Fifth Harvard University Forum
Islamic Finance: Dynamics and Development

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Each year, the Harvard Islamic Finance Information Program (HIFIP) of the Center for Middle Eastern Studies organizes this forum. This year's forum had an international flavor, thanks to participants from Malaysia, South Africa, the Middle East, and Europe. Participants were mainly finance industry representatives from the Islamic Development Bank, the Kuwait Finance House, HSBC Amanah Finance, the Dow Jones Islamic Index, Bank Indonesia, Freddie Mac, and others. In addition, several experts in Islamic economics and finance, such as Monzer Kahf, M. Nejatullah Siddiqi, Nizam Yaquby, and Frank E. Vogel participated. Many other participants sought to educate themselves about the principles of Islamic finance and the availability of Islamically approved financial products.

Overall, the forum was more of an opportunity for those interested in Islamic finance to meet each other, network, and present some of their latest Islamically approved financial instruments and contracts. The forum featured a few research papers and many case studies. Most presentations and panel discussions focused on current and past experiences in the Islamic finance industry, challenges facing the development of new financial instruments, effective marketing and delivery of products to end-users, and areas where applying *ijtihad* is most needed and promising. Participants also discussed the need to develop relevant financial institutions to strengthen the stability and performance of Islamic financial service providers (e.g., managing liquidity and risk).

Thomas Mullins, HIFIP's executive director, welcomed the guests. He stressed the Islamic finance industry's important role in creating a dialogue between Islam and the West – a role made especially relevant after September 11. Forum chairperson Samuel Hayes, Jacob Schiff Professor Emeritus at Harvard Business School, used his opening remarks to commend the industry on its many accomplishments during the past decade and outlined areas for improvement. In his introduction, Saif Shah Mohammed, president of the Harvard Islamic Society, suggested that the industry should provide relevant services to students, such as Shari`ah-compliant educational loans and young professional programs.

Ahmad Mohamed Ali, president of the Islamic Development Bank (IDB), delivered the keynote address: "The Emerging Islamic Financial Architecture: The Way Ahead." He discussed the infrastructure required to strengthen the Islamic financial industry, which is in a process of evolution. Some recent major initiatives include the Accounting and Auditing Organization for Islamic Financial Institutions, the Islamic Financial Services Organization, an international Islamic financial market with a liquidity management center, and an Islamic rating agency. Currently, there are about 200 Islamic financial institutions worldwide with combined assets valued at $150-180 billion.

Frank E. Vogel, adjunct professor of Islamic legal studies at Harvard Law School and coauthor of *Islamic Law and Finance: Religion, Risk, and Return*, followed the keynote address. Under the title of "*Ijtihad* in Islamic Finance," he observed that a great deal of *ijtihad* has been accomplished in this area relative to other areas of modern *fiqhi* concern. Vogel briefly described and analyzed *ijtihad* in Islamic finance as a case study for understanding contemporary Islamic *ijtihad* more generally, and elicited some more general hypotheses about its methods, institutions, accomplishments, and challenges in contemporary Muslim life.

He argued that radical change may come at the expense of previously established *qawa'id* (legal maxims), due to the underlying arguments' obsolete nature. He advocated the development of new rules and institutions. The *takaful* system, the Islamic alternative to conventional insurance, is a great example of such *ijtihad*. Under *takaful*, an institution is created to govern the new rules of Islamic insurance and to overcome the objections leveled against conventional insurance schemes. In the spirit of successful *takaful* institutions, maybe another one can be developed for risk hedging, which is needed in the today's erratic financial markets.

The remaining sessions dealt with numerous topics discussed in past years, including legal and structural issues in Islamic finance, strategic trends, product development, and Islamic finance for newcomers.

The strategic trends session brought together an impressive array of top Islamic finance executives and academics. Monzer Kahf, an independent Islamic economic and finance expert, presented an important paper entitled "Strategic Trends in the Islamic Finance Movement." He stated that the growth and spread of Islamic banks is closely associated with newly developed working relationships between bankers and ulama striving to develop Muslim societies. This new economic *cum* political alliance between scholars and bankers affects the invention of new finance modes and will affect the future of Islamic finance on the theoretical and practical levels. A byproduct of this new alliance is the redistribution of economic and political power in Muslim countries toward moderation and more mass involvement. It is hoped that the Islamic finance movement will restore the banking profession to its original role: financing commodity production and exchange.

Interestingly, the bulk of Islamic banks' financing activities consist of *mudarabah* financing (mark-up sale) rather than partnerships or joint ventures. Another important point raised is the actual degree of the Shari`ah boards' independence and their ability to supervise Islamic financial operations. Usually, the financial institutions themselves hire these boards, which gives rise to a possible conflict of interest. In short, are these scholars' salaries correlated with their *fiqhi* positions?

The second session focused on legal and structural issues facing Islamic financing institutions. In an interesting lecture, Muddassir H. Siddiqui talked about how Muslim jurists need to develop Islamic criteria for judging the permissibility and impermissibility of various transactions. One must ask about and search for the reasoning behind various Qur'anic prohibitions, such as *riba*, to develop a precise definition of a usurious transaction. Islamic products should not merely camouflage the interest element; rather, they should conform to the Shari'ah's letter and spirit.

Engku Rabiah Adawiah Bt. Engku Ali of the International Islamic University, Malaysia, contributed a serious paper entitled "Redefining Property and Property Rights in the Islamic Law of Contract." According to her, Muslim jurists have set conditions on a contract's subject matter (*mahall al-`aqd*) to avoid uncertainty (*gharar*) and ignorance (*jahalah*). A recurring issue among Islamic finance practitioners is what constitutes a valid subject matter, particularly when the asset is something not as tangible as readily accepted conventional property (*amwal*), such as intellectual property, rights to receivables, and rights to concessions. Can these assets be bought and sold like exchange contracts (*mu`awadat*)? Legal schools seem to differ over this complex subject. One opinion, which can be further probed, recognizes some assets as valid subject matter for an exchange contract, because they function as property rights. Yet this question is far from resolved.

Saturday's final session featured a panel discussion on "Islamic Finance in the Contemporary Context." Panelists reviewed the industry's challenges and opportunities facing the Islamic financial industry since September 11, as well as the market downturn, crises, and bankruptcies that followed. They argued that despite the initial withdrawal of sizable funds by some international Muslim investors, the trend has subsided or reversed, as the American market remains the strongest and most promising one in the investment world. Some financial institutions delayed the launching of Islamic financing products in response to the ensuing environment of uncertainty following September 11, as well as the ensuing general anti-Muslim sentiment.

Sunday morning saw one of the eagerly anticipated sessions: "Community Banking in the West." The session stressed the difficulties and opportunities faced by financial institutions trying to provide Islamic financing options to Muslim communities in the West (generally) and the United States (specifically). Panelists addressed the internal difficulties of having competent legal teams that can develop products that satisfy both Shari'ah requirements and American regulations. In addition, there is the external difficulty of dealing with community suspicion about the sources of funding and generally accepting Islamic products provided by such conventional institutions as HSBC and Citibank. Despite these challenges, the market for Islamic financial products remains highly lucrative and widely untapped. Thus, both Muslim and non-Muslim institutions are eager to attract Muslim customers.

The experience of several Muslim states with establishing Islamic banking and the overall restructuring of the economy to comply with Shari`ah requirements was discussed in several presentations and one specific case study session. Case studies dealing with Indonesia, Bahrain, Pakistan, and Turkey also were presented.

Mahmoud A. El-Gamal and Hulusi Inanoglu, both from Rice University, delivered an original, well-documented, and analytical research paper entitled "Islamic Banking in Turkey: 1990-2000." The share of Islamic banks in Turkey is less than 3 percent (partially due to the restrictive regulatory environment) and has a 15-year history. Yet the study showed that Islamic banks are just as efficient as their conventional counterparts and are even more efficient when controlling for the size of operations.

Tariq Hassan, an advisor to Pakistan's finance minister, delivered a profound speech entitled "Eliminating *Riba:* A Proposed Alliance between Law and Economics in Pakistan." Pakistan represents a unique example of attempting to establish a Shari'ah-based comprehensive financial sector without *riba.* Yet the hurried manner of this attempt has proven to be almost impossible and at times harmful to the economy. Economic restructuring, bringing Islamic institutions up to standard, and training a proper workforce are all major challenges to the immediate implementation of Shari`ah ordinances. It was suggested that a Malaysian style of evolutionary and gradually implemented financial Islamization is probably more appropriate and fruitful.

Mulya E. Siregar and Nasirwan Ilyas presented "The Experience of Indonesia in Developing Shari`ah Banking." Indonesia's central bank adopted a dual banking system (Shari'ah and conventional), as is the case in Malaysia. This case study explored the proper techniques of managing liquidity constraints, the fair treatment of all banking institutions in the dual system, and the decision not to deal with the Islamic-banking sector as an infant industry.

Ahmed Bin Mohammed Al-Khalifa, governor of the Bahrain Monetary Agency, spoke on "The Progress of Islamic Banking and Finance in Bahrain." Bahrain is a special case of a strongly growing global financial center. As such, the Islamic financial industry needs to focus on establishing an industry-specific regulatory regime that can compare favorably with international best-practice standards in regulating conventional financial institutions. Since such standards do not exist, the maturing Islamic finance industry has to invest in those human resources that can develop such standards.

In the session on "Product Development," Omar Fisher and Dawood Taylor, both of Takaful Ta`awuni at Bank al-Jazirah, explored the viability of *takaful* (Islamic insurance) to hedge against medium- to long-term risk in an Islamically acceptable way. In their joint paper, "Prospects for the Evolution of *Takaful* in the 21st Century," they presented *takaful* schemes as an alternative to the conventional system insurance. Financing or investing beyond the short-term clearly involves risk, for the return to and the return of capital are uncertain. *Takaful* schemes are designed to manage such risks and engage in longer-term financial transactions. Numerous *takaful* and re-*takaful* (reinsurance) facilities now exist in many countries and can be categorized into three groups: non-profit, *mudarabah,* and *wakalah* (agency). Although a *takaful*'s overriding purpose is cooperative risk-sharing for community well-being, and not profit maximization, some commercialization is unavoidable. The array of challenges confronting *takaful* operators ranges from Muslim client profile to general Shari`ah issues.

After lunch, the forum continued with two parallel sessions: "Investing and Trading Islamically" and a "Workshop on Islamic Finance for Newcomers." For the second year, the Harvard Forum offered this free workshop to audience members by describing Islamic finance from a theoretical, Shari'ah, and practitioner's perspective.

The final session of the conference featured the unveiling of the New HIFIP Portal and iDataBank. Mr. Abdul-Basser, who is also the coordinator of Software Development at HIFIP, described how the new remote Data Entry System (DES) will allow researchers from around the world to contribute to the iDataBank. He also stressed that by providing online access to the iDataBank, information would be made available instantaneously to HIFIP sponsors, thus eliminating the lag time of publishing the DataBank CD-ROM.

There are a host of other demanding issues facing the Islamic finance industry, such as adequate capital structures for Islamic banks. A proper capitalization of Islamic banks will insure their prudent behavior and provide products suitable to risk-averse investors. Islamic investors also must be provided with several comprehensive strategies and choices to build their portfolios. One way to help in this regard is to develop quantitative methods to test Shari'ah-compliant portfolios and to back-test models over an extended period of time.

Developments in the field of Islamic finance and economics are far from being adequately explored. As research intensifies, more critical and controversial issues are likely to surface and demand proper attention and original *ijtihad.* This forum can serve as a good sounding board to further the research agenda of those interested in this field.

Unfortunately, one gap remains in Islamic economic theory and was reflected in the presentations: What is the logical link between eliminating *riba* and the resulting stability and strong growth of an economy? Why or how inflation will or should be eradicated was not explained. Inflation can be a byproduct of government spending (e.g., antipoverty programs). Would the ensuing inflation be desirable and equitable?

The fundamental problem and confusion in analyzing these issues is probably due to the fact that Islamic economics lacks a proper analytical framework. Therefore, efforts in this field may be more fruitful if concentrated on establishing the axiomatic foundations of Islamic economics that can be used to build a more cohesive system of economic analysis in line with the Qur'an and Sunnah. In this ground-breaking quest, examples of the efforts of heterodox economics researchers (e.g., post-Keynesians, institutionalists, and neo-Marxists) to develop radically different analytical economic frameworks, instead of those of neoclassical economics, can enrich our approach to the evolving Islamic economics discipline.

The forum proceedings should be available before the next forum. Additional information can be obtained at the HIFIP Website: www.hifip.harvard.edu.

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