



EIGHTH HARVARD UNIVERSITY FORUM ON ISLAMIC FINANCE
HARVARD LAW SCHOOL - APRIL 19-20, 2008

INNOVATION AND AUTHENTICITY: A SHORT REPORT

The Eighth Harvard University Forum on Islamic Finance, entitled “Innovation and Authenticity,” was held on April 19–20, 2008 at Harvard Law School in Cambridge, Massachusetts. This year’s forum focused on four major themes: Law, policy, and supervision; Conceptual directions in *shari’a*; Debt and equity modes of financing; and *Shari’a* supervision of modern Islamic finance (IF).

The biennial event was hosted by the Islamic Finance Project (IFP), a program sponsored by the Islamic Legal Studies Program (ILSP) at Harvard Law School. As with past forums, the Eighth Forum attracted leading international academics, *shari’a* scholars, and practitioners in the field of Islamic finance from around the world as presenters and attendees. In his opening remarks, IFP Director Nazim Ali reminded the audience that IFP is an academic project that does not endorse any one viewpoint, but rather seeks to facilitate discussion in an open forum.

Innovation and Authenticity

Baber Johansen, the director of ILSP and Affiliated Professor at Harvard Law School and Professor of Islamic Religious Studies, Harvard Divinity School, set the tone for the forum in his welcoming address. He noted that this year’s forum marks a departure from the social and legal debates surrounding Islamic finance as we move to an economic analysis in the discussions about the future of Islamic finance.

The keynote speech was then delivered by Robert C. Merton, a Nobel Laureate and the John and Natty McArthur University Professor at Harvard Business School. Merton identified important areas for economic development and for the efficient management of risk. He asserted that given modern technological advances, risk is now a separable managerial decision and that risk transfer innovations increase the efficiency of risk-diversification. He commented on the potential of utilizing available conventional market innovations in a *shari’a*-compliant manner. Merton posed a challenge for the IF industry to further probe *shari’a*-compliant derivatives for risk-mitigating strategies. Using Taiwan as a hypothetical example, he suggested that the country’s heavy direct investment in the electronics industry could be diversified if Taiwan contracted with other countries to exchange similar returns from unrelated industries. This would effectively increase the risk-weighted return without requiring a long-term change in infrastructure, and it could be enacted, as well as reversed, virtually overnight, thereby causing no disruptions to the country. Applying risk to an IF context, he argued that innovation is often structural and the task remains to balance the tension between the benefits of innovation and keeping the infrastructural support.

Providing a somewhat complementary perspective, M. Umer Chapra delivered the Forum Speech entitled, “Innovation and Authenticity in Islamic Finance.” Well known for his scholarship in the field of Islamic economics, currently Chapra is an adviser to the Islamic Development Bank research arm, Islamic Research and Training Institute in Jeddah. He began by lauding innovation as integral to progress and development: “If it is necessary for a society to move forward to prevent stagnation and decline, innovation is also, therefore, indispensable.” And yet this rapid development gives us pause as we have witnessed a global financial system plagued by crises over the last 30 years. Highlighting the lack of adequate market discipline in the financial system as the cause of excessive lending and high leverage, Chapra posited that risk-sharing on an Islamic finance model can curb lax lending and instill greater discipline. Islamic finance can help raise the share of equity in businesses and of profit-and-loss sharing (PLS) in projects and ventures through the *mudarabah* and *musharakah* modes of financing. To make such a system workable, Muslim countries should develop unified financial institutions such as a Centralized *Shari’a* Board or a *Shari’a* Clearance and Audit, and a secondary market for Islamic financial instruments. In Chapra’s eyes, through such institutionalized mechanisms innovation in Islamic finance can be wedded to a sense of authenticity.

A discussion panel was thereafter moderated by Samuel Hayes III, Jacob H. Schiff Professor of Investment Banking, Emeritus at Harvard Business School. The participants included Adnan al-Bahar (Chairman & CEO, The International Investor, Kuwait), Abdul Kadir Barkatulla (*Shari’a* Consultant, London, United Kingdom), Neil D.

Miller (Partner, Norton Rose, London, United Kingdom), and Frank E. Vogel (Founding Director, Islamic Legal Studies Program). How Islamic finance struggles with authenticity and innovation raises significant questions about how Muslims choose to live by *fiqh* and *shari'a* in the modern era.

Recognizing that we are in a world dominated by non-Islamic capital markets, Hayes posited that the challenge for Muslims is to practice their religious tradition in the context of a conventional western capital model. While there are many instances where the “Islamic” solution is only modestly different from that of a conventional western contract, the importance of finding a *halal* solution is the person’s *intent* to conform to religious principles, not simply a sleight of hand to get around rules imposed by *shari'a* boards. Hayes concluded that what motivates Muslims is not the effort to westernize Islamic concepts but rather to maintain a relationship with God and invest in a way that they find to be morally in line with God’s plan.

Discussants pondered who has authority to speak to authenticity. For about a thousand years this authority has been in the hands of scholars of *fiqh*, *fuqaha*, practicing *ijtihad* according to the age-old science of *usul al-fiqh*; and it remains with them today. Should greater transparency as to *fiqh* decisions now be adopted so that the public can better make their decisions? Are *fatwas* issued to individual financial institutions by individual scholars or by small *shari'a* boards a sufficient guarantee of authenticity, or must institutions in the industry be created to evaluate individual *fatwas* and fortify them through reviews and votes by larger groups of scholars, among them non-*fuqaha*? A final issue raised in the discussion was how broadly or narrowly authenticity is to be judged. Is IF’s compliance with traditional *fiqh* a question to be addressed solely within the relatively micro sphere of commercial law? Or is Islamic finance to be judged by broader, more macro objectives believed to be *maqasid* of *shari'a*, such as strengthening Muslim economies, aiding the underprivileged, or better distributing wealth?

Frank Vogel asserted that the dilemma concerning authenticity and innovation is central to *shari'a*. Vogel pointed out that the authenticity of a proposed law depends on its grounding in the Qur’an and Sunnah. However, only a few Quranic verses deal with the issues in question and innovation becomes necessary. In modern times the tension between authenticity and innovation has grown sharper because colonialism’s sweeping legal reformulations destroyed *fiqh*’s capacity for organic adaptation to change at the very time when modern societies began to transform rapidly. The normal balance between *shari'a* authenticity and social change evaporated, to be replaced by a gulf between modern daily life and the provisions of Islamic law.

According to Adnan al-Bahar, there are two distinct forms of innovation. One type is through the repackaging of existing tools to serve a new need or more efficiently serve an existing need. These include the hedging of currency positions with a swap-like transaction achieved through a simultaneous purchase and sale of the same commodity (deferred payment *murabaha* contract) denominated in two different currencies. The second type is through new *fatwas* and breakthroughs in *shari'a* thought, such as in the *fatwa* defining the *shari'a*-compliant listed shares and the associated formula of dividend cleansing.

While most panelists shared a vision of innovation, there was a lively debate regarding authenticity. Whether something is “legally correct” may be easy to answer, but questions of authenticity per se remain open to discussion, and this may be more about how an idea sounds and feels rather than its sheer legality. Holding a somewhat minority opinion, al-Bahar asserted that authenticity often comes down to ideas, products, and concepts that are legally correct by the letter of *shari'a* while also having both scholarly and consumer (market) acceptance.

Neil Miller, a partner at Norton Rose in London, spoke on the tension that exists in providing legal advice while giving *shari'a* guidance. He contended that product development occurs along a spectrum, and issues of innovation and authenticity run throughout that spectrum. Perhaps, Miller notes, it is best to move away from the idea of innovation and toward evolution, a more comprehensive concept that better encompasses the manner in which conventional products are made *shari'a* compliant.

Shari'a Scholars' Perspectives on Innovation and Authenticity

A video prepared especially for the forum presented the views of several *shari'a* scholars on innovation and authenticity to wrap up the discussion of innovation and authenticity as general concepts. These scholars included Anas Zarka, Daud Baker, Hussain Hamed Hassan, Nizam Yaqubi, and Esam M. Ishaq. Most of the scholars agreed that there needs to be a balance between innovation and authenticity, while stressing that *shari'a* welcomes innovation within boundaries. Esam Ishaq of Manama, Bahrain advised: “There is no need to cut corners and not to observe what the *shari'a* requires, because the whole world is open for you. Just keep away from what is forbidden and essentially they are the contracts that contain *gharar*, *maisir* or *riba*.” He optimistically concluded: “The room and the opportunity for innovation is infinite.” Hussain Hassan of Dubai Islamic Bank believed that the task of developing new products lies between bankers, *shari'a* scholars, and lawyers. This view was echoed by Anas Zarka of The International Investor, Kuwait who opined that the greatest potential for useful, *shari'a*-compliant innovation lies with individuals who have dual knowledge in finance from a commercial and Islamic perspective. The key, according to Zarka, is cooperation between *shari'a* scholars and bankers.

The Sub-Prime Mortgage Crisis

Umer Chapra spoke on the current-day sub-prime mortgage crisis in the United States, including its causes, impacts, and how IF fits into the discussion. The crisis, according to Chapra, is a reflection of excessive lending. Although securitization is a useful innovation, it allowed mortgage originators to pass the risk of default to the ultimate purchaser of the loan security. This created less incentive to undertake careful underwriting, and, consequently, loan volume gained priority over quality. The check that market discipline could have exercised on self-interest therefore did not come into play. Chapra concluded that a lack of market discipline leads first to excessive lending and then to financial crises. With the Federal Reserve lowering interest rates to increase liquidity and avoid a recession, it creates a risk of exacerbating the vicious cycle of loose funding followed by further financial crisis. The solution, instead, exists in finding an effective way of introducing greater discipline into the financial system with an objective to check excessive and loose lending. This is the direction in which IF wishes to make a valuable contribution to the international financial system.

Law, Policy, and Supervision

The second session of the day, entitled “Law, Policy, and Supervision,” was chaired by Frank Vogel. Kilian Bälz (Visiting Fellow, Islamic Legal Studies Program), opened the session by comparing IF to other socially responsible (SR) forms of investment, such as socially or ethically oriented funds, in an effort to elucidate the common agenda between SR investment and IF. Bälz further noted that the difference between IF and other SR industries are that the former focuses on rules while the latter focus on values and principles. According to Bälz, “regulatory arbitrage” between *shari’a* and local laws may be permissible, but formalistic adherence to Islamic legal rules may not be the only correct way forward. When addressing whether IF would enhance emissions trading, Bälz considered whether the right to pollute can be considered property in *shari’a*. Abdul Kadir Barkatulla examined whether the IF industry can move from the current model of using conventional product structures and simply adjusting them to gain *shari’a* approval, to creating original *shari’a*-based products for any market’s benefit. He also summarized what he saw as lines of products carrying high *shari’a* risk, including certain capital protected structured products, money markets, linked notes, hedge funds, and exchange-traded funds. Addressing similar issues, Abdurrahman Y. Habil, the Senior Vice President of Abu Dhabi Islamic Bank, discussed the authenticity of IF in light of *maqasid al-shari’a* (the higher objectives of *shari’a*), stating that the definitions of *riba* and *gharar* are too broad to form any solid basis for agreement. Lastly, Mohamed Ali Vaid representing Mansoor Shakil (Director, HSBC Amanah), closed the session by examining the role of *al-maslahah al-shari’a* in contemporary IF discourse by asking how to determine the *shari’a* objectives in the modern age. He concluded that the pursuit of human goals and the principle of utility based on human reason is not what is meant by *maslahah* or *maqasid al-shari’a*. Furthermore, *maslahah* may or may not be in compliance with commonly held beliefs of human reasoning, thereby addressing the topic of whether there is a need for an economic justification for the prohibition of *riba*.

Conceptual Directions in Shari’a

The third and fourth panels were parallel sessions. The third session was entitled “Conceptual Directions in *Shari’a*” and was chaired by Ibrahim Warde, adjunct professor at the Fletcher School of Law and Diplomacy at Tufts University. Yousra Fazili opened the session by delivering a paper written by Abdulazeem Abozaid, a consultant and *shari’a* trainer at Emirates Islamic Bank in Dubai. His paper questioned the wisdom of some current Islamic banking and finance practices that seek their legitimacy from adherence to only formalistic contractual requirements, as opposed to looking into the contractual substance and content. Providing a more open-ended view on *shari’a*-compliant financial stability, Hari Bhambra, senior partner at Praesidium in Dubai, presented a paper dealing with the application, interpretation, and impact of *shari’a* compliance in the Islamic financial services industry. Applying a more theoretical perspective, Kristin Smith Diwan, assistant professor at American University in Washington, D.C., analyzed the renewal of *waqfs* as a pivotal player in the creation of a distinctively Islamic conception of development that balances socioeconomic objectives with religious concerns. Mohammad O. Farooq, associate professor at Upper Iowa University, focused on loans, or *qard*, as problematic in IF because they can be associated with *riba*. Lastly, L. Ali Khan, professor at Washburn University School of Law, explored the boundaries of investment risk in IF, analyzing financial risk in terms of gain, temporality, and moral engagement in order to determine permissible investments under Islamic law.

Current Academic Research

The fourth session featured a selection of current academic research, and was chaired by M. M. Mahmud Al-Awan, Chief Academic Officer at INCEIF in Kuala Lumpur, Malaysia. Mohammed Tameme and Gaffar Ahmed (respectively, a doctoral candidate and research fellow at the University of Durham, United Kingdom) began the session with a paper entitled “The Demand and Products of the Islamic Mortgage in Europe: Empirical Study from the United Kingdom.” In a unique blend of economics and sociology, the two evaluated the perception of Islamic mort-

gages among British Muslims and whether the current structures of Islamic mortgages play a role in helping low-income groups in the Muslim community achieve homeownership. This was followed by Sameer Meerali (Master's candidate, Harvard University), who spoke on Islamic finance in praxis, as part of the wider platform of the global asset management industry. Criticizing the fragmented marketplace whereby larger corporate entities compete in the market alongside smaller competitors, Meerali suggested a new path forward in order for Islamic financial institutions to achieve critical mass and capture market share on a global scale. Aisha Nadar (Doctoral candidate, University of London), delivered a paper on IF as a source for dispute resolution in the UK system. Nadar contended that international commercial arbitration, free from the constraints placed on national courts, can serve as a meaningful alternative venue capable of giving effect to the will of the contracting parties to comply with the mandatory principles of Islamic law. Huma Sodher (Director of Corporate Development, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)), discussed the implications of emerging global legislation on Islamic banking, addressing issues pertaining to the development of IF statutes, a regulatory and reporting framework, and standardization and harmonization of *shari'a*, documentation, and compliance requirements. Rounding out the session was Azeemuddin Subhani, Adjunct Assistant Professor from the University of Waterloo, who sought to provide a critical perspective on Islamic financial theory by critiquing the extant understanding of *riba* and offering a deeper scriptural understanding of the term, one focused on imparting hermeneutical balance to the *riba* paradigm, by transforming it from a mere financial/economic paradigm to a broader theological paradigm. In what came out as rather controversial, Subhani went off paper at the end of his presentation, interpreting *riba* in some unconventional ways that clearly went beyond the content and scope of a paper on Islamic finance.

International Perspectives on Governance and Policy

The second morning of the conference, the IFP welcomed the officials from Pakistan who are involved with the work of making Islamic finance a reality for millions of Pakistanis who seek to have their religious faith play a role in their daily financial lives. Shamshad Akhtar, the Governor of the State Bank of Pakistan, delivered the Sunday Forum Speech, focusing on *shari'a* supervision in modern Islamic finance and using Pakistan as a model of IF in praxis. She described the issues facing Pakistan's finance industry and the importance of developing products and models with an eye to sustainability in the modern world. Mohammadmian Soomro, the Chairman of the Senate of Pakistan who served as the discussant for Akhtar's speech, noted that while Pakistan is developing its finance structures, much room for improvement exists, especially with regards to industry transparency and access. During the question and answer session, Akhtar remarked that this process is still in its infancy and that Pakistan is still developing a model of Islamic finance that serves its population's needs while remaining true to the principles of Islamic law.

Debt and Equity Modes of Financing

The first formal session of the day, entitled "Debt and Equity Modes of Financing" was chaired by Samuel Hayes, who guided both the discussion and the ensuing questions in a manner that kept the focus on specific modes of Islamic financing. Habib Motani and Andrew Coats, both partners at Clifford Chance in London, delivered a presentation on purchase undertakings in *sukuk* issuances based on their work as counsel in the Gulf States. Motani and Coats posited financing structures meeting AAOIFI requirements that already exist in a modern IF paradigm, so that we need not reinvent the wheel, but rather apply current best practices under an AAOIFI model. Later in the afternoon, Hatim el-Tahir, manager of training for the Dubai International Financial Exchange, presented a paper entitled "Islamic Securitization Market: The GCC Debt Market Turns to *Shari'a*-Compliance," which focused upon the issuance and use of Islamic Securitized Debt Instruments (ISDIs) (e.g., asset-backed *sukuk*) now gaining popularity in the GCC. Mr. el-Tahir asserted that the financing of infrastructural projects can reduce governments' borrowings, as private and para-state companies could raise capital directly from the financial market. He emphasized the importance of standardized features for Islamic finance instruments and noted the regulatory challenges for this asset class.

Shari'a Scholars' Perspectives on Debt and Equity

Husam El-Khatib, an attorney at Mayer Brown International in the United Kingdom, reviewed videos of several *shari'a* scholars speaking on debt and equity concerns. Most scholars agreed that *mudaraba* and *musharaka* as equity-based contracts can be used in many areas of financing and investment, including deposit-taking kind of products, venture capital, and *sukuk*. According to Daud Bakar of Kuala Lumpur, Malaysia, the problem with *sukuk* in particular arises as we strive to strike a balance between authenticity and innovation for Islamic fixed income investors. Providing a somewhat minority opinion, Esam Ishaq opined, "I think that is truly a non-issue, *shari'a*-wise." He argued that since the comparison is between a *shari'a*-approved product and a *shari'a*-compliant product, there is little room for differentiation. The relevant issue is risk management and mitigation; thus we must look to the structuring of the instrument so that the instrument or the product retains its original purpose, remaining

validly *mudaraba* or *musharaka*. Nizam Yaquby cautioned that it is difficult to give blanket pronouncements for such a wide range of products. To make *shari'a*-compliant products that are not at a disadvantage compared to conventional products, Islamic banks must be able to provide sophisticated tools to hedge against currency and interest rate fluctuations. On the other hand, Seif el-Din Tag el-Din of Markfield Institute of Higher Education, Leicestershire, United Kingdom asserted that the tension is not between conventional banking and IF, but rather between risk management and its proximity to a structured sort of gambling. As such, modern Islamic finance has yet to truly address the problem of risk assurance and avoidance in a *shari'a*-compliant framework.

Misconceptions about Religion and Politics in Islam

William A. Graham, Dean of Harvard Divinity School, John Lord O'Brian Professor of Divinity, and Murray A. Albertson Professor of Middle Eastern Studies, delivered the banquet address, speaking about the implications and misconceptions regarding politics and Islam in the United States and globally. He provided the historical context of Islamist movements in the last three decades, stating that there have been only a few pre-modern attempts to found Islamic states based on religion. Furthermore, Graham noted that the idea of a theocratic state never became a widespread reality in the Islamic world, much like it never became a popular reality in the Christian world. Indeed, there has often been a functional split between the state and *ulema*, and this has remained so in modern times. He concluded that today's more extreme Islamist elements, which call for the creation of polities around Islamic ideals, are moved by nostalgia for an Islamic religio-political reality that in fact never really existed.

On a Final Note

As the conference neared its end, the closing remarks were given by M. Umer Chapra. Returning to themes touched upon throughout the weekend, Chapra analyzed the role of *maqasid al-shari'a* in financial systems. What exactly is Islamic about Islamic banking? How do we stay true to *shari'a* objectives while at the same time accounting for modern financial needs that perhaps had no equivalent in pre-modern times? These questions remain vital and vibrant, as they had been discussed throughout the weekend. This year's forum provided robust intellectual debate and discussion on these important matters in the hopes of providing a platform for different parties to come together to better understand their various perspectives, the needs of the IF industry, and the people whose lives these theories ultimately affect.