

# Responsibility in Islamic Finance

Konrad Adenauer Stiftung

Simon Gray, Director - Supervision

13<sup>th</sup> February 2012

Khalidiya Palace Hotel, Abu Dhabi

- Oh, East is East and West is West, and never the twain shall meet, till Earth and Sky stand presently at God's great Judgment Seat; *but there is neither East nor West, border, nor breed, nor birth, when two strong men stand face to face, tho' they come from the ends of the earth!*

– Rudyard Kipling, *The Ballad of East and West* -  
1895



# Agenda

- Responsibility
- Context
- Principles of Islamic Finance
- Social responsibility
- Unethical investments
- DFSA and Islamic Finance
- Conundrum
- Standard setting bodies
- Islamic Finance a Conventional - differences?
  - SRI, Ethical Finance and Islamic Finance
- A rosy future – *carpe diem*?

# Thinking of responsibility

I keep six serving honest men, they taught me all I knew.  
Their names are *what* and *why* and *when* and *how* and  
*where* and *who*.

Rudyard Kipling

- *what* are the issues?
- *why* are they issues?
- *when* do we need to do this?
- *how* will the issue be resolved?
- *where* does it need to be done?
- *who* needs to be involved?



# Responsibility

- compliance with Islamic Principles
- corporate social responsibility
- pragmatism and practicality
- Standard setting
- regulatory responsibility
- legal responsibility
- Scholarly responsibility
- links with conventional finance
  - *Ethical* and *SRI* already embedded!

- over last few years, Islamic finance has consistently shown double digit growth rates but
  - still only c. 1% of conventional finance
  - no Islamic financial institution of global systemic significance
  - growth driven by sustainable economic trends
  - substantial petrodollar surpluses
  - more general shift of economic power towards Asia
- global financial crisis has provided an opportunity for Islamic finance, in that the obvious failures in the conventional financial system have at least created a willingness to listen to alternatives
  - why so little progress?



# Principles of Islamic Finance

- Shari'a is *not* a codified system
  - more a set of core principles open to interpretation
    - interpretation leads to divergent options
    - confusion
    - no doctrine of precedent re Scholarly decisions
- riba – interest
  - intolerant of risk free reward for return
  - not everyone agrees – though most do!
- uncertainty of contract (*gharar*)
- gambling (*quimar*)
- speculation (*mays'r*)

# Unethical investments

- unethical investments (haram)
  - alcohol
  - pornography
  - pork
  - armaments
  - animal testing
  - environmental damage
- unfairness
- unjust gain at expense of other party
- riba / interest



# Social responsibility

- fulfilment of broad socio-economic benefits
  - focus on promising economic sectors
  - job creation and stimulation of entrepreneurship
  - maintenance of equity and fairness
  - alleviation of poverty
  - promotion of regional distribution of investments
- *CSR is generally associated with the concern of companies for the welfare of society*

- wholly Islamic firms and Islamic Windows
- Shari'a Systems Based approach
- most flexible approach
- AAOIFI Standards
- no central Shari'a Supervisory Board (SSB)
- SSB duty on Firms (SYSC)
- Standard Setters
  - active role on IFSB and AAOIFI Working Parties

# Responsibility and the 4 “P”s

- Practicality
  - scholarly inconsistency
  - lack of precedent
- Proportionality
  - too rigid an interpretation can limit the investment universe (hotel / airlines – alcohol / shopping centres with cinemas / shops offering credit facilities). I-REITs
- Pragmatism
  - zakah – to make good what is bad
- Purification
  - care not to damage investment returns



# A conundrum

- Certainty
  - a contract lacking in certainty poses problems for conventional contracts of insurance which presupposes payment of compensation for an event that may happen but which people rather hope will never happen
  - contrary to shari'a as:
    - trigger event for pay out is *not* guaranteed
    - amount of compensation payable bears *no* predictable relationship with the amount paid by way of premium
  - but – insurance is a good thing and the workaround is to use Takaful which means mutual or joint guarantee with both parties agreeing mutually to share both losses by making periodic donations with the right to share in any surplus profits

## Another conundrum

- sensible insurers reinsure at the first opportunity – this is prudent as it spreads risk
- many conventional reinsurers but very few takaful reinsurers. Thus to reinsure purely using a Takaful reinsurer would concentrate risk and be imprudent
  - solution – pragmatism applies (though depends on the scholar), acceptable to use reinsurance if no other alternative but to apply purification

# Standard setters in Islamic Finance

- Islamic Financial Services Board (IFSB)
  - Shari'a Governance Standards
- Accounting & Auditing Organisation for IFIs (AAOIFI)
  - Shari'a Governance Systems
- Asian Oceanic Standard Setters Group (AOSSG)
- International Islamic Financial Market (IIFM)
  - how are scholars regulated?
  - ability to bring disciplinary action against errant scholars?
  - litigation involving scholars?
  - *self*-regulation?
  - Interest is haram / banned!
    - what about self-interest?



# Human fallibility

- AML risk using charities
- Affinity fraud
  - often Ponzi / Pyramid schemes
- Bernie Madoff
  - largest fraud in world history
  - focussed on charities with religious affiliations
- “The Lebanese Madoff”
  - Salah Ezzedene
  - promises of up to 60% returns “guaranteed”
  - profits *not* interest as Islamic investing
  - many have lost everything

# Social responsibility

- Vicegerency
  - humans are representatives of Allah on earth
- Divine Accountability
  - on Day of Judgement
- Enjoin good and forbid evil
  - supremacy of good conquering evil
  - encapsulates responsibility as trustees and vicegerents
    - Mandatory forms and Recommended forms

# Mandatory Forms

- screening of investments
- earnings prohibited by Shari'a
- responsible dealings with clients
- employees
- zakah



## Recommended Forms

- Qard Hasan (*gratuitous loan*)
- reduction of impact on environment
- screening clients and contractors
- industry wise investment quotas
- social impact based investment quotas
- environmental impact based quotas
- par excellence customer service
- micro finance
- employee welfare
- charitable activities
- waqf management



# Conventional Finance has Responsibilities too..!

- Conventional finance has high ethical standards too
  - Officers duties
  - listing requirements – disclosure and transparency
  - Corporate Governance
  - authorised individuals
    - regulatory action against an individual employed by a firm and an AI
  - authorised firms
    - regulatory action against a firm / fiduciary duties
- Within conventional finance
  - Socially Responsible Investing - SRI
  - Ethical Finance
  - Laws exist to protect investors, stakeholders, employees, creditors etc.
  - *Court of public opinion* – topical now re bonus debate

- *Court of public opinion* - it is only a matter of time before the media latches onto the management of conflicts re the number of boards some Scholars sit on
- Legal arbitrage:
  - Islamic Investment Company of the Gulf v. Symphony Gems NV (2002)
  - Beximco Pharmaceuticals v. Shamil Bank of Bahrain EC (2004)  
the customers of Islamic banks argued that the markup constituted interest on a loan, and therefore violated provisions in the contract that it would be governed by Islamic Shari`a. In both cases, English courts reasoned that the Shari`a was not the recognized law of a state, that different Islamic legal scholars will differ in opinion on various contracts, and therefore applied English law only, awarding the contested interest charges to the Islamic banks in both cases.

# International architecture

- AAOIFI and IFSB have created series of standards – very little applied
- FSAP - “*What gets measured, gets done*”
- if performance measures don't include Islamic finance services – no incentive for implementation
- conventional standards may force Islamic finance back into conventional moulds
- new product surveillance bound to look at Islamic products
- signs of difficulties accommodating Islamic finance
- Islamic finance forced into conventional pigeonholes unless differences recognised?
- Indonesia, Saudi Arabia and Turkey joined G20 FSB
- opportunity for Islamic Finance to be considered seriously



## Reform from within

- IFSB's work on governance standards for cis and Takaful shows how some Islamic structures have conflicts and incentives different from those of conventional finance, & proposes ways of managing these
- structures of Shari'a governance
- need to reduce burden, especially cost burden, of Shari'a governance
- increased contract standardisation
- increasing supply of scholars
- doctrine of precedent
- need to create formal training framework and professional structure
- in the future, the key Shari'a assurance may come from firms rather than individuals, though of course the reputation of any firm will depend on the quality of the leading individuals within it.

# Business as usual

- most of developments in accounting standards and Basel regime
- work to do to adapt these to the specificities of Islamic finance
- work in the area of group supervision & group consolidation
- to date, very little work on how to consolidate Islamic entities at group level, and even less on how to consolidate them with conventional firms
- clearly the way the world is moving
- these areas of standard development will be intellectually demanding, but it is work that, collectively, we know how to do.
  - Irresponsible not to take note of these issues

## Key message

- Still considerable skepticism, but at least Islamic finance has an opportunity to show what it can do
- Opportunity for the institutions of Islamic finance (IFSB, AAOIFI, Islamic Development Bank)
- Real time pressure
- conventional standard-setters distracted by financial crisis – time for Islamic finance world to get its house in order.
- complacency could lead more powerful conventional regulatory bodies that will do the job for it –perhaps not in way it would choose.

## Key message

- East and West are not irreconcilable
  - Neither is conventional and Islamic
- social responsibility vital
  - so is pragmatism and proportionality
- responsibility includes persons being held accountable
  - Pure *self*-regulation carries risks
  - Need for secular accountability – held to account
- responsibility includes *limits* on Boards
- responsibility includes *more* scholars to help this growing industry
- human greed, ignorance and fallibility will always exist
  - Like conventional finance, Islamic finance must be aware of mis-selling risks and fraudsters



# Conclusion

- if serious interest in Islamic finance then regulatory bodies need to find a way to engage with the FSB and be recognized as global standards-setters
- a powerful central driver for creation and implementation of standards
- a huge amount of development of the standards themselves
- if Islamic finance is *not* part of process it will live in a world created by others with less freedom of maneuver
- Islamic standards-setters will have to change:
  - standards drafted in more definitive forms, capable of implementation
  - more members need to commit
- more intellectual effort to ensure quality and assessment
- doctrine of precedent
- opportunity for Islamic finance to play a key part in the world economy



Thank You