

Beyond Shari‘a Arbitrage

We have seen a number of examples in the previous chapters illustrating how nominate contracts in classical Islamic jurisprudence can be used to synthesize almost any contemporary financial transaction. The art of Shari‘a arbitrage consists of identifying a captive market, with religious injunctions that forbid a given set of financial products and services, and synthesizing those products and services from variations on those premodern nominate contracts. Indeed, the governor of the Bahrain Monetary Agency admitted this nature of Islamic finance in a recent speech:

“Islamic banking and other Islamic financial institutions are rapidly approaching a cross-roads,” Sheikh Ahmad bin Mohammad Al Khalifa told the opening session of a conference on Islamic Banking and Finance in Manama [in late February 2004]. “Islamic banks have grown primarily by providing services to a captive market, people who will only deal with a financial institution that strictly adheres to Islamic principles.”¹

In this regard, the potential for Shari‘a arbitrage seems unlimited. Conventional financial products and services will continue to grow indefinitely, thus providing the Shari‘a arbitrageur an unlimited scope for synthesizing subsets of the ever-growing set of financial choices available to conventional customers. We shall illustrate briefly in this chapter how some of the financial products previously considered impossible to synthesize have in fact been offered in recent years. Indeed, a moderately lucrative industry may be sustained for the foreseeable future based on such Shari‘a arbitrage methodologies. However, there are a number of considerations that suggest that Islamic finance will be better served by moving beyond the Shari‘a arbitrage mind-set.

We have discussed in the introduction some of the main reasons for inefficiency of any industry built on Shari‘a arbitrage: (1) Such an industry will be – by necessity – chasing past returns, and (2) synthesized products are almost certain to increase transactions costs, legal and juristic fees, and the like. Those issues

notwithstanding, perhaps the most compelling reason for Islamic finance to move beyond Shari'a arbitrage is the simple financial objective of reaching a larger customer base and mobilizing the talents of Muslim financial professionals. In this regard, Islamic financial products have to date attracted a surprisingly small percentage of potential Muslim clients. More importantly, the fast-growing educated Muslim middle class, perhaps the most likely customer base for the industry in the long term, has mostly shied away from participation in the industry.

In this regard, it might historically have been more lucrative for the industry to cater to a relatively small number of high-net-worth individuals and a segment of the Muslim population that is satisfied by Shari'a-board certification of various form-oriented replications of conventional products. However, for sustained long-term growth, there appears to be no substitute for reaching the growing group of middle class Muslim investors and customers, as well as poorer Muslims aspiring to that middle-class status. The bulk of this Muslim middle class are not as willing to accept sacred authority arguments. Hence, they tend to consult with multiple jurists within and outside the industry and to form their own opinions regarding the Islamicity or lack thereof of any battery of financial products and services offered at any point in time. To cater to the needs of this middle-class potential customer base, Islamic finance needs to outgrow the current Shari'a-arbitrage mode of operation, and to market its products and services based on economic merit rather than formulaic juristic support.

10.1 Shari'a Arbitrage and Criminal Finance

Another major reason to move beyond Shari'a arbitrage is the danger inherent in its mechanics, especially in today's post-9/11 legal and regulatory environments. For instance, although some jurists might find *tawarruq*- or *murabaha*-style commodity and asset trading to be acceptable substitutes for interest-based lending and insist on separation of the multiple commodity sales with which the synthetic loan is structured, such spurious trading raises multiple flags for government authorities, which are increasingly concerned about money laundering and various other forms of criminal financing. Indeed, the "asset-based" distinction – highlighted by Islamic finance practitioners as a virtue – makes Shari'a-arbitrage methods very similar to money laundering and criminal finance methods that rely on commodity and asset trades – with over- or underinvoicing – to achieve their illicit goals.

Moreover, the "degrees of separation" utilized by Islamic bankers to camouflage an interest-bearing loan as commodity or asset trading bear a striking resemblance to the "layering" techniques used in financial crimes. For instance, *tawarruq* or *murabaha* camouflaging of loans relies on two degrees of separation: the third

trading party, and an underlying asset or commodity. Some recent efforts, such as in Saudi Arabia, have moved toward “domestic *tawarruq*,” that is, ensuring that the underlying commodity and its traders reside within the country’s borders, but those efforts merely address the first-order layering concerns of those fighting money laundering and other criminal financial activities. It is always possible to add more layers through which the domestic commodity dealer trades with foreign counterparties, which international trade at least on the surface would appear to be bona fide commerce.

Finally, the use of offshore special purpose vehicles for structuring Islamic financial products, such as lease-based receivables, raises many issues for authorities involved in combating money laundering and criminal financing. In the meantime, the juristic focus on form rather than substance of financial practice often leads to excessive utilization of degrees of separation such as SPVs, for technical reasons not dissimilar to those motivating financial criminals. Tragically, while Islamic financial providers are for the most part far removed from any interest in committing financial crimes, their utilization of Shari‘a-arbitrage methods that resemble those of financial criminals is dangerous nonetheless. Since financial criminals have expertise in utilizing similar methods, it would be easy for them to abuse the mechanics of Islamic financial Shari‘a arbitrage to reach their criminal ends (in the process relishing the lack of transparency afforded by multiple degrees of separation and spurious “real transactions”).

In this regard, it is important to note that the structured finance methods of Shari‘ arbitrage – which were copied from Western regulatory arbitrage methods aiming to reduce tax burdens on high-net-worth individuals – have already had a checkered history. Indeed, American regulators and accountants were slow to uncover some of the abuses of those structures, which later featured prominently in corporate scandals, such as Enron’s. In this regard, regulators and enforcement officials in the countries wherein Islamic finance has thrived are clearly less sophisticated than their Western counterparts, and hence less likely to uncover devious intentions underneath complicated financial structures. Given the industry’s young age and fragility, it would be wise to move to simpler and more transparent modes of operation, to minimize the risks of abuse by criminal elements.²

10.2 Shari'a Arbitrage at the Limit

In addition to this existential concern for Islamic finance, based on its possible and potentially ruinous association with criminal financial activity, there are a number of economic concerns regarding the sustainability of its current Shari‘a-arbitrage mode of operation. The dangers inherent in the Shari‘a-arbitrage mode of oper-

ation can be easily recognized once we consider the logical limiting behavior of recent industry trends.

Benchmarking ad Absurdum

The history of Islamic finance has illustrated beyond doubt that any conventional financial product can be synthesized from premodern contracts. This is perhaps best exemplified in the “benchmarking” argument utilized by jurists, including Justice Usmani and many others. Their argument states that if my neighbor brews beer, while I am a carpenter, I may demand to make the same profit rate as the brewer next door, without rendering my business activity impermissible. Of course, this formulaic juristic analysis belies the fact that the purpose of finance is not to brew beer, but to allocate credits and risks in a manner that is likely to generate profits. Needless to say, one can use the economically incoherent juristic benchmarking approach to synthesize instruments that track the return on any investment vehicle, for example, the price of a particular vintage of wine or pork bellies, utilizing structures that avoid actually trading in the underlying impermissible commodities.

For instance, in the Bahrain Monetary Agency *sukuk al-salam* structure discussed in Chapter 6, the structure could have just as easily stipulated that the government will act as the *sukuk* holders' agent and guarantees marketing their commodities (permissible aluminum) at the same price as pork bellies. According to the analysis of Shari'a scholars associated with Islamic finance, such a practice cannot be condemned, since, in fact, the Qur'an and Prophetic traditions reserve the severest prohibitions to interest-bearing usurious loans, whose interest rates are being used as benchmarks in various *sukuk* and other Islamic financial products. Thus, given that structures have been approved with flexible rates of return guaranteed to track LIBOR, returns on all other indices and impermissible investment vehicles can be replicated using *sukuk* structures together with benchmarking arguments.

Savings Accounts via Shari'a Arbitrage

Shari'a-arbitrage methodologies can also be used in the limit to solve many of the heretofore troublesome problems in Islamic finance. For instance, Islamic banks since their inception have adhered to the notion that depositors whose principals are guaranteed by the bank cannot earn a rate of return, while “investment account” holders who share in bank profits must also be exposed to potential loss of principal. This provision dates back to the early days of Islamic economics, when an Islamic bank was envisioned as a mutual-fund-like two-tier *mudaraba*. Of course, Islamic banks – as we have seen in Chapter 8 – have in fact replicated all

conventional bank assets through Islamized structures. However, on the Islamic bank liabilities side, Islamic finance jurists and practitioners alike have adhered to the notion that the bank cannot guarantee principal for depositors seeking a rate of return on their savings.

The approach most commonly sought by Western banks in recent years has been securitization based. Under those structures banks aim to offer variable-rate savings accounts, certificate-of-deposit accounts, and other vehicles, based on the actual rate of return made on their portfolios of *murabahas*, *ijaras* and *sukuk*. The idea behind those structures is that investment depositors will be directly exposed to the credit risk and interest-rate risks that the Islamic bank faces, and hence that they could suffer a loss of principal. In the United States and the United Kingdom those efforts have, to date, run against regulatory provisions that require depository institutions to guarantee the principal for depositors. The surprising solution proposed in the United States and apparently followed at the Islamic Bank of Britain proceeds as follows:³ The ideal Islamic structure would require exposing the investor to risk of principal loss. However, regulators require guaranteeing the principal, and hence the Islamic bank will adhere to that provision until such a time as regulations allow otherwise.⁴ In the meantime, Muslim depositors can voluntarily participate in bank losses if they are sufficiently substantial to exhaust the entire bank reserves held for the purpose of smoothing depositor returns.

Of course, as we have seen in Chapter 8, conventional savings account structures can be quite easily structured by utilizing the same Shari'a-arbitrage methods that Islamic banks have utilized extensively on their assets side. Thus, savings accounts can be structured through synthetic *murabahas* or *ijaras*, wherein the depositor is the seller or lessor, and the Islamic bank is the buyer or lessee, who thus guarantees the principal plus interest rate dictated by the market (rather than tied to the specific bank's portfolio). The customer's ability to withdraw funds can be easily enhanced through unilaterally binding promises on the Islamic bank – also allowed by Islamic finance jurists – to buy the property at any time, based on an agreed-upon formula reflecting interest rates and possible penalties for early withdrawal. Although this solution is inferior to the proposal in Chapter 9, based on combining agency and guaranty, it would – at least – allow Islamic banks to fulfill the intermediation function of depository institutions, albeit by taking Shari'a arbitrage another step forward.

In fact, that step is very likely to occur in the next few years, driven by increased competition for the funds of skeptical and informed middle-class Muslims. Interestingly, as Saeed (1999) argued, taking that extra step may increase the level of skepticism among educated Muslims, as substantive differences between Islamic and conventional finance are blurred further. This may, in turn, give rise to a new wave of "Islamization," built on attacks of excessive laxity of the existing Islamic fi-

nance framework. Thus, the cycle restarts with highly inefficient Shari'a-arbitrage ruses catering to a small conservative market, then becoming more efficient but, for example, losing credibility as competition intensifies. We shall discuss this loss of credibility problem in greater detail later in this chapter.

Hedge-Fund Instruments – Shari'a-Arbitrage Style

The search for a hedge-fund structure that would be acceptable to the largest possible set of jurists (as well as other diversification vehicles that may improve returns in bear markets, such as REITs) started circa 2000, following the burst of the tech bubble on U.S. exchanges. In recent years there has been significant chatter in Islamic finance circles about Islamic hedge funds. Some were launched reasonably quickly (e.g., as offered by SEDCO in Saudi Arabia), while others took over three years in development (e.g., Sharia Funds of the United States, which relies on UBS Noriba for fund gathering in the GCC). The two cited examples also represent, respectively, Islamic finance veterans who are regional insiders and multinational newcomers to the industry.

Short Sales

The idea of a classical (long/short) hedge fund seemed somewhat natural within Islamic finance. After all, the *salam* contract reviewed in Chapter 5 has a natural short-sale interpretation, both in terms of selling what one does not own at sale time, as well as profitability when spot prices decline (and one can deliver the object of sale by acquiring it at the lower spot price). At various Islamic finance conferences, groups competing to come to market with the first Islamic hedge fund (potentially with significant funds under management) presented their ideas for short sales, ranging from a simple *salam* sale of stocks (without addressing the details of borrowing stocks to execute short sales) to ideas about recharacterization of the process of borrowing such stocks from a primary broker in terms of lease transactions.

Public literature on the exact mechanics used by recently launched Islamic hedge funds is not readily available. That is hardly surprising, since hedge funds generally are not known for their transparency. In fact, as already noted in Chapter 7, even the new screening methods that those hedge funds will use to determine which stocks can serve as underlying assets remain proprietary and secret. Ideas about synthesizing derivatives such as forwards and options also remain well guarded (we were told in jurists' public statements that elements of conventional options exist in *salam* and '*urbun*' contracts, but no further details were furnished). Needless to say, derivative-based trading strategies have become

indispensable leverage tools for today's hedge-fund managers, especially those restricted in their borrowing behavior, as Islamic hedge-fund managers are likely to be. Taking into account the inevitable significant increase in Islamic hedge-fund transaction costs (even compared to conventional hedge-fund costs, which are high because of the number of active parties required for a simple short sale transaction), this increased leverage is necessary to generate any reasonable rate of return to investors.

Of course, synthesizing short sales is not difficult, at least in principle. The purpose of a short sale is to sell now, collecting the current price p_t . The collected price grows at the riskless rate r . Tomorrow the short seller needs to buy the stock to close the short position, which purchase takes place at p_{t+1} . Thus, the short seller's profit tomorrow is $p_t(1+r) - p_{t+1} - costs$, where *costs* cover the interest and dividends paid to the original stock owner, brokerage fees, and the like. Obviously, the same effect (with different *costs*) could be achieved by engaging in a forward contract (synthesized from *salam*, through a square transaction such as the one illustrated in Figure 5.1) with forward price equal to $p_t(1+r)$. In other words, there is no conceptual mystery as to how short sales can be structured. The question merely centers around efficiency of the cost structure.

Synthesized Options

There are no conceptual problems regarding the structuring of options either. In fact, many active participants in Islamic finance have argued that options are similar both to *salam* and to *'urbun*, perhaps referring to some of the existing call options synthesized from *'urbun* (e.g., by National Commercial Bank in their protected principal funds reviewed in Chapter 5). Just as call options can be synthesized from *'urbun* (down payment) sales, it is equally easy to synthesize call options from *salam*-long positions with the right to revoke the contract.

Of course, the most profitable (and riskiest) of hedge fund strategies has been widely compared to writing puts, which is particularly lucrative when the public are excessively bearish on asset prices. Since we have shown how to synthesize a forward contract, we simply need to apply the elementary call-put parity structure, which describes the payoff from a forward contract as the difference between the payoff from a put option and the payoff from a call option. This simple formula is used extensively to hedge complex positions in derivatives, and it will no doubt play a significant role in Islamic hedge funds as well.

10.3 Self-Destructiveness of Shari'a Arbitrage

The pursuit of Shari'a-arbitrage profit opportunities contains within its mechanics hidden ruinous dynamics. As can be gleaned from our reviews of various

financial products and services currently offered in Islamic finance, the reader can readily see that “innovation” in Islamic finance has nearly caught up with the conventional sector. In other words, new Shari'a-arbitrage opportunities that arise from offering new Islamic financial services and products will shortly be limited by the pace of innovation within the conventional sector itself. Shorter lags in bringing conventional innovations to the Islamic finance sector have the undeniable positive effect of improving overall efficiency in the sector. For instance, although Islamic REITs were generally introduced two to three years after their peak profitability (possibly during the downside of their well-documented secular cycle of that asset class), the successor diversification strategy in a bear market will be introduced within months, potentially bearing fruit for Islamic investors.

Declining Shari'a-Arbitrage Profit Margins

On the other hand, this enhanced efficiency has its downside for the industry. As the gap between Islamic and conventional financial practices continues to shrink, barriers to entry become much more easily surmountable. Early industry players, most of which were indigenous financial institutions in the Islamic world, have already faced growing fierce competition from multinational behemoths such as HSBC, Citi, and UBS. The indigenous providers have been able to survive because of their advantage at the retail level (e.g., National Commercial Bank in Saudi Arabia) and by forging partnerships with the investment banking arms of the multinationals. This has focused the indigenous providers' role on asset gathering, mainly in the GCC region, and mostly for the purpose of investing in Western markets. Needless to say, this specialization at the retail level exposes indigenous Islamic finance providers to declining “terms of trade” in their dealings and competition with multinationals who specialize in the more lucrative investment banking and structuring operations. As those terms of trade worsen for local Islamic financial providers, the overall rents from Shari'a arbitrage are expected to dwindle as more competitors try to tap this lucrative market.

As competition drives Shari'a-arbitrage profit margins down, providers – especially the ones that do not share the economies-of-scale advantages of multinational behemoth financial service providers – are likely to pursue cost-cutting measures to remain competitive. The most likely areas for cost cutting are those associated with Shari'a-arbitrage layering mechanics: costs for the creation of special purpose vehicles, legal fees, and the like. Although the bulk of Islamic financial practice is likely to remain very conservative in those areas, because of the justifiable fears of further scrutiny by anti-money-laundering and criminal-financing agencies, some providers may be less careful and thus fall prey to criminals.

In this regard, it is obvious that a young and relatively obscure industry such as Islamic finance (with the unfortunate “Islamist” stereotypes attached to it in the minds of many) will be judged in the area of combating financial crimes by the practice of its least prudent participants (the weakest links most likely to be abused by financial criminals). In this regard, the inevitable temptation to cut costs by using less reputable law firms, and incorporating SPVs in less reputable and transparent offshore centers, will drive some industry participants to pursue such strategies. To the extent that such strategies in turn increase the risk of a BCCI-type scandal that can prove ruinous to the industry, it would be advisable for industry participants – especially those that do not have economies-of-scale advantages in Shari'a arbitrage – to pursue different strategies that redefine the “Islamic” brand name in terms of such things as community banking and microfinance, as discussed at the end of the book.

Dilution of the “Islamic” Brand Name

Another major effect of “convergence” of Islamic financial practice to conventional finance is the dilution of the industry’s “Islamic” brand name. As we have shown in Chapters 1–3, Islamic jurisprudence is in fact a highly adaptive common-law system, despite its constant reference to the fixed canon of Islamic scriptures. We have already reviewed a number of cycles of juristic adaptation to conventional financial practices (e.g., in the areas of secured-loan financing through *murabaha* and *ijara* and fund management with advanced derivative-based strategies). As previous juristic innovations become commonly accepted, and as competitive pressures mount, jurists are likely to continue offering innovations that lead to convergence of Islamic financial practice with its conventional counterpart. This, in turn, will cause disenchantment among potential new customers and existing customers of Islamic finance, as product differentiation between an Islamic product and its conventional counterpart appears increasingly more contrived.

Similarly, this loss of credibility may be driven by a new wave of highly qualified jurists who have not played any significant part in the industry’s development to date. Institutions that retain the services of such highly credible jurists may claim that other Islamic finance institutions have in fact gone too far in their innovation. They may thus capture a significant market share by offering less efficient, but more easily defensible, “Islamic” alternatives to conventional financial products. This approach is in fact superior, from a purely economic viewpoint, to replicating the services and products of existing providers of Islamic finance. By segmenting the market into lower-efficiency/higher-credibility versus higher-efficiency/lower-

credibility products, the industry can extract more profits, in a manner analogous to price-discriminating monopoly.⁵

This relatively static analysis of industry profitability notwithstanding, the accusatory rhetoric likely to arise from credible jurists (some of which we have already witnessed in recent years) is likely to undermine the overall credibility of the industry among its existing and potential customer base. This credibility crisis is likely to be strongest among the fast-growing Muslim middle-class populations, which we have identified earlier in this chapter as the most important group for future industry growth. In this regard, the industry would be well served by deemphasizing Shari'a-arbitrage innovations that are likely to undermine its credibility, and instead focusing on developing a positive image based on ethical and developmental considerations that resonate with this growing Muslim middle class, and poor Muslims aspiring to join that middle class, as discussed in the last section of this book.

10.4 Toward a New Islamic Finance Identity

A brilliant recent study on ethical, developmental, and environmental considerations in finance was endorsed by a number of financial institutions. Those institutions were initially invited by United Nations Secretary General Kofi Annan in January 2004 to participate in his initiative on implementing universal principles in business (originally launched in 2000). The study was labeled “Who Cares Wins: Connecting Financial Markets to a Changing World.”⁶ It provided “recommendations by the financial industry to better integrate environmental, social, and governance issues in analysis, asset management and securities brokerage.” The participating institutions provided the following insights that can provide a general framework for a new “Islamic finance” identity:

The institutions endorsing this report are convinced that in a more globalised, interconnected and competitive world the way that environmental, social, and corporate governance issues are managed is part of companies’ overall management quality needed to compete successfully. Companies that perform better with regard to these issues can increase shareholder value by, for example, properly managing risks, anticipating regulatory action or accessing new markets, while at the same time contributing to the sustainable development of the societies in which they operate. Moreover, these issues can have strong impact on reputation and brands, an increasingly important part of company value.⁷

Elaborating on this idea of brand-name value based on social and environmental agendas, the report’s authors argued that

ESG [environmental, social, and corporate governance] issues can have a strong impact on reputation and brands, an increasingly important part of company value. It is not

uncommon that intangible assets, including reputation and brands, represent over two-thirds of total market value of a listed company. It is likely that ESG issues will have an even greater impact on companies' competitiveness and financial performance in the future.⁸

In all three areas of environmental, social and corporate governance, Islamic finance has golden opportunities to redefine the brand name in a manner that enhances its providers' profitability and market value, increases access to the fast-growing potential market segment of middle-class Muslims, and enhances its ability to recruit top-drawer talent from that same market segment for its products. In what follows, we shall review some of the possible features of Islamic finance that are currently underutilized or unutilized in defining the industry's brand name. However, multinational as well as large indigenous Islamic finance institutions are not directly capable of engaging in the poverty alleviation, microfinance, and other socially beneficial activities that are necessary for establishing this new identity and brand name. A network of mutual financial institutions with close ties to religious establishments can perform the necessary intermediation between those institutions' world of high finance and those required social functions.

Macroeconomic Substance: Privatization Sukuk

We have argued in Chapter 6 that asset-based *sukuk* structures can serve two economic functions: (1) They can limit the issuer's indebtedness to the value of its assets, hence minimizing the probability of default or bankruptcy, and (2) they provide a second benchmark for the interest rate paid on the bonds, through market rents of similar properties, which may enable the issuer to borrow at lower rates. Those two sets of benefits to individual corporate and sovereign issuers may be realized only if all borrowing is limited to secured forms (such as *ijara sukuk*, as opposed to commodity-trading-based structures), and if the sold usufruct of underlying assets is marked to market rents, rather than serving merely as a ruse for charging interest rates based only on the issuer's credit rating.

A third advantage of lease- or asset-based *sukuk al-ijara* can be realized at the macroeconomic level. In this regard, it is noteworthy that many of the most active countries in issuing sovereign *sukuk* (e.g., Bahrain, which has been a pioneer in the area) have had their privatization programs stalled for many years. Interestingly, the asset-leasing approach to *sukuk* issuance can solve many of the economic reasons underlying the slowness of privatization programs in various countries.

There are many economic reasons for slow or stalled privatization processes in various developing Islamic countries, including uncertainty about the potential profitability of state-owned enterprises envisioned for privatization and fear of massive and sudden dismissal of public-sector workers by new management.

Overcoming those problems requires preparation of state-owned enterprises for privatization (e.g., collection and dissemination of more accurate information to potential investors, passing appropriate labor law reforms, and putting in place training programs for workers likely to be dismissed). Those steps are costly and difficult, thus requiring some form of precommitment mechanism for the privatizing government.

To date, those precommitment mechanisms have been mostly proposed and enforced by international financial institutions such as the International Monetary Fund. However, most of the GCC countries that are active issuers of *sukuk* (e.g., Bahrain, Qatar) are likely to remain net creditors of the IMF for the foreseeable future. Hence, pressure by such international financial institutions is unlikely to accelerate the privatization processes in those countries – where they are needed to assist in long-term diversification of their economies away from petrochemicals and related industries.

In this regard, lease-based *sukuk* structures can serve as an alternative precommitment mechanism, while simultaneously avoiding thorny Shari'a issues regarding sale-repurchase (*'ina*) or compulsory gift clauses in *sukuk* issues, discussed in detail in earlier chapters. The issuing government can sell its state-owned property (designated for privatization in the medium to long term) to an SPV, which finances the purchase through *sukuk* issuance as done currently. Those *sukuk* would pay fixed interest designated as rent for a period, say, of five to ten years, thus encouraging purchase despite uncertainty about the profitability of the state enterprise that owns that property.

At maturity, instead of selling or giving the property back to the state, the *sukuk* would be made convertible into private shares in the enterprise that had owned the property. In other words, the SPV that was used for issuing *sukuk al-ijara* is not dissolved at maturity. Instead, it becomes the privately held corporation envisioned in the privatization program. Having committed to a privatization time table (term-to-maturity of the issued *sukuk*), the process of information collection, and various reforms to labor and capital structures of the firm, can take place gradually. Indeed, governance of the eventual private corporation can also be done in a smooth manner by allowing a board of directors consisting of government employees and representatives of the *sukuk* holders to oversee the transition.

Mosque-Based Network of Financial Mutuals

Disappointment at the low levels of economic and social development of Muslims worldwide was highlighted in a recent report by the Organization of Islamic Conference and discussed at the opening session of the Conference's meeting in Turkey in November 2004.⁹ The problem in the Islamic world is not lack of

funds. In fact, banks in the GCC region, as well as in other majority-Muslim countries, have suffered from excessive liquidity, which has generally led to massive increases in all asset prices in the region. Neither is the problem one of lack of desire on the part of wealthy Muslims (and the world community at large) to help poorer Muslims around the world. Indeed, Muslim charities have been faulted mainly for their means of collection and disbursement of funds, but never for lack of resources. The problem, in fact, is one of financial disintermediation in the Islamic world, in which perception about Islamic permissibility of various credit extension schemes may be to blame.

In this regard, while the success of Grameen Bank's microfinance operations in Bangladesh has given many Westerners cause to celebrate, Islamist groups and Islamic finance providers alike have generally criticized Grameen for its social agenda (especially as it pertains to empowerment of women) as well as the relatively high interest rates that it charges on its conventional loans.¹⁰ Some attempts have been made to provide Islamic alternatives, with assistance of institutions such as cash trusts (*waqf*).¹¹ Such initiatives would be particularly useful, since trusts (*awqaf*) can serve as ideal vehicles for channeling Muslim charitable contributions to subsidize microfinance operations to some of the poorest Muslims around the world. However, those initiatives, as well as socially focused ones that utilize more traditional "Islamic financing" tools such as *murabaha*, remain very few, and they are largely viewed as being on the fringe of Islamic finance.

For "high finance" (Islamic or otherwise) to reach the masses of poor and undereducated Muslims worldwide, intermediation through a network of smaller financial institutions with close social connections to those populations is required. In this regard, our calls for mutuality in Islamic finance (made in Chapters 8 and 9) can provide the formula. Large multinational and indigenous banks can perform their social function by training religious leaders and community members in various Muslim societies to run small-scale thrift institutions (credit unions or mutual banks) and mutual insurance company offices out of at least one mosque in each community. Thus, the extensive network of mosques in the Islamic world can be used to give poorer Muslims access to credit and risk mitigation vehicles, as well as general training on saving and prudent spending and the like. Moreover, since mosque networks have traditionally had a close connection to networks of charitable trusts (*awqaf*) and *zakah*-disbursement organizations, charitable donations can be channeled to the poorer Muslims in the form of financial training and affordable credit and insurance, for example. The actual mechanics of lending and insurance are no obstacle – as we have seen throughout this book.

Appropriate Shari'a-arbitrage schemes may be employed for each region, as necessary, to enable the most underprivileged Muslims to gain access to credit and risk-mitigation vehicles (rather than rent seeking). Sophisticated Muslims will be

less likely to shy away from the industry – despite the inefficiency of using juristic ruses – if it fulfilled a valuable social function along those lines. In the meantime, the large indigenous and multinational Islamic financial institutions can continue to fulfill a useful role beyond training, by pooling credit and insurance instruments from the proposed networks of mosque-based credit unions and mutual insurance offices, for placement with socially conscious investors worldwide. Toward achieving those goals, partnerships can be forged between Islamic financial institutions, large multinationals, international financial institutions such as the World Bank and the Islamic Development Bank, and other entities, each providing value based on their own past experience in economic development. Linking charitable giving through the institutions of *zakah* and *awqaf* with the efforts of those international financial consortiums would also ensure applying the best international accounting, regulatory, and enforcement standards, thus allaying many of the current security fears attached to Islamic financial practices.

Positive Screens, Ethical Investment

One of the easiest ways to introduce value to the Islamic finance brand name is to supplement the obvious negative screens discussed in Chapter 8 with some positive screens that contribute to economic development in the Islamic world. Some recent advances, such as Dow Jones' launching an Islamic Market Index for Turkish companies passing the negative screens, are promising. However, to solidify a positive image of Islamic finance, some methodology for balancing negative and positive screens must be developed, so that companies that serve a developmental, educational, or poverty-alleviation role may be allowed to carry more debt/leverage than ones that do not. Needless to say, the manner and extent to which such social and developmental goals are introduced in positive screening can vary significantly between fund managers, allowing for further within-industry brand-name differentiation, as well as customization of social and economic developmental agendas to investors particularly sensitive to specific issues.

Product differentiation through positive social and developmental marketing can also provide indigenous Islamic finance providers with a competitive advantage against the onslaught of multinational financial providers with decisive superiority in mass production of funds based on negative screens. The advantage of indigenous Islamic world financial institutions can be particularly effective when paired with their existing mechanics for distribution of *zakah* for their own companies as well as their Muslim clients. The competitive advantages of those indigenous institutions in establishing domestic trusts (*awqaf*) for charitable and developmental purposes can further enhance their advantage in capturing market share and moving beyond their "asset-gathering" role. Partnerships with multi-

national investment banks will no doubt remain profitable, given the vast advantage of the latter in know-how and market access. Both types of Islamic finance providers would be well served to develop a positive brand-defining social role.