association’ with illegal activities such as terrorist finance and money laundering (Warde 2000).

Indices create a ‘universe’ of investable stock whose performance they measure. As De Goede (2005, p. 118, original emphasis) argues, “financial indicators have assumed the role of defining the markets and embodying their objective movements. […F]inancial indices in general and the Dow Jones in particular create the financial market as a unified, observable, and measurable phenomenon”. While methodologies of index compilation are not unambiguous, they basically determine what is – and what is not – a legitimate part of the market.

The major international Islamic market indices such as the Dow Jones Islamic Market (DJIM) Indexes and the FTSE Global Islamic Index Series (GIIS) are not generic Islamic indices. They reflect the constitution of the secular indices compiled by these companies, from which non-Islamic stocks are then excluded. As the Dow Jones (2007, p. 5) selection criteria state, “[t]he DJIM universe corresponds with the pool of stocks contained in the Dow Jones Global Indexes. […] DJIM components are selected by filtering the index universe through screens for business activities and financial rations to remove stocks that are not suitable for Islamic investment purposes” (see also FTSE 2001). Apart from this highly questionable selection practice, Islamic market indices only measure the financial performance of Islamic stock but not its ‘ethical performance’. Islamic stock market indices thus reproduce conventional financial ‘performativity’ (De Goede 2005, p. 118), neither challenging the methodology of
index creation nor the narrow conceptualisation of performance as relating only to financial considerations.

And yet, the creation of Islamic indices was an important milestone in the development of Islamic financial markets. DeLorenzo (2005) argues that they were crucial for the establishment of Islamic mutual funds which on their own could hardly have afforded the costs associated with screening stocks. Within a year of the creation of the first DJIM index, more than 100 Islamic mutual funds were on offer.

Rating agencies, important sources of private epistemic authority in international capital markets, assess an obligor’s capacity to repay a (bonded) loan. As such, they are meant to inform investment decisions. However, the role of ratings agencies has evolved beyond this, a trend which has been partly reinforced by regulatory provisions (King and Sinclair 2003). For example, the investment rules of a large number of institutional investors as particularly many pension funds stipulate that they can only invest into investment graded assets. Furthermore, some domestic financial regulations make the issuance of debt instruments such as bonds conditional on being rated. For instance, Malaysia, a predominantly Muslim country, introduced such a requirement in 1992. The role of credit ratings is currently being expanded with the introduction of the Basel II framework (King and Sinclair 2003). Years of reputation building give rating agencies the ‘epistemic authority’ to confer credibility to - and thus legitimise - financial products (Sinclair 2005, p. 177). Similarly, ratings are in many cases necessary to create (legal) investability.

Nevertheless, as Sinclair (2005, pp. 65-66) puts it, in conventional finance “creditworthiness is both a causal belief - being creditworthy means that debt issuers are likely to repay their debts - and a principled belief, in that placing a priority on repaying debt is morally right and obligatory”. However, as has been discussed above, a core principle of Islamic finance and economics more generally is that capital should be employed for productive purposes whilst Islam explicitly allows for the suspension of debt repayments in adverse conditions. As such, even from a theoretical perspective it seems difficult to reconcile the historical role of rating agencies as reproducers of the ‘repayment norm’ with the objectives of Islamic finance and its ‘productive (ethical) investment norm’.
The two by far biggest international rating agencies, Standard & Poor’s and Moody’s have only recently started to rate Islamic financial instruments and entities. However, they do not assess a product’s Shariah compliance. As a recent Standard & Poor’s report (2006, p. 35) states, “Standard & Poor’s does not form opinions on whether a financial instrument is in accordance with Shariah principles, but analyzes creditworthiness in the context of a broad array of capabilities and incentives”. However, in so doing rating agencies deny Islamic financial products their core characteristic. The question which should be answered by rating agencies is whether a financial product is worthy to obtain credit from an ethical responsible investor to enable the investor to make an informed investment decision. Yet, ratings are self-restricted to an assessment of financial creditworthiness, not ethical creditworthiness. They legitimise Islamic products as investable financial products. However, what they do not do is to create ethical legitimacy. It is the financial creditworthiness that is rated, but not the economic, social and Islamic-worthiness of the project.

Furthermore, this does not only apply on the international level. Malaysia has probably the most mature market for Islamic debt instrument. However, both domestic rating agencies, Rating Agency Malaysia Berhad and Malaysian Rating Corporation Berhad do not even assess the Shariah compliance of Islamic financial products let alone the extent to which they meet the Shariah’s ethical objectives. The situation is different in the Gulf Cooperation Council states. Here, the lack of domestic rating agencies puts these markets at a competitive disadvantage to more institutionalised markets such as Malaysia in particular. Furthermore, it increases their dependence on the US based international rating agencies and their local subsidiaries. However, there are incremental efforts to address the issue. The Bahrain-based Islamic International Rating Agency (IIRA) was set up in October 2002 and started operations in July 2005. It assesses conventional financial creditworthiness as well as the compliance of entities and instruments with Shariah principles and its ‘Shariah quality’ (IIRA 2006). Nevertheless, it lacks the decades of reputation building on which the other agencies can look back. Furthermore, Islamic legitimacy and financial legitimacy are established in separate rating processes.

In a nutshell, there appears to be an incongruence between the ethical-religious legitimacy which should be at the heart of Islamic finance, and the financial legitimacy which both indices and rating agencies provide. More generally, what has to be questioned here is the knowledge base from which Islamic financial products are constructed and assessed.
Concepts like mudharaba and musharaka date back to pre-Islamic medieval times. Efforts to develop and means to assess modern Islamic financial products and services have, at least to some extent, been modelled after their conventional counterparts, adjusted for an Islamic component, as was e.g. demonstrated with regard to the establishment of Islamic indices.

Recent innovation in Islamic finance “focuses on making modern financial instruments compatible with Islamic principles” (Warde 2001). The same seemingly scientific, physics-oriented principles which arguably furthered the exclusion of moral and ethical values from conventional finance in the first place are called for by some advocates of Islamic finance (see e.g. the contributions in Archer and Karim 2002; Vogel and Hayes 1998). It is questionable to what extent Islamic finance will be able to maintain its ‘ethical profile’ and commitment to social embeddedness with the increasingly abstract nature of Islamic financial instruments (FT 2007b). The push of Islamic finance to achieve more credibility and ‘sophistication’ to become an investable alternative for the mainstream makes it awkwardly dependent on existing international knowledge and power structures.

A further case in point is the involvement of big conventional market actors such as Citibank, HSBC, UBS, or Deutsche Bank which are becoming increasingly important providers of Islamic financial products. On the one hand, this involvement is often deemed necessary to further the fortune of Islamic finance. This is plainly expressed in a Euromoney publication on Islamic finance, “it is clearly to the advantage of the industry as a whole to encourage the participation of the global giants because this brings credibility to the entire sector” (DeLorenzo 2005, pp. 8-9). In particular, their innovative skills and means to invest in the development of Islamic financial products are perceived as being highly important for the further progress and mainstream capability of the industry. On the other hand, these actors act according to the profit-maximising principle enshrined in conventional financial and economic episteme. And again, the question arises of how this can be reconciled with the primacy of equity - of the sharing of profit and loss - of Islamic financial philosophy and its distributive and social goals. Hence, it can be argued that the existing power and knowledge structures in global finance create an environment in which Islamic finance can only serve to reproduce these structures rather than offer an ethical alternative. This does not mean that a Shariah-compliant financial system is unattainable. Yet, Shariah-compliant is not necessarily Shariah-based.
However, challenges to the ethical core of Islamic finance do not only arise from private power/ knowledge structures. The emerging international regulatory framework for the governance of Islamic finance is another case in point. Improving the regulatory framework for Islamic finance and developing common standards and best practices is seen as paramount for the industry’s future progress. As El Qorchi (2005) argues, “Islamic banking remains quite limited in most countries and is tiny compared with the global financial system. For it to take off and play a bigger role, especially in the Middle East, policymakers must tackle enormous hurdles - notably on the regulatory front”.

The rise of Islamic finance has not been ignored by the major institutional building blocks of the conventional financial architecture. For example, the Financial Sector Assessment Programmes introduced by Worldbank and IMF in 1999 acknowledge issues of Islamic banking (Worldbank and IMF 2005). In 2004, IOSCO published its *Islamic Capital Market Fact Finding Report* which continues to remain a major reference work for policymakers and financial regulators. However, emerging Islamic financial markets require developmental efforts that go beyond the expertise and core competencies of these organisations. Hence, recent years have seen a proliferation in the creation of new organisations, institutions and initiatives of which the Bahrain-based International Islamic Financial Market (IIFM) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and the Malaysia-based Islamic Financial Services Board (IFSB) are the most important. Their roles and functions will be discussed in turn.

The IIFM is a multilateral institution founded by Bahrain, Brunei, Indonesia, Malaysia, Sudan and the Islamic Development Bank. Its principle objectives are to establish, develop and promote Islamic money and capital markets. In doing this, it focuses on the provision of infrastructure and the development of common platforms and standards for Islamic financial markets. However, its name is deceptive. No trading occurs via the IIFM. Instead, it is a state-driven initiative that endorses the issuance of sukuk.

Much progress has been achieved in the areas of financial reporting and prudential standards. Currently by far, the two most important organisations working on establishing an international regulatory framework for Islamic finance through common standards are AAOIFI and IFSB. AAOIFI was the first Islamic international financial institution to emerge. It was founded in 1990 in Algeria. It is a standard setting organisation which has so far issued
up to 70 standards on accounting, auditing, governance, ethics and Shariah (aaoifi.com). In addition, it offers training programmes and confers qualifications, most importantly those of Certified Islamic Public Accountant and Certified Shariah Adviser and Auditor. Having been set up by the Islamic finance industry, its self-proclaimed role is that of an “interface between market players and regulators” (aaoifi.com). Its standards are endorsed by regulatory authorities of the major centres for Islamic finance, either as mandatory requirements or as guidelines used by regulators. AAOIFI’s major publications are the Accounting, Auditing & Governance Standards for Islamic Financial Institutions with the newest edition dating from 2005 and the Shariah Standards.

IFSB was founded in 2002 and became operational in 2003. Its full members are the central banks and regulatory authorities of 18 African, Middle Eastern and Asian countries and the Islamic Development Bank. In addition, there exists a second and third membership tier, mainly consisting of further regulatory authorities and international financial institutions, and Islamic banks and financial institutions respectively. IFSB’s major role is the setting of prudential standards to enhance the “soundness and stability of the Islamic financial services industry” (ifsb.org). As of mid-2007, its major publications are the Capital Adequacy Standard for Institution Offering only Islamic Financial Services, the Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services and the Guiding Principles of Risk Management for Institutions Offering Only Islamic Financial Services.

The problems faced in developing the regulatory infrastructure for Islamic finance bring its inner conflicts to the fore. Regulators have to strike a difficult balance between ethical-religious and regulatory-financial practice. Religious legitimacy of the rules and decisions of these organisations is thought to be ensured through the legal advice of Shariah scholars. The organisational structures of both AAOIFI and IIFM are complemented by a Shariah Board respectively Shariah Supervisory Committee. The IFSB’s organisational chart does not contain a standing Shariah body. However, IFSB’s Articles of Agreement (30 (e)) stipulate that the IFSB’s Technical Committee has to “engage the services of an established representative body of Shariah scholars with the knowledge of industry practice approved by the Council to guide their deliberations”. Its standards and guidelines are prepared by working groups which refer the draft to the Technical Committee, which then in turn refers it to the body of Shariah scholars to endorse its compliance with Shariah principles. However, all
three organisations face difficulties developing an independent knowledge base. Recourse is taken to existing governance structures and models. As AAOIFI justifies, “[…] it is not harmful to begin where others have ended, if what has been developed by others is beneficial and does not contradict the Islamic Shari’a” (aaofii.com). Hence, to a large extent, template standards from the existing international financial architecture are adopted. Yet, this makes it challenging to propagate an alternative value system.

To give an example, the main task of the IFSB since its inception has been to develop capital adequacy standards for Islamic financial institutions. Yes, this could even be seen as its major rationale. In doing so, it works closely with the Bank for International Settlements and the Basle Committee. This leads Cordewener (2007, no pagination) to the conclusion that the IFSB’s 2005 Capital Adequacy Standards are “primarily based on the BCBS documents with the necessary modifications and adaptations”. The result complies both with international norms (Basel II) and with the Shariah. However, fundamental asymmetries of the economic and social impact of the new capital adequacy rules endorsed by the Basel Committee are not addressed (King and Sinclair 2003). This might be partly due to the fact that currently Islamic international regulatory organisations prioritise the promotion of the “acceptance and integration with mainstream markets” (IIFM Mission, no date). Islamic finance is thus reconstituted as part of the international financial architecture.

In short, the emerging regulatory framework for Islamic finance reproduces existing governance structures rather than offering an ethical alternative. Hence, given the path currently taken, Islamic finance will actually serve to reproduce, to legitimise, and thus to reify current inequitable financial structures, instead of creating a more equitable economic order.

4 Quo Vadis, Islamic Finance?
The last years have witnessed the rapid expansion of Islamic finance, both in volume and geographically. Based on the religious and ethical principles of the Koran and the Shariah, Islamic financial instruments and services are characterised by certain features - such as the prohibition of riba and the distinction between halal and haram products and activities - which clearly distinguish them from their conventional counterparts. However, this paper has argued that Shariah-compliant Islamic finance is not necessarily Shariah-based. Or, to put it in other words, what is Shariah-legal does not automatically meet the Shariah’s ethical objectives of
risk-sharing and participatory economic growth. Does Islamic finance then offer an alternative to existing inequitable financial structures? Could it be a site of resistance? Given the relatively early stage of economic development of many Muslim countries, there is a genuine concern about how equitable growth can be attained and for which Islamic finance could be the answer.

However, this paper has argued that the currently emerging power, knowledge and governance structures for Islamic finance tend to reproduce, legitimise and thus to reify the status quo of global finance. To make Islamic finance acceptable to the mainstream, it is reconstituted as part of the international financial architecture. Hence, it is questionable whether Islamic finance can evolve into a mainstream capable alternative to the existing international financial system, while still meeting its own ethical pretences, an ongoing struggle. In particular, three areas can be identified in which the paradigm of Islamic finance will be tested and where its future could be decided. They are the handling of financial distress, attitudes towards risk (management) and the role of accountability within governance structures for Islamic finance.

As discussed above, the Koran foresees for times of financial distress the suspension or cancellation of debt repayments. This is a manifestation of the emphasis on risk-sharing and participatory economic growth constitutive for Islamic financial and economic thought. However, current international financial governance structures prioritise the safeguarding of the stability of the international financial system (for example signalled by the bail-outs of the 1990s). As a consequence, in case of financial distress, it can be assumed that these organisations will favour stability over equity.

To give an example, the permissibility of lender-of-last-resort action in Islamic finance is not clearly established. If a big international Islamic bank collapsed, how could common treatment according to (yet to be established) Islamic financial principles be achieved across conventional and dual or Islamic regulations? And if fraud should be involved as in the case of the collapse of the (non-Islamic) Bank of Credit and Commerce International in 1991, to which instance can investors take recourse? Equally important, what happens if fraud is not restricted to the financial, but also to the Islamic side of Islamic financial products and services? On a similar point, so far no major issuer of sukuk has defaulted on its obligations. It will be interesting to see how a default would be treated by Western courts. Recent rulings
in the UK on cases involving Islamic murabaha agreements were decided on English law, not Shariah.

A second closely related issue is that of the management of risk, a concept contested within Islamic finance itself. The question of how to handle risk in an increasingly integrated global financial order is not restricted to Islamic finance itself. However, given the religious precautions on maisir and gharar, it becomes even more pertinent. Both the Islamic credibility of instruments and services and the cohesion of Islamic financial practice depend on whether a common attitude towards risk and risk management can be found. The outcome of this debate will in turn influence whether Islamic finance can succeed in encouraging a more responsible lending culture. This issue also shows that the development of a knowledge base for Islamic finance which is at the same time independent and consensual is crucial.

Finally, the issue of participation and representation in the organisations governing Islamic finance will arise. Currently, Islamic finance is characterised by a bipolar structure with Malaysia and Bahrain on the top. The international Islamic regulatory framework is quite elusive, both in its membership and in its centring on state- and industry-sponsored initiatives. However, only in providing a more inclusive structure than conventional finance, Islamic finance will be able to position itself as a serious alternative to the existing financial paradigm, providing for more participatory economic growth. The broadening of participation in the decision-making structures for Islamic finance will posit new challenges to the not always easy relationship between state, Shariah and the broader public.

Foremost depending on future developments in these areas, it remains to be seen whether Islamic finance will be able to emancipate itself from existing knowledge and power structures or whether it will end up as the paradoxon of ‘secularised Islamic finance’, a reproduction of conventional finance with a few cosmetic changes, Islamic only in name. Yet, what the discussion of the resurgence of Islamic finance has also shown is how closely it is linked to the political events of our time. Recent years have seen the massive withdrawal and repatriation of Middle Eastern funds from US financial markets. This happens at a time when European companies de-list from US stock exchanges to avoid the costs caused by the post-Enron imposition of the Sarbanes-Oxley Act of 2002. Furthermore, regional monetary and financial arrangements are becoming increasingly influential, in Europe, but also in other parts of the world as most famously the emerging East Asian financial and monetary
regionalism. Together, these developments increasingly challenge Anglo-American financial dominance. In so far as that it contributes to the creation of a multi-polar, more diverse financial system, Islamic finance can be seen as a site of resistance.
The more reflective and normative strands put some emphasis on cultural and ethical factors. Yet, they hardly ever refer to non-secular value systems. Religion is still taboo. As Mohamed Aslam (2005) cynically states, “it seems to be easier to talk of ‘ethical economics’ rather than religious economics in the West”.

A money transfer system outside the institutionalised Western style banking system used by many (but not only) Muslims. For a more comprehensive account, see Warde (2000) or Venardos (2006).

Other sources speak of a market size of nearly USD 1 trillion of assets. Despite ratings are usually presented as neutral and free from political interference, experience suggests that there is no complete separation. For example, when Iran issued a bond in 2005 in its first attempt to tap the international capital market since the 1979 revolution, the US administration made Moody’s withdraw its rating in line with its sanctions policy (Gulfnews).

The prohibition of maisir makes conventional financial practices such as speculation, certain derivatives, and conventional insurance not compliant with the Shariah. Thus, Islamic insurance and re-insurance (takaful and re-takaful), for example, are based on the principle of mutuality (Venardos 2006, p. 43). However, the discussion of Islamic insurance goes beyond the scope of this paper.

Unfortunately, these accounts are often only referred to as profit sharing investment accounts which playsdown the risk element. Thus, consumer education about the benefits and risks associated with Islamic finance is even more imperative. A highly controversial issue is that of deposit insurance (Warde 2000; Kuran 1995). On the one hand, guaranteeing deposits held in PSIs would undermine the idea that both profits and losses have to be shared. On the other hand, concerns about consumer protection have to be weighted.

These practices date back to medieval Islamic times (Warde 2000). In comparison, Western style limited liability legislation was only enacted in the mid-19th century (Rajan and Zingales 2003, p. 45).

Currently, Pakistan has a dual (conventional and Islamic) financial system (IOSCO 2004, p. 48).

‘Specialised’ Islamic banks are commercial and investment banks structured wholly according to Islamic principles and dealing only with Islamic instruments. Islamic ‘windows’ are special facilities offered by conventional banks to provide services to Muslims who wish to engage in Islamic banking (Iqbal 1997, p. 43).

However, Al-Harran (1995b), for example, recommends the establishment of an Islamic stock exchange in Asia and the Philippines to cater for the needs of small and medium businesses. Also, countries whose financial system is Islamic on a national level as e.g. Iran have an Islamic stock market.

The member states of the Gulf Cooperation Council are the United Arab Emirates, Bahrain, Saudi Arabia, Oman, Qatar and Kuwait. Although ratings are usually presented as neutral and free from political interference, experience suggests that this is not always the case. For example, when Iran issued a bond in 2005 in its first attempt to tap the international capital market since the 1979 revolution, the US administration made Moody’s withdraw its rating in line with its sanctions policy (Gulfnews). Indicative for this is that these actors do not completely convert which would be only appropriate if they believed in the ethical goals of Islamic finance.

And so far, Islamic finance has mostly been spared from IMF and Worldbank’s ‘mission creep’.

Another organisation set up in 2002 is the Bahrain-based Liquidity Management Centre (Imcbbahrain.com). However, it will not be discussed here.
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