

THE CORPORATE GOVERNANCE OF ISLAMIC BANKS: A BETTER WAY OF DOING BUSINESS?

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Banking is the industry that failed. Banks are meant to allocate capital to businesses and consumers efficiently; instead they ladled credit to anyone who wanted it. Banks are supposed to make money skillfully managing the risk of transforming short-term debt into long-term loans; instead, they were undone by it. They are supposed to expedite the flow of credit through economies; instead they ended up blocking it.¹

“Give not unto the foolish your wealth which Allah has made a means of support for you.” – *Qur’an, 4:5*

INTRODUCTION

The years 2008 and 2009 have brought the world considerable problems, many stemming from bank failures. The conventional Western system of finance is in a quagmire.² There is a banking system however, that has not

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1. *A Special Report on International Banking: Rebuilding the Banks*, ECONOMIST, May 16, 2009, at 43.

2. Chris Isidore, *New Recession Worry: Bank Failures*, CNN MONEY (Mar. 3, 2008), http://money.cnn.com/2008/03/03/news/economy/bank_failures/index.htm; Luke Mullins & Kimberly Palmer, *Bank Failures: Should You Be Worried?*, U.S. NEWS & WORLD REPORT, Mar. 3, 2008, <http://money.usnews.com/money/personal-finance/articles/2008/03/03/bank-failures-should-you-be-worried.html>; Jill Konieczko, *The Ten Biggest U.S. Bank Failures*, U.S. NEWS & WORLD REP., July 15, 2008, <http://money.usnews.com/money/business-economy/articles/2008/07/15/the-10-biggest-us-bank-failures.html>; Alistair Barr, *Bank Failures to Surge in Coming Years*, MARKET WATCH

suffered much in the present crisis; the Islamic Banking System.³ Islamic banks seem to have emerged mostly unscathed in the current phase of the crisis, and industrialized Western countries are looking at them to see why, and to see if they provide some better ways of doing business.⁴ Regulators in many countries are asking whether the Islamic paradigm has any answers.⁵ Even before the crisis occurred, the United States Department of the Treasury unveiled a plan to teach Islamic finance to U.S. bank regulatory agencies.⁶ Islamic banking seems to have been on the minds of many Western financiers for a while.

The University of Reading, in England, recently started a Masters degree in Investment Banking and Islamic Finance, as have other universities throughout the United Kingdom. John Board, director of Reading's International Capital Markets Association Centre says that "[w]e started to get prospective students asking us if we knew about it [Islamic finance], while current students going to job interviews, even for non-Islamic posts, said it came up as a conversation piece."⁷

Islamic banking has been proliferating around the world since the 1970's. There are in excess of 300 Islamic financial institutions in the

(May 23, 2008), [http://www.marketwatch.com/story/bank-failures-surge-credit-crunch; Number of U.S. Bank Failures This Year Hits 22](http://www.marketwatch.com/story/bank-failures-surge-credit-crunch;Number+of+U.S.+Bank+Failures+This+Year+Hits+22), FOX NEWS (Nov. 22, 2008), <http://www.foxnews.com/story/0,2933,456426,00.html>; Catherine Clifford, *21st Bank Failure This Year*, CNN MONEY (Mar. 27, 2009, 6:00 PM), http://money.cnn.com/2009/03/27/news/companies/bank_failure/index.htm; *Qatar Banking Sector Unhurt by Financial Crisis: Moody's*, ZAWYA.COM, (Feb. 24, 2009), <http://www.zawya.com/story.cfm/sidZAWYA20090224033005?q=qatar%20banking%20sector%20unhurt%20by%20financial%20crisis&pass=1> [hereinafter *Qatar Banking Sector*].

3. Lucy Williamson, *Islamic Banks Better in Crisis*, BBC NEWS (Mar. 2, 2009), <http://news.bbc.co.uk/2/hi/asia-pacific/7918129.stm>; *Islamic Banks Unhurt by Crisis, Indonesian VP*, THE PENINSULA, March 2, 2009; *Qatar Banking Sector, supra* note 2; *Experts Say Islamic Finance Sector More Resilient to Crisis*, INTELLASIA.NET (Mar. 25, 2009), <http://www.intellasia.net/news/articles/finance/111260684.shtml> [hereinafter *Islamic Finance Sector Resilient*].

4. *Islamic Banks Sought in Crisis*, THE MIAMI HERALD, Dec. 25, 2008; Brett Corbin, *European Takes Closer Look at Islamic Financing*, INT'L HERALD TRIB., Oct. 24, 2008; Ann Blackaby, *Non-Muslims Turn to Islamic Banks as a Safe Option*, BIRMINGHAM POST, Oct. 3, 2008, <http://www.birminghampost.net/birmingham-business/birmingham-business-news/other-uk-business/2008/10/03/non-muslims-turn-to-islamic-bank-as-a-safe-option-65233-21962049/>; Int'l Comm. for the Support of the Final Prophet, *U.S. Takes a Closer Look at Islamic Banking*, WHY MUHAMMAD.COM (Dec. 23, 2008) <http://www.whymuhammad.com/en/contents.aspx?aid=5014>; *France: Senate Looks at Easing Limits on Muslim Finance*, ADNKRONOS INT'L (Dec. 23, 2008), <http://www.adnkronos.com/AKI/English/Business/?id=3.0.2846242034>.

5. James Abbas Zaaidi, *Shari'a Harmonization, Regulation and Supervision* (Nov. 2008) (paper presented to AAOFI-World Bank Islamic Banking and Finance Conference).

6. Supna Zaidi, *U.S. Government Embraces Islamic Banking*, HUDSON N. Y. (Jan. 2, 2009), www.hudson-ny.org/165/us-government-embraces-islamic-banking; *WorldNetDaily*, November 5, 2008.

7. Shyamantha Asokan, *New Class for Islamic Finance*, FIN. TIMES (Jan. 19, 2009), <http://www.ft.com/cms/s/2/13df108c-e3df-11dd-8274-0000779fd2ac.html>.

world today in 51 countries throughout the Muslim world, Europe and North America.⁸

A. Purpose of the Paper

The measure of the effectiveness of any system of governance is the degree to which the governed organization achieves its purpose. One must look at the purpose of the various systems, and ask the question, does the system achieve its purpose? Indeed, does the current global economic order perform call for a change in the purpose?⁹

This paper intends to describe the governance system of Islamic banks in order to see the differences that exist between the Islamic banking paradigm and that of its conventional Western counterpart. This is a timely topic since within that governance paradigm there may be elements that can be useful in shoring up the risks that conventional banks have faced and which have precipitated the current banking crisis. Certainly the current governance paradigm of Western banks is coming under increased scrutiny. According to some researchers, “bank regulation will top the global policy agenda.”¹⁰ It certainly is on the minds of policy makers, commentators and the public alike.¹¹ The Federal Reserve is working on new regulations.¹² The British are doing the same.¹³

Since the late 1990’s, and especially in the early 2000’s, there has been a world-wide dramatic increase in the interest in, and concern for, corporate governance.¹⁴ Conventional Western bankers also have been concerned about widely acceptable and effective principles of corporate governance,

8. Raed Rafei, *Indonesia: Islamic Banking Hailed as Shield From Financial Crisis*, L.A. TIMES, Mar. 8, 2009, <http://latimesblogs.latimes.com/babylonbeyond/2009/03/indonesia-islam.html>. See also Nasser M. Sulieman, *Corporate Governance in Islamic Banks*, AL-BAB.COM (Oct. 2005), <http://www.al-bab.com/arab/econ/nsbanks.htm>.

9. Frederick V. Perry & Sheherezade Rehman, *The Transformation of European Corporate Governance: A Case of Germany and France*, 5 CORP. OWNERSHIP & CONTROL 254 (2008).

10. Luc Laeven & Ross Levine, *Governance of Banks*, VOX, (Sept. 29, 2008), <http://www.voxeu.org/index.php?q=node/1717>.

11. Binyamin Appelbaum & David Cho, *Geithner to Propose Vast Expansion of U.S. Oversight of Financial System*, WASH. POST, Mar. 26, 2009, at A1.

12. *Bernanke: AIG Shows Urgent Need for New Regulations*, REUTERS, Mar. 24, 2009, available at <http://www.reuters.com/article/idUSTRE52N4II20090324>; *Broad New Financial Regulations Unveiled*, WCCO.COM (Mar. 31, 2008), <http://wcco.com/national/new.financial.regulations.2.688411.html>.

13. See *Bank Regulation Approach Wrong*, BBC NEWS (Feb. 25, 2009), <http://news.bbc.co.uk/2/hi/business/7910699.stm>.

14. The OECD Principles of Corporate Governance were first issued in May of 1999, and revised in 2004. See ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT [OECD], *OECD PRINCIPLES OF CORPORATE GOVERNANCE* (2004), [hereinafter *OECD PRINCIPLES*] available at <http://www.oecd.org/dataoecd/32/18/31557724.pdf>.

so as to make for an effective and transparent international banking system in which shareholders, depositors and borrowers alike have confidence.¹⁵ National and international banking authorities agree that banks must be supervised—not simply to avoid chicanery, fraud, theft and bank failures—but also to provide for a system in which businesses and consumers have confidence.¹⁶ The officials of the Basel Committee believe that effective supervision cannot take place unless effective systems of corporate governance are in place.¹⁷

The Basel Committee heartily endorses the principles and definition of corporate governance as espoused and published by the Organisation for Economic Co-operation and Development (OECD), which state:

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth.¹⁸

So for the purposes of this study, the starting point is the proposition that any organization—whether it be simply a club, a company or a state—has a controlling mechanism composed of rules, procedures and customs by means of which decisions are taken and the organization is run. Whatever

15. See BASEL COMMITTEE ON BANKING SUPERVISION, ENHANCING CORPORATE GOVERNANCE FOR BANKING ORGANIZATIONS (Sept. 1999), <http://www.bis.org/publ/bcbs56.pdf?noframes=1> [hereinafter ENHANCING CORPORATE GOVERNANCE 1999]. The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central-bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located. *Id.*

16. See generally *id.*

17. *Id.* at 1.

18. OECD PRINCIPLES, *supra* note 14.

its system and body of rules and decision-making procedures by which the organization is run is the organization's system of governance.¹⁹

In any corporation, the need for a system of governance arises from the inherent agency problem. In a sole proprietorship, the most prevalent type of business entity,²⁰ the owner manages the enterprise, and knows where the money goes and where it comes from. However, in the corporation, owners are separated from managers, and it is the latter who actually control the operations and finances of the corporation. These managers are the agents of the shareholders, and the shareholders, who wish that their investments be fruitful, will want to ensure that the managers do not engage in self-dealing; rather, the shareholders will desire that the managers act in the best interest of the corporation, and thus of the shareholders' investment. The main objective of a system of corporate governance is to overcome this agency problem—to provide a monitoring system to oversee the activities of the agents.²¹ So, according to some, even though the Western system of economic activity considers itself a system of capitalism and therefore an ownership system, its system of organization and management of corporations is, in effect, a system of agency rather than ownership.²² The questions many are asking today in that Western system—especially in the financial system—is whether the agents are doing their job properly and whether they are being properly monitored.

Banks are essential in any economy, as they provide financing for commercial enterprises, financial services to the population in general and a system for making all manner of payments.²³ For conventional Western banks, the Basel Committee has been very active in providing rules by which the banks within its system are governed.²⁴ Government regulatory agencies and the banks which they supervise have generally adopted these principles, of course taking into account their national and local constraints. That is why the conventional banking systems work in much the same way on a world-wide basis.

19. Scheherazade Rehman & Frederick V. Perry, *The Global Convergence of Corporate Governance Systems: Is it Really Happening?*, J. CURRENT RES. GLOBAL BUS. (Fall 2004).

20. According to the U.S. Bureau of the Census, of the 25 million business entities in the United States, over 91% are sole proprietorships. *Statistics About Business Size from the Census Bureau*, CENSUS BUREAU, <http://www.census.gov/epcd/www/smallbus.html> (last visited Nov. 6, 2010).

21. See KENNETH A. KIM & JOHN R. NOFSINGER, CORPORATE GOVERNANCE 3 (2004).

22. See Gretchen Morgenson, *He Doesn't Let Money Managers Off the Hook*, N.Y. TIMES, Apr. 12, 2009, <http://www.nytimes.com/2009/04/12/business/12gret.html>.

23. See BASAL COMMITTEE, ENHANCING CORPORATE GOVERNANCE 1999, *supra* note 15.

24. These include PRINCIPLES FOR THE MANAGEMENT OF INTEREST RATE RISK (1997), FRAMEWORK FOR INTERNAL CONTROL SYSTEMS IN BANKING ORGANIZATIONS (1998), ENHANCING BANK TRANSPARENCY (1998), and PRINCIPLES FOR THE MANAGEMENT OF CREDIT RISK (1999).

In the conventional Anglo–American system of corporate governance, the main objective of the company is to make a profit and increase shareholder wealth. In other words, it is the interest of the shareholders which the managers and directors of the corporation should be looking out for. In this paradigm, the “exclusive focus of corporate governance should be to maximize shareholder value.”²⁵ The Franco–German model of corporate governance, or what has been also termed the European bank-based system of governance, looks at a broader base of what has been termed “stakeholders” to include employees, lenders, customers and vendors, among others.²⁶ So in this latter paradigm, management is concerned with protecting the interests of a much broader base of stakeholders than in the Anglo–American model. This at times gives rise to conflicts, since there will be times when the interests of such a diffuse group will clash. The manager is faced with a whom–do–you–protect–first dilemma in such an event.

Generally—at least in the Anglo–Saxon model—owners of a corporation, the shareholders, wish to increase their wealth. They are familiar with the old maxim “the more the risk, the more the reward,” and so often owners will wish that the managers take certain risks in order to reap more rewards. A non–shareholder manager often has no incentive to take risk, since he or she knows that if the enterprise fails, he or she will have no job. This is where the alignment of shareholder interest with manager’s interest comes in by providing incentives that align the manager’s rewards with the shareholders’ interests. Stock awards and stock options, and sometimes bonuses, do just that.

Lenders, on the other hand, have no such interest; lenders do not wish the corporate borrower to take risk. The lender wants to be assured that its loan will be repaid. Loan covenants are a means by which lenders have a very strong influence on the governance of their corporate borrowers. In this sense, banks are themselves important elements of the governance of corporations in the places in which they operate.

I. THE GOVERNANCE OF CONVENTIONAL BANKS

Banks are an essential cog in the wheel of commerce in any society. Banks differ markedly from general corporations insofar as governance needs are concerned:

Banks Matter. When banks efficiently mobilize and allocate funds, they lower the cost of capital to firms and accelerate capital accumulation.

25. Jonathon R. Macey & Maureen O’Hara, *The Corporate Governance of Banks*, 9 *ECON. POL’Y REV.* 91, 95 (2003).

26. See generally JONATHAN CHARKHAM, *KEEPING GOOD COMPANY: A STUDY OF CORPORATE GOVERNANCE IN FIVE COUNTRIES* (1994); see also Perry & Rehman, *supra* note 9.

When banks allocate credit to entrepreneurs with the best ideas (rather than to those with the most accumulated wealth or strongest political connections) productivity growth is boosted and more people can pursue their economic dreams. And, when banks manage risk prudently, the likelihood of systemic crises is reduced.²⁷

Others have said that “when banks efficiently mobilize and allocate funds, this lowers the cost of capital to firms, boosts capital formation, and stimulates productivity growth. So, weak governance of banks reverberates throughout the economy with negative ramifications for economic development.”²⁸ The corporate and financial structures of banks differ from the typical corporation. Banks are opaque; it is hard to determine where exactly the money is and how much risk is covering the funds out on loan. Opacity makes monitoring for governance purposes difficult. The relative risk of loans outstanding on a bank’s balance sheet is difficult to determine simply by looking at the balance sheet.

A second problem is regulation.²⁹ This may seem counterintuitive, since many would say that the regulation of banks is a good thing as it protects banks, their shareholders, and their depositors. But regulation may have the opposite effect. As mentioned above, in the typical corporate scenario, an outside lender has an ameliorating effect on shareholders’ propensity to take risks—with the lender’s money. With a bank, the depositor is, in effect, a lender to the bank. But such lenders take no interest in the governance of the bank or in the level of risk that it runs in its operations. Generally the depositor/lender does not require more or less interest be paid to him or her on the deposit dependent on the level of risk the bank runs. So the “debt holders” do not share in the upside potential, no matter the level of risk. In fact, because depositors feel comfortable that the government will protect their “loan” to the bank, they take no interest whatsoever in the bank’s practices. Some studies have shown that government regulations generally have an adverse impact on the governance of banks.³⁰ It has been suggested that such regulation often encourages low capital–asset ratios.³¹ It has even been argued that banking regulation brought about the destruction of AIG.³²

As a practical matter, the stakeholders in the typical bank, even in those countries where the Anglo–American model of corporate governance prevails, are multiplied. The bank not only has the owners, that is, the

27. Laeven & Levine, *supra* note 10.

28. Ross Levine, *The Corporate Governance of Banks: A Concise Discussion of Concepts and Issues* (World Bank Policy Research, Working Paper No. 3404, 2004).

29. See generally Andrea Polo, *Corporate Governance of Banks: The Current State of the Debate* (MPRA Paper No. 2325, Mar. 19, 2007), available at <http://mpra.ub.uni-muenchen.de/2325/>.

30. See Levine, *supra* note 29.

31. Polo, *supra* note 30, at 5.

32. John Carney, *How Bank Regulation Destroyed AIG*, THE BUS. INSIDER (Mar. 2, 2009), <http://www.businessinsider.com/how-bank-regulation-helped-destroy-aig-2009-3>.

shareholders, but there are depositors and society in general, which depend on the viability of its banks for its economy to run smoothly. So banks should be looking out for a variety of interests. It is questionable whether they actually do. Lest anyone continue to say that the interest and profit of shareholders—the only relevant stakeholders—and their say in management and governance in the Anglo–Saxon model is the way the truth and the light, one need only look at who has bailed them out and where the money came from for that bailout: the governments and the taxpayers. So for financial institutions at least, many stakeholders abound, even in the Anglo–Saxon model.

Concerned over renewed problems in the international commercial world and the ethical and other failures in the governance systems of companies around the world, and mindful of the fact that certain banking structures around the world lack transparency and that many banks exist in jurisdictions that purposefully impede information flows, the Basel Committee issued a revision to its 1999 guidance in 2006.³³ That revision set forth eight principles by which sound banks were to be governed.³⁴ This system presupposed that the governance systems would ensure that the banks in question would adhere to the guidelines respecting such things as

33. BASEL COMMITTEE ON BANKING SUPERVISION, ENHANCING CORPORATE GOVERNANCE FOR BANKING ORGANISATIONS 3 (Feb. 2006), *available at* <http://www.bis.org/publ/bcbs122.pdf>.

34. Those principles are:

Principle 1: Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.

Principle 2: The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organisation.

Principle 3: The board of directors should set and enforce clear lines of responsibility and accountability throughout the organisation.

Principle 4: The board should ensure that there is appropriate oversight by senior management consistent with board policy.

Principle 5: The board and senior management should effectively utilise the work conducted by the internal audit function, external auditors, and internal control functions.

Principle 6: The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment.

Principle 7: The bank should be governed in a transparent manner.

Principle 8: The board and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency (i.e. "know-your-structure").

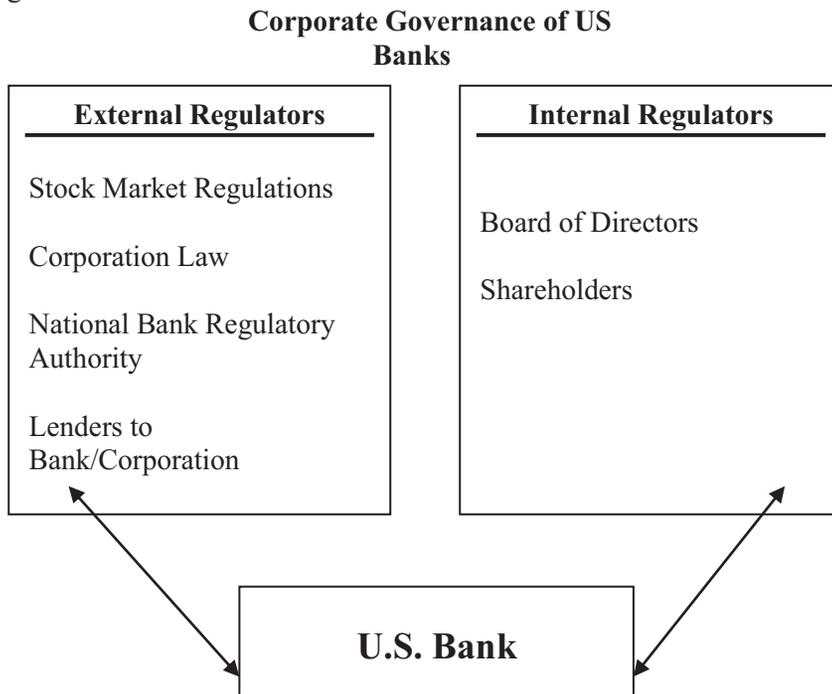
the management of interest rate risk, the management of credit risk, transparency and internal controls systems.

Even so, there has not been an intense scrutiny and push for enhanced corporate governance in banks, at least not in the U.S., where some of the world's largest banks are headquartered.³⁵

In the U.S. there are some problems going forward even after the financial debacle and the infusion of billions of dollars in the banking system by the U.S. government. Compensation and risk taking, according to some governance experts, have not been curbed, despite the rhetoric of the U.S. Congress and the infusion of billions of dollars. For example, directors have been left in place—those same directors who allowed the problems to arise in the first place—and compensation levels that encourage risk-taking are not really controlled in a meaningful way.³⁶ The British, in their bailout program, have at least replaced a number of directors.³⁷

The corporate governance of the typical US bank is shown in the following diagram:

Diagram 1.1



35. Macey & O'Hara, *supra* note 26.

36. See Alistair Barr, *Corporate Governance Takes Back Seat in Bank Bailouts*, RISKMETRICS GROUP (Oct. 17, 2008), http://www.riskmetrics.com/press/articles/20081017_djn.html.

37. *Id.*

II. THE GOVERNANCE OF ISLAMIC BANKS

Islamic banks are governed differently than Anglo–American banks. In order to understand how and why they are different, it is first necessary to understand a modicum of Islamic law, since the law, as Muslims define it, is the normative basis and indeed the reason for the existence of Islamic banking.

The source of the law and the definition of law are different between the typical Western legal tradition and that of Islam. Even though some highly regarded U.S. practitioners have suggested that to ask “what is law” is a meaningless question,³⁸ in most industrialized countries—and certainly in the United States—law is considered to be “a body of rules of action or conduct prescribed by controlling authority, and having binding legal force. That which must be obeyed and followed by citizens subject to sanction or legal consequence”³⁹ The Mexican jurist defines law as a norm or rule that sets the limits of human conduct, in order to settle social conflict, and to which all people must forcibly subject themselves.⁴⁰ Another Western, civil law example is the Mexican Constitution, which states that all the resolutions of the Congress will be considered law.⁴¹ In the United States, the source of all law is the Constitution of the United States, and its source is the people.⁴² The Constitution gives authority to the Congress to make the laws, and the Congress is also elected by “the People of the several States.”⁴³ In a typical civil law country, such as Mexico, law is considered as “emanating from legitimate authority.”⁴⁴

Islamic law is different, and Muslims believe differently. Since in the West the lawgiver is man and the institutions of man, the law can be changed by man. But for Muslims “[t]he absolute knowledge which is required to lay down a path for human life is not possessed by any group of people.”⁴⁵ For Shari’ah, which is the Muslim concept of law, God is the

38. Richard A. Posner, *The Decline of Law as an Autonomous Discipline: 1962-1987*, 100 HARV. L.REV. 761, 765 (1987).

39. *Gilmer v. Interstate/Johnson Lane Co.*, 500 U.S. 20 (1991). The foregoing is a definition from a Common Law jurisdiction, and in practice, that definition fairly represents the operation of “law” in most industrialized countries. However the Civil Law tradition, which often deals with such subjects from both a broader and more theoretical approach, defines law as: “A rule of conduct . . . (which is) . . . the combination of rules that govern social relations.” Eugene Petit, 21 DERECHO ROMANO 15 (2005). See also Charles Louis de Secondat, Baron de La Brède et de Montesquieu, *Del Espiritu de las Leyes*, Editorial Porrúa, México, Capítulo Primero (1992). Of course in this tradition, there is a distinction between *droit* and *loi*, or *derecho* and *ley*, which distinction is not easy to translate into English, but the Common Law concept and word *law* is broad enough to cover them.

40. TRINIDAD GARCIA, APUNTES DE INTRODUCCIÓN AL ESTUDIO DEL DERECHO (1978).

41. I RAFAEL DE PINA, DERECHO CIVIL MEXICANO 92 (11th ed. 1981).

42. U.S. CONST. pmbl.

43. U.S. CONST. art I, §2.

44. De Pina, *supra* note 42, at 44.

45. ABDUR RAHMAN I. DOI, SHARI’AH: THE ISLAMIC LAW 2 (5th ed. 1984).

lawgiver, and no one—no power on earth—has the authority to change the law.⁴⁶ The source of Islamic law is the Qur'an, considered by Muslims to be the holy word of God, and the Sunna, the sayings and way of life of the Prophet Mohammed.⁴⁷

Shari'ah, or the law for Muslims, is an all-encompassing set of concepts and rules that govern nearly every aspect of daily life, including the laws of contract and commerce; in light of this, according to most legal and religious scholars, Islamic law is divinely inspired and revealed, and therefore not given to changes by man—as are the laws in the other two traditions.⁴⁸ The other two legal traditions, which govern most of the world's citizens and its commerce, are what are known as the Common Law tradition and the Civil Law tradition.⁴⁹ The laws in both a Civil Law society and a Common Law society are made by human beings, and therefore are changeable by them. This is not so in divinely revealed Shari'ah, the revelation of which has been interpreted to some extent, but not changed.⁵⁰ This can be problematic in finance law since we need to bridge the gap of one thousand years of jurisprudential development to meet today's modern financial needs. At about 1000 A.D., the *Ulema* declared that enough interpretation had taken place, and most schools of Islamic law did not develop their jurisprudence any further⁵¹ despite radical changes in other societies thereafter. In contrast, Western systems of law change with society's changing circumstances.

Even though the first bank to use Islamic concepts can be traced to Egypt in 1963, the truly modern idea of an Islamic bank and Islamic banking industry was raised at the Islamic Summit in Lahore, Pakistan in 1975.⁵²

46. DAVID M. NEIPERT, *LAW OF GLOBAL COMMERCE* 27 (2002).

47. RAHMAN, *supra* note 46, at chs. 2-4.

48. SEYYED HOSSEIN NASR, *IDEALS AND REALITIES OF ISLAM* 86 (KAZI Publications 2000) (1966). Rafei, *supra* note 8.

49. Siegfried H. Elsing & John M. Townsend, *Bridging the Common Law and Civil Law Divide in Arbitration*, 18 *ARBITRATION INT'L* 1, 1. For a list of countries governed by the common law tradition, see *Common Law*, WIKIPEDIA (Oct. 21, 2010, 10:46 AM), http://en.wikipedia.org/wiki/Common_law ("The common law constitutes the basis of the legal systems of: England and Wales, Northern Ireland, Ireland, federal law in the United States and the law of individual U.S. States (except Louisiana), federal law throughout Canada and the law of the individual provinces and territories (except Quebec), Australia (both federal and individual states), Kenya, New Zealand, South Africa, India, Malaysia, Brunei, Pakistan, Singapore, Hong Kong, and many other generally English-speaking countries or Commonwealth countries (except Scotland, which is bijuridical, and Malta). Essentially, every country that was colonised at some time by England, Great Britain, or the United Kingdom uses common law" with few exceptions. "The main alternative to the common law system is the civil law system, which is used in Continental Europe, and most of the rest of the world.").

50. Frederick V. Perry, *Shari'ah Islamic Law and Arab Business Ethics*, 22 *CONN. J.INT'L L.* 357, 368 (2007).

51. JOSEPH SCHACHT, *AN INTRODUCTION TO ISLAMIC LAW* ch. 10 (1982).

52. *Id.*

Banking in the Arab world has traditionally been identified with the colonial powers, and freedom from colonial rule sparked an interest in a return to the culture and customs of the people—that is, to Islam. Oppression would, it was believed, be eliminated through the fairness and justice that Islam espoused. Locally owned banks did not start in the Arab world until the 1920's.⁵³ The Western banking system was seen as an instrument of Western corruption and exploitation; so for the people to have confidence in the banking system that was to be home grown, it had to be based on Islamic principles and not Western principles.⁵⁴ Banking activities were to be associated with the tenets espoused by the Prophet Mohammed and the Qur'an. Commercial ventures, borrowing, and lending therefore could all be associated with acts of piety. But for this to happen, people had to be assured that what the banks were doing actually was sanctioned by Shari'ah.

The banks, which started proliferating in the Middle East in the 1970's, covered this requirement by using Shari'ah boards to "bless" their activities and their financial instruments. The idea was that since Islamic banks were new, they must submit all new types of transaction to a "Shari'ah committee" in order to ensure that they conformed with Islamic principles.⁵⁵ It was essential that the expectations of the Muslim community be met⁵⁶ in order to give the banks legitimacy. An Islamic organization must serve God, and "act within the framework of an Islamic formula, so that any person approaching an Islamic bank should be given the impression that he is entering a sacred place to perform a religious ritual, that is the use and employment of capital for what is acceptable and satisfactory to God."⁵⁷ There has been a broad interest in the use and function of the Shari'ah boards, since it is believed that compliance with Shari'ah is the *raison d'être* of the Islamic financial services industry.⁵⁸ Indeed "the core mission of an Islamic financial institution is to meet its stakeholders' desire to conduct their financial business according to Shari'ah principles."⁵⁹

53. Eur. Inst. on Res. on Mediterranean and Euro-Arab Cooperation, *Islamic Banks*, MEDEA.BE (Mar. 2000), <http://www.medeabe.be/index.html?page=2&lang=en&doc=28> [hereinafter *Islamic Banks*].

54. See Mohammad Nejatullah Siddiqi, *Shariah, Economics and the Progress of Islamic Finance: The Role of Shariah Experts* (Concept paper presented to the Seventh Harvard Forum on Islamic Finance, Apr. 21, 2006), available at http://www.siddiqi.com/mns/Role_of_Shariah_Experts.htm [hereinafter Siddiqi, *Finance*].

55. *Islamic Banks*, *supra* note 54.

56. Sulieman, *supra* note 8.

57. A. L. Janahi, ISLAMIC BANKING: CONCEPT, PRACTICE AND FUTURE 42 (2d ed. 1995).

58. ISLAMIC FIN. SERVS. BD., EXPOSURE DRAFT: GUIDING PRINCIPLES ON SHARI'AH GOVERNANCE SYSTEM 1 (Dec. 2008) [hereinafter EXPOSURE DRAFT].

59. Wafik Grais & Matteo Pellegrini, *Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options* 6 (World Bank Research Working Paper 4052, 2006).

Just like a modern day Catholic may turn to her priest to answer certain questions about her religion, Muslims turn to experts also when interpreting their religion and in order to answer certain wooly questions; they turn to the scholars—the *Ulema*.⁶⁰ The word *Ulema* is the plural form of the Arabic *Alim*, and means a learned man or scholar.⁶¹ Such men are learned in Shari'ah and all aspects of Muslim traditions, are knowledgeable in divine law, and serve as its guardians and interpreters. They are the closest thing to a priest that the religion has, but they are not priests, and they do not rule over Islamic society (aside from the exception of Iran after the revolution of 1979).⁶²

In order to fill this need for legitimizing Islamic banking, the bankers invented the concept of the Shari'ah board, made up of *Ulema* who could interpret and evaluate the operations and transactions of the bank.⁶³ All new ways of doing business and new types of transactions—including contracts—are submitted to the Shari'ah board for scrutiny and approval.⁶⁴

A. Islamic Banking Law

Islam looks at wealth as something to be used efficiently to sustain life;⁶⁵ and justice and fairness for all concerned are the theoretical and religious basis for the institution of Islamic finance.⁶⁶ The idea is to ensure the equitable distribution of wealth, so that wealth does not simply circulate among only the wealthy.⁶⁷ Shari'ah prohibits the charging of interest.⁶⁸ Many in the West are not unfamiliar with the prohibition of interest, but in Islamic banking there are four other important elements. Essentially there are five basic principles of Islamic Banking:

60. RAHMAN, *supra* note 46 at 5-6.

61. 2 MARSHALL G.S. HODGSON, *THE VENTURE OF ISLAM* 438-39 (1974) (explaining that the word *Ulema* is the plural form of the Arabic *Alim*, and means a learned man or scholar, and such men are learned in Shari'ah and all aspects of the Muslim traditions).

62. SEYYED HOSSEIN NASR, *THE HEART OF ISLAM: ENDURING VALUES FOR HUMANITY* 148 (2002).

63. *See* Siddiqi, *Finance*, *supra* note 55.

64. *See id.*

65. Mohammad Nejatullah Siddiqi, *The Foundation of Islamic Finance*, Lecture Delivered at the Anderson Graduate School of Management, UCLA (Oct. 25, 2001), available at <http://www.siddiqi.com/mns/Lecture1.htm> [hereinafter Siddiqi, *Finance Lecture*].

66. Mohammed Nejatullah Siddiqi, *Recent History of Islamic Banking and Finance*, Lecture Delivered at the Anderson Graduate School of Management, UCLA (Nov. 7, 2001), available at <http://www.siddiqi.com/mns/Lecture2.htm>.

67. Hasan Zubair, *Islamic Finance Education at Graduate Level: Current Position and Challenge*, 5 (MPRA Paper No. 8712, May 2008), available at mpra.ub.uni-muenchen.de/8712/.

68. *Id.* at 12.

- 1) In a loan any predetermined payment over and above the actual amount of principal is prohibited, that is, no interest.
- 2) Arising from the interest prohibition, the lender must share in the profits or losses arising out of the enterprise for which the money was lent.
- 3) Making money from money is not acceptable, as money has no intrinsic value.
- 4) Gharar (uncertainty, risk or speculation) and the related Maysir (gambling, bets and wager) are also prohibited⁶⁹
- 5) Investments can only support practices or products that are not forbidden (alcohol, pornography, investment in real estate for a casino, etc. are forbidden).⁷⁰

B. Prohibition of Interest

The reason set forth in the Qur'an and Shari'ah for the prohibition of interest is that the depositor (or the lender) should not profit unduly from the hard work and risk bearing of others. Although Islam prohibits interest, it encourages profit and return from investment where the investor takes a calculated risk; commerce and trade are encouraged,⁷¹ so banks can give an investor a share of their annual profits (and losses) in proportion to the investor's (depositor's) deposit based on the share of an individual's deposit in relation to total assets of the bank being lent out.

This rate of return to the investor is different from interest in two important ways: the amount to be paid is not known at the outset of the transaction (there are no guarantees as to amount of return), and the investor (read lender or depositor) has to accept more risk. On the other hand, as an example, the depositor in the conventional western bank takes less of a risk because the bank's capital (that is, the capital investment of the stockholders of the bank) is first at risk before the capital of the depositors.

Because of the foregoing, equity participation and profit and loss sharing are the basis of Islamic banking. Such banks do not charge interest; rather they participate in the profits arising from the use of lent funds. The depositors also share in the profits arising from the use by the bank of their funds in lending activities based on a predetermined ratio. However, in the event of losses (for certain types of deposits, as will be explained), the depositor also loses a proportional share of his or her funds on deposit. The bank also is arguably more at risk than is a conventional Western bank,

69. *But see infra* note 123.

70. *See* Sulieman, *supra* note 8; Mohammad Netjatullah Siddiqi, *The Wisdom of Prohibition of Interest*, Lecture at LaRiba Annual Meeting at Los Angeles (Mar. 30, 2002); Siddiqi, *Finance Lecture*, *supra* note 66.

71. *Qur'an* 4:32.

since the bank cannot require a guarantee or security in the form of collateral to cover a potential loss in the event of default on repayment. Theoretically, the liability of the borrowing entrepreneur is limited to their ability to repay based on success of the enterprise, absent negligence or mismanagement, in which case the borrower can be liable for repaying the lender's financial loss.⁷²

The source and use of funds are a bit different with Islamic banks. Reserves are fractioned; that is, deposits are not simply mingled and placed wherever the banks wish. Not all depositor accounts are used by the bank for the same purpose. Some are used for financial investments and commercial loans, and some are not; it depends on the type of deposit account. Further, some deposit accounts give the depositor the claim to the full amount of the deposit, along with a premium payment or an amount based on the bank's earnings. The deposit of funds into an investment deposit account allows the bank to use the funds in a long term loan. The depositor may lose some or all of his funds if the bank incurs losses; however, the returns to the depositor—if there are returns—are normally higher.⁷³ Rather than a depositor earning a fixed rate of interest as in conventional western banks, the depositor only earns money if she subjects herself to the same risk that the bank undergoes, and thus receives only a share in the profits.⁷⁴

In sum, Shari'ah and Islam in general seek economic fairness and justice; in fact, Muslims are commanded to seek justice and fairness.⁷⁵ A loan from a conventional Western bank requires repayment no matter the outcome of the business venture of the borrower, but Islam considers this unfair—ergo the prohibition of interest—and a sharing in the profit and loss is considered to be fairer, more legitimate, and thus this principle is the basis for Islamic banking.⁷⁶

C. The Governance of Islamic Banks

Islamic banks are typically organized as corporations under the laws of their jurisdictions of incorporation. Those laws differ from place to place in their vision of the relationships among the stakeholders and the role that the corporation is to play in society,⁷⁷ but they all have a governance system,

72. See Sulieman, *supra* note 8.

73. *Id.*

74. *Id.*

75. Examples are *Qur'an* 57:25, 16:90 and 7:29; this is the theme found throughout the *Qur'an*.

76. Sulieman, *supra* note 8.

77. See Scheherazade Rehman & Frederick V. Perry, *Globalization and its Effects on the Convergence of Corporate Governance Systems?*, 17 J. GLOBAL BUS. 5 (2006). See also Larry A. DiMatteo & Lucien J. Dhooge, *INTERNATIONAL BUSINESS LAW: A TRANSACTIONAL APPROACH* ch. 3 (2d ed. 2006).

varied though it may be, which conforms to the commercial laws and customs of the jurisdiction in question. So it is that the typical corporation—for example, in the case of a bank under the Anglo-Saxon model—has both an internal and an external governance system. The external system is made up of the stock exchange rules, the corporation or company laws of the jurisdiction, and any central bank regulatory authority and lenders, who require certain restrictive covenants in their loan documents. On the other hand, the Islamic bank has a more complex governance system.

It must be remembered that in the Franco-German model of the corporation, there are a variety of stakeholders in addition to the shareholders whose interests are looked after in the running of the corporation, and in countries like Germany, there is a two-tiered board of directors.⁷⁸ In this sense, the Islamic bank is similar to the German corporation in its governance model. In essence it has two boards: the one required by secular law, and the one required by religious law. So the Islamic bank has to comply with the laws of man and the laws of God at the same time. This is not always easy, since it also has to compete within the marketplace.

The Islamic bank has at least one further outside governance body: the Islamic Accounting Standards Board, also known as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).⁷⁹ The

78. CHARKHAM, *supra* note 27, at 14.

79. The AAOIFI website provides:

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an Islamic international autonomous not-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shari'a standards for Islamic financial institutions and the industry. Professional qualification programs (notably CIPA, the Shari'a Adviser and Auditor "CSAA", and the corporate compliance program) are presented now by AAOIFI in its efforts to enhance the industry's human resources base and governance structures.

AAOIFI was established in accordance with the Agreement of Association, which was signed by Islamic financial institutions on 1 Safar, 1410H, corresponding to 26 February 1990, in Algiers. Then, it was registered on 11 Ramadan 1411, corresponding to 27 March 1991, in the State of Bahrain.

As an independent, international organization, AAOIFI is supported by institutional members (155 members from 40 countries, so far) including central banks, Islamic financial institutions, and other worldwide participants from the international Islamic banking and finance industry.

AAOIFI has gained assuring support for the implementation of its standards, which are now adopted in the Kingdom of Bahrain, Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria. The relevant authorities in Australia, Indonesia, Malaysia,

AAOIFI develops, recommends, and promulgates accounting standards for Islamic banks, and while its standards do not generally have the effect of being rules of law or having sanctions for their transgression, they have been adopted by many Muslim and Western countries, and for a bank to state that it adheres to them is good for its reputation and provides yet another measure of comfort for the bank's customers.

In addition to the outside regulators, however, the internal regulators are multiplied for the Islamic bank. First, there are the two boards: the one required by law and the one "required" by God. Then there are, of course, the shareholders. In addition, the depositors are stakeholders; they share in the profits and losses of the bank's operation. The borrowers are also stakeholders, since the bank is in essence a partner with the borrower in the borrower's business ventures.

The Shari'ah board and its use can give rise to a number of thorny issues for the bank. The members of the Shari'ah board are supposed to be objective outsiders who make their decisions in consultation with the other Shari'ah board members, but in a way that is to be unbiased by any financial or other interests respecting the bank or the transaction.

An Islamic bank has its Shari'ah board, which is supposed to be external and independent (though its members are paid by the bank), revising policies and documents, but answerable only to themselves and God. Additionally, the bank will often, and usually does, have an internal Shari'ah compliance person or committee,⁸⁰ whose job it is to ensure that the bank complies with that which the Shari'ah board has mandated through its *fatwas*.⁸¹

The Islamic Financial Services Board⁸² is working toward better governance in Islamic banking. In a speech before the meeting of the Arab Bank-

Pakistan, Kingdom of Saudi Arabia, and South Africa have issued guidelines that are based on AAOIFI's standards and pronouncements.

AAOIFI Overview, THE ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS, <http://www.aaofi.com/overview.html> (last visited Nov. 6, 2010).

80. One is recommended by the Islamic Financial Services Board in the GUIDING PRINCIPLES ON SHARI'AH GOVERNANCE SYSTEM. EXPOSURE DRAFT, *supra* note 59, at 2.

81. A *fatwa* is the considered legal opinion of a mufti; an expert on Shari'ah. JOSEPH SCHACHT, AN INTRODUCTION TO ISLAMIC LAW 73 (1982).

82. The Islamic Financial Services Board based in Kuala Lumpur, was officially inaugurated on 3 November 2002 and started operations on 10 March 2003, and states on its website:

The Islamic Financial Services Board (IFSB) is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The IFSB also conducts research and coordinates

ing Association of North America, the executive vice president in charge of the Bank Supervision Group at the Federal Reserve Bank of New York and a member of the Bank's Management Committee commented that:

To this end, institutions like the Accounting and Auditing Organization for Islamic Financial Institutions and the Islamic Financial Services Board [IFSB] are serving a critical function . . . the IFSB recently released exposure drafts of capital adequacy and *risk* management standards for Islamic financial institutions. These standards will help regulators both in countries that already have well-developed Islamic financial systems and in Western countries, to understand and supervise Islamic finance . . . [the IFSB] is also working to strengthen the corporate governance framework for the Islamic financial services industry, and the Federal Reserve Bank of New York . . . [involvement to date has been its via in the 2007 IFSB-sponsored summit on Islamic finance] . . . of course, corporate governance issues and compliance have become particularly important . . . [to the Fed over the past few years] . . . and some of the approaches [the Fed] has taken to address this issue already have much in common with the practices of Islamic finance.⁸³

The IFSB has issued a set of principles on corporate governance for Islamic banks,⁸⁴ as has the AAOIFI.⁸⁵ In fact, the AAOIFI has commenced a training program to educate the market and practitioners about its standards.⁸⁶ Other organizations have been formed to standardize the

initiatives on industry related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders.

ISLAMIC FINANCIAL SERVICES BOARD, <http://www.ifsb.org> (last visited Nov. 6, 2010).

83. William L. Rutledge, Regulation and Supervision of Islamic Banking in the United State, Remarks at the 2004 Arab Banking Association of North American (ABANA) Conference on Islamic Finance: Players, Product & Innovation in New York City (Apr. 15, 2005), available at https://abanaboard.bluestep.net/download/123321_U127360_71877/Rutledge%20Presentati%20on.pdf. Mr. Rutledge was a member of the Basel Committee on Banking Supervision from 1999 through 2004. William L. Rutledge, FED. RES. BANK OF N.Y., <http://www.ny.frb.org/aboutthefed/orgchart/rutledge.html> (last visited Nov. 6, 2010).

84. ISLAMIC FIN. SERVICES, GUIDING PRINCIPLES ON CORPORATE GOVERNANCE FOR INSTITUTIONS OFFERING ONLY ISLAMIC FINANCIAL SERVICES (EXCLUDING ISLAMIC INSURANCE (TAKAFUL) INSTITUTIONS AND ISLAMIC MUTUAL FUNDS) (2006), <http://www.ifsb.org/standard/ifsb3.pdf>.

85. The AAOIFI, whose main objective is to promulgate standards for accounting and audit for Islamic banks, also issued its "Accounting, Auditing and Governance Standards" (for Islamic Financial Institutions) in 2008. See AAOIFI Overview, *supra* note 80.

86. The AAOIFI has training programs on Certified Shari'ah Advisor and Auditor, and Certified Islamic Professional Accountant. AAOIFI, THE ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS, <http://www.aaofi.com/> (last visited Nov. 6, 2010).

system, such as the International Islamic Rating Agency, the International Islamic Financial Market and the Liquidity Management Center. None have the force of law. While the IFSB principles do call for a variety of measures to strengthen the governance of Islamic banks, they do not really push in a meaningful way for global standardization; rather, they take the view that “there is no single model of corporate governance that can work well in every country.” These principles go on to say that “[a]ny rigid, rule based approach adopted in haste with the aim of strengthening the corporate governance of [Islamic banks] may hinder their potential and healthy growth.”⁸⁷ These principles accept the principles promoted by the OECD,⁸⁸ and the Basel Committee’s “Enhancing Corporate Governance of Banking Institutions.” This may be unfortunate, since those companies complying with the OECD principles are a varied group of all sorts of companies, and global standardization is not essential for their ability to interact and compete. Financial transactions are different, and do require more standardization. According to the Basel Committee:

Implementation of the Basel II Framework continues to move forward around the globe. A significant number of countries and banks already implemented the standardized and foundation approaches as of the beginning of this year. In many other jurisdictions, the necessary infrastructure (legislation, regulation, supervisory guidance, etc) to implement the Framework is either in place or in process, which will allow a growing number of countries to proceed with implementation of Basel II’s advanced approaches in 2008 and 2009.⁸⁹

But the original Basel Capital Accord introduced by the Basel Committee in 1998 has been introduced in “virtually all countries with internationally active banks.”⁹⁰ Banks are not as dissimilar as industrial corporations are dissimilar, and the conventional Western style banks of the world are attempting to comply with the Basel standards—as opposed to the more loose OECD standards. Thus, a conventional loan in Mexico City, New York, Paris or London is fairly uniform. On the other hand, the financial instruments and offerings used by Islamic banks around the world are quite dissimilar, as will be discussed below.

Given all this, if asked, most Muslim financiers appear to say that the Islamic controls provide for a more regulated, less risky, user friendly,

87. See Rutledge, *supra* note 84.

88. OECD PRINCIPLES, *supra* note 14.

89. *Progress on Basel II Implementation, New Works Streams and Outreach*, BASEL COMMITTEE NEWSLETTER (Basel Committee on Banking Supervision), May 2007, available at http://www.bis.org/publ/bcbs_n111.htm.

90. BASEL COMM. ON BANKING SUPERVISION, HISTORY OF THE BASEL COMMITTEE AND ITS MEMBERSHIP (Aug. 2009), <http://www.bis.org/bcbs/history.pdf>.

community friendly, ethical way of doing business⁹¹ and they believe that any effects of the current crisis on Islamic banks will be limited.⁹² Many Muslims believe that their system has the answer. The Prime Minister of Malaysia, in speaking about the current world-wide crisis, stated in a conference on Islamic banking that:

We have inherited a system where people can trade what they do not own and the resulting inflationary pressure in the global market has caused immense damage to the economic well-being of the world's poor Such is the impact of unbridled greed in the financial system where there is no accountability on money lending The world is beginning to appreciate the need for alternative financial arrangements.⁹³

In March of 2009, "Muslim presidents, prime ministers and prince[s] called on the world to adopt Islamic financial practices to overcome the global crisis and urged Islamic banks to undertake 'missionary work' in the west to promote Shariah banking."⁹⁴

D. Standardization

While Muslims may feel confident that the bank they go to adheres to Islamic principles, it appears that those principles are not uniformly defined, and that banks and their Shari'ah boards differ in their interpretations of Islamic principles. This makes for difficulties in cross-border banking activities and a truly globalized system of Islamic banking and finance. Many are calling for standardization. John B. Taylor, a former Under Secretary for International Affairs of the U.S. Treasury Department, in discussing Islamic banking, has said that "[t]here needs to be some level of consistency in regulatory treatment across the board . . ."⁹⁵ However, with

91. Rafei, *supra* note 8; *Islamic Finance Sector Resilient*, *supra* note 3; Adnan Yusuf: *Arab, Gulf Banks Not Hurt by Global Mortgage Crunch*, DUBAI FINANCIAL BROKERAGE, LLC (Aug. 26, 2008), http://ae.zawya.com/researchreports/p_2008_08_06_08_07_34/20080826_p_2008_08_06_08_07_34_093131.pdf.

92. Mohammed Al-Hamzani, *Islamic Banks Unaffected by Global Financial Crisis*, ASHRAQ ALAWSAT, Sept. 30, 2008, <http://www.aawsat.com/english/news.asp?section=6&id=14245>.

93. Rafei, *supra* note 8.

94. John Aglionby, *Islamic Banks Urged to Show the Way*, FIN. TIMES, Mar. 2, 2009, <http://www.ft.com/cms/s/0/0f74e17a-0757-11de-9294-000077b07658,s01=1.html>.

95. John B. Taylor, Under Sec'y, Treasury for Int'l Affairs, Keynote Address at the Forum on Islamic Finance: Understanding and Supporting Islamic Finance: Product Differentiation and Int'l Standards (May 8, 2004), *available at* www.stanford.edu/ (search for "Understanding and Supporting Islamic Finance.").

the growth of and proliferation of Islamic banks, efforts at standardization have become even more difficult.⁹⁶

There are some problems respecting standardization. The IFSB and Basel II are attempting to nudge banks in the direction of standardized practices, but a major stumbling block to the development of an internationally accepted Islamic banking industry is the lack of broadly accepted standards. The Shari'ah board of an Islamic bank in Malaysia may approve a financial product, and that same product may not be acceptable or approved in a country within the Gulf Cooperation Council.⁹⁷ Some countries set up Shari'ah compliance and Shari'ah boards at the national level. Malaysia, Pakistan, Sudan, and Iran have set up Shari'ah boards for approving banking standards at the level of the central bank. In most other countries, the finance industry appoints its own Shari'ah board,⁹⁸ which in many cases is at the institutional level; that is, within each bank or finance house. This gives rise to a variety of different interpretations. Khaled Yousaf, head of business development in the Islamic finance sector of the Dubai International Finance Center, states that "Egypt and Malaysia have very liberal interpretations of Shari'ah law, while Saudi Arabia and Kuwait are quite strict. Dubai is somewhere in the middle."⁹⁹

Moreover, there is the lack of trained Islamic legal scholars with knowledge of the world of finance to become members of banks' Shari'ah boards. This can prove to be a disadvantage for the industry.¹⁰⁰ Additionally, there do not appear to be enough trained business people and economists who understand the Islamic financial industry to man the banks.¹⁰¹

For a Western trained banker, the term "standardization" is fairly common and easy to understand. This is not so easy for proponents of Shari'ah law. Religious views are not easily changed or compromised. In addition to the varying level of conservatism versus liberalism regarding Islam in the various Islamic countries, the matter is further complicated by the fact that there are four main schools of Sunni Islamic jurisprudence and one Shi'a school.¹⁰² Accordingly, "the lack of clarity in Shari'ah practices

96. James Abbas Zaaidi, *Shari'a Harmonization, Regulation, and Supervision 1* (Nov. 2008) (paper presented to AAOFI-World Bank Islamic Banking and Finance Conference).

97. The Gulf Cooperation Council was formed for mutual self defense and consists of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

98. Gordon Platt, *Profits With Principle*, GLOBAL FIN., July/Aug. 2006, <http://www.gfmag.com/archives/51-51-july-2006/1355-cover-story-profits-with-principles.html#axzz137eVx6Z2>.

99. *Id.*

100. *Id.*

101. Zubair, *supra* note 68.

102. The Sunni schools (Hanbali, Shafi, Malik and Hanbal) do not differ on major issues, but do on certain essential smaller issues. The Shi'a school is known as the Jafaria

leads to lower mobility of these practices within the same country and across borders, which handicaps the growth of the industry.”¹⁰³

Some Islamic scholars are now espousing a supreme Shari’ah board that will oversee all Shari’ah boards and which will bear responsibility for supervising the activities and the *fatwas* of all other boards.¹⁰⁴ In fact, Indonesia, the most populous Muslim nation, has set up such a “super” Shari’ah board. The Indonesian Council of Ulema has set up a National Shari’ah Board, which issues *fatwas* that are binding on the other Shari’ah boards. And under this system, the board members of the individual banks must be highly qualified in order to be able fully to understand the *fatwas* and to be able to draft and approve contracts that comply with such *fatwas*.¹⁰⁵

On an international basis, it appears that both the regulators of banks and the Shari’ah scholars agree that the Shari’ah standards and the methods of their interpretation and application must be standardized, especially if the Islamic Banking system really wants to grow in an international way and wants to appeal to a broad array of international commercial capital consumers. But it is also clear that this will require close cooperation and collaboration among the interested parties.¹⁰⁶ This does not appear to be an easy task. Despite a lot of vocal chords being exercised and ink being spilled on the matter, no one has to date clearly and fully defined the term “Shari’ah Governance System.”¹⁰⁷

To that end—and in order to strengthen and standardize the Islamic financial services industry—the Islamic Financial Services Board, in a meeting in Jeddah, Saudi Arabia, promulgated an exposure draft on Guiding Principles on Shari’ah Governance System and requested comments on that draft to be sent in by May 15, 2009.¹⁰⁸ This document goes a long way in an attempt to standardize the industry; however, even when it is finally agreed upon, it is unlikely to be anything more than a set of guiding principles, with no real sanctions for non-compliance. In fact, other international institutions have issued their own guidelines regarding Shari’ah governance.¹⁰⁹ One area of interest for the IFSB is that of the professionalism of the members of the Shari’ah boards.

As noted above, and according to the IFSB, the word “scholar” in the context of Islam refers to a translation of the Arabic *alim*, the plural of *ulema*, which are people who are learned and expert in the study of the

school. RAHMAN, *supra* note 46, at ch. 5. See also LALEH BAKHTIAR, *ENCYCLOPEDIA OF ISLAMIC LAW: A COMPENDIUM OF THE MAJOR SCHOOLS* (1996).

103. Zaaidi, *supra* note 5, at 3.

104. *Id.* at 4.

105. *Id.*

106. *Id.* at 5.

107. EXPOSURE DRAFT., *supra* note 59.

108. *Id.*

109. *Id.* at n.4.

Qur'an and Islam. However, when the IFSB use the term "Shari'ah Scholar," they refer to a more specialized person, someone who is an expert in commercial law in the Islamic context—as opposed to someone who is simply well versed in Islamic studies. On Shari'ah boards, the IFSB wants people who, more specifically, are specialized in providing expert opinions and resolutions related to Islamic financial services. They want professionals as opposed to merely academics. Accordingly, the IFSB prefers the term "Shari'ah Board" as opposed to "Shari'ah Scholars" in referring to the phenomenon of using Islamic legal experts in the administration of Islamic banks and banking instruments.¹¹⁰ Of utmost importance to the IFSB is the independence of the Shari'ah Board.¹¹¹

Ideally, according to the IFSB, the Shari'ah Board should have at least three members; it would be good if they were of different nationalities or at least trained in different schools of Islamic law, and they "should possess some exposure in the areas of commerce or finance"¹¹²

The IFSB suggests that there be either a department or a person within the bank, a sort of Shari'ah compliance officer or department (ISCU), who will disseminate the *fatwas* and monitor day-to-day compliance with them by bank operations and financial instruments. This person should also be independent from other departments, just as the audit function in most any standard publicly traded corporations or banks in the United States is independent. The third organism of Shari'ah compliance at the bank or corporation level would be the internal Shari'ah compliance review and audit function (ISRU), the task of which is to verify compliance with Shari'ah as defined in the *fatwas* and to recommend the strengthening or modification of systems to ensure such compliance if weaknesses are detected. This function is similar to that of an internal audit department in most any standard publicly traded corporations or banks in the United States, but its task is more specific and targeted than that of a standard corporate audit department. An annual Shari'ah compliance review—much like the typical annual financial audit of a Western bank—is a further recommendation of the IFSB.¹¹³

110. *Id.* at 3-4.

111. *Id.* at n.5.

112. *Id.* at 7.

113. EXPOSURE DRAFT, *supra* note 59, at 7.

Accordingly, the corporate governance framework recommended by the IFSB for an Islamic bank would be along the lines set forth in the following Diagram:

Diagram 1.2¹¹⁴

FUNCTIONS	TYPICAL FINANCIAL INSTITUTION	ADDITIONS IN ISLAMIC BANKS
Governance	• Board of directors	• <i>Sharī`ah</i> board
Control	• Internal auditor • External auditor	• ISRU ¹¹⁵ • External <i>Sharī`ah</i> review
Compliance	• Regulatory and financial compliance officers, unit or department	• ISCU ¹¹⁶

As already mentioned, the major Western banks follow the Basel Accords in accordance with and interpreted by their own national regulatory structures. Because the major Western banks are the ones who, as a practical matter, control most of the finances for the world's commerce, they are the ones that count in conventional banking. For this reason, among others, Basel II is respected and fairly well followed around the world. As we have seen, this is why banking activities are similar in the major world capitals.

The IFSB, on the other hand, and other such institutions recognize “the detailed scope of the Shari’ah Governance System may vary from one jurisdiction to another, depending on the types of structures adopted.”¹¹⁷ The IFSB promulgates merely “guiding principles.” Nothing is mandated, monitored, or controlled.

The AAOIFI, headquartered in Bahrain, also understands the problems of standardization in an industry that is located in many countries with differing political, commercial and religious standards, and expects that the

114. *Id.*

115. Internal Shari’ah review/audit unit.

116. Internal Shari’ah unit/department. If the ISCU is part of the IIFS’s compliance team, the internal Shari’ah review/audit unit/department (ISRU) may be established to function in a similar manner to the IIFS’s internal audit team. The major difference is that while the internal auditor will usually report to the Audit Committee, the ISRU will report to the Shari’ah board. EXPOSURE DRAFT, *supra* note 59 at 3.

117. *Id.* at 4.

institutions will implement its standards to the extent that they wish to do so or are able to do so.¹¹⁸

Despite all the hype and the successes of Islamic banks and the recent favorable press, all is not milk and honey. *The Financial Times* has reported that Islamic banking could play a useful role in our troubled financial world, but that it would not be a “silver bullet” for the crisis.¹¹⁹ It

118. *Accounting and Auditing Standards Board*, THE ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS, <http://www.aaofii.com/aaofii/TheOrganization/AAOIFIStructure/AccountingandAuditingStandardsBoard/tabid/68/language/en-US/Default.aspx> (last visited Nov. 6, 2010). The powers of the Standards Board include, among others, the following:

- (1) To prepare, adopt and interpret accounting and auditing statements, standards and guidelines for Islamic financial institutions.
- (2) To prepare and adopt code of ethics and educational standards related to the activities of Islamic financial institutions.
- (3) To review with the aim of making additions, deletions or amendments to any accounting and auditing statements, standards and guidelines.
- (4) To prepare and adopt the due process for the preparation of standards, as well as regulations and by-laws of the Standards Board.

The powers of the Shari'a Board include, among others, the following:

- (1) Achieving harmonization and convergence in the concepts and application among the Shari'a supervisory boards of Islamic financial institutions to avoid contradiction or inconsistency between the fatwas and applications by these institutions, thereby providing a pro-active role for the Shari'a supervisory boards of Islamic financial institutions and central banks.
- (2) Helping in the development of Shari'a approved instruments, thereby enabling Islamic financial institutions to cope with the developments taking place in instruments and formulas in fields of finance, investment and other banking services.
- (3) Examining any inquiries referred to the Shari'a Board from Islamic financial institutions or from their Shari'a supervisory boards, either to give the Shari'a opinion in matters requiring collective Ijtihad (reasoning), or to settle divergent points of view, or to act as an arbitrator.
- (4) Reviewing the standards which AAOIFI issues in accounting, auditing and code of ethics and related statements throughout the various stages of the due process, to ensure that these issues are in compliance with the rules and principles of Islamic Shari'a.

AAOIFI Shari'a Board, THE ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS, <http://www.aaofii.com/aaofii/TheOrganization/AAOIFIStructure/AAOIFISHARLABOARD/tabid/71/language/en-US/Default.aspx> (last visited Nov. 6, 2010).

119. John Aglionby, *Islamic Banks Urged to Show the Way*, FIN. TIMES, Mar. 2, 2009, <http://www.ft.com/cms/s/0/0f74e17a-0757-11de-9294-000077b07658.html>.

appears that greater transparency and standardization are required throughout the industry as a whole, since “[t]he . . . combination of requirements of Shari’ah compliance and business performance raises specific challenges and agency problems, and underlines the need for distinctive [corporate governance] structures.”¹²⁰ The CEO of the recently formed and licensed BBK Capanova, the investment bank owned by the Bank of Bahrain and Kuwait, has said the industry needs to improve its transparency, and others have echoed this call.¹²¹

Even though Islamic banking and financial institutions contend that they base themselves on piety, concern for social justice and the laws of God, some, such as Nobel Laureate Economist Hirschman, have contended that generally businesses, individuals, and organizations suffer legal and ethical lapses.¹²² Islamic bankers have proven to be no exception, and “[t]he history of Islamic finance shows that cases of [corporate governance] failures, neglect of minority shareholders’ interests, imprudent lending and excessive risk taking by management.”¹²³

There appear to be at least three possible reasons why the Islamic banks have not suffered much in the current stage of the world economic crisis, and they all stem from their governance based on Shari’ah principles. First, because the banks share in the profits or losses of their borrowers’ ventures (and in the case of mortgages, generally the mortgage is on the books of the bank until paid off), which is a result of the principle of no interest, the Islamic bank is very careful about where they put their money; credit worthiness is therefore a paramount concern. Second, since money is not be made from money and uncertainty or gambling is prohibited, the bundling and securitization of financial instruments—the bundling and further selling of loans, or making and selling of derivatives,¹²⁴ for example—is prohibited.

120. Grais & Pellegrini, *supra* note 60, at 7.

121. Frederik Richter, *Capinnova Urges More Islamic Finance Transparency*, ARABIANBUSINESS.COM (Mar. 29, 2009), <http://www.arabianbusiness.com/capinnova-urges-more-islamic-finance-transparency-40755.html>. See also A.L.M. Abdul Gafoor, *Riba-Free Commercial Banking*, ISLAMICBANKING.NL (May 2001), <http://www.islamicbanking.nl/article3.html>; His Excellency Hamad Al-Sayari, Governor of the Saudi Arabian Monetary Agency, Speech to the Symposium on Islamic Banking Prudential Standards (Jan. 15, 2007); Khurshid Ahmed, *Islamic Banks Need to Introduce Transparency*, ISLAMIC FINANCIAL INDUSTRY NEWS CENTRE (July 4, 2010), <http://www.cibafi.org/newscenter/english/Details.aspx?Id=7684&Cat=0>; ISLAMIC FIN. SERVS. BD., DISCLOSURES TO PROMOTE TRANSPARENCY AND MARKET DISCIPLINE FOR INSTITUTIONS OFFERING ISLAMIC FINANCIAL SERVICES (Dec. 2007), available at <http://www.ifsb.org/standard/ifs4.pdf>.

122. ALBERT HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970), cited in Grais & Pellegrini, *supra* note 60, at 6.

123. Grais & Pellegrini, *supra* note 60, at 6.

124. Bright and creative bankers are attempting to come up with new financial instruments in order to compete with conventional banks and finance houses and thus capture more of the market. The International Islamic Financial Market (IIFM) has submitted to its Shari’ah board a scheme for making and selling derivatives. Cecilia Valente, *Sharia*

The bank generally keeps the paper and this not only makes the bank concerned about proper credit checks, but it inhibits the bank's ability to multiply capital; that is, continue to lend based on a fixed amount of reserves. And finally, because Islamic banking does not allow the same level of the fractionalizing of reserves as conventional banks, (that is, not all deposits can be used for certain types of—or long term—lending) theoretically the bank puts a lower amount of its total reserves at risk. Even so, Islamic bankers believe that the recent world financial crisis has “leveled the playing field,” making it easier for Islamic banks to compete; but they also believe that the industry has to work to come up with new and innovative financial instruments in order to appeal to a broader market.¹²⁵

CONCLUSION

No international institution governs, monitors or controls the internal corporate governance standards in the far-flung Islamic banks, and because an important aspect of the internal standards is Shari'ah compliance, this gives rise to differing standards for financial instruments and financial operations from place to place. So of course, in order for Islamic banks to have universal appeal and full cross-border application, most believe that they will have to have standardized practices. This will require standardized governance structures. How long this will take is an open question. Conventional banks took centuries to evolve into what they are today, while Islamic banks are still in their infancy.¹²⁶

Derivative Standard out by Year-End - IIFM, ARABIAN BUS., Sep. 11, 2009 <http://www.arabianbusiness.com/sharia-derivative-standard-out-by-year-end-iifm-12913.html>. They are still waiting for it to be approved by the Shari'ah board. Even if some do approve such derivatives, it is questionable whether even a majority of the mainstream Islamic Shari'ah boards will approve such instruments, since they have traditionally been a violation of Islamic tenets. IIFM is a non-profit international infrastructure development institution supported by the central banks and government agencies of Bahrain, Brunei, Dubai, Indonesia, Malaysia, Pakistan, Sudan and the Islamic Development Bank, Saudi Arabia, in addition to number of financial institutions from various jurisdictions. *Founding and Permanent Members*, INTERNATIONAL ISLAMIC FINANCIAL MARKET, <http://www.iifm.net/default.asp?action=category&id=60> (last visited Nov. 6, 2010).

125. *Islamic Finance Needs Dynamism, Innovative Products, Say Experts at Sibos*, ISLAMIC FIN. INDUS. NEWS CENTER, Sept. 9, 2009, <http://www.cibafi.org/newscenter/English/Details.aspx?Id=5086&Cat=0>.

126. Zubair, *supra* note 68, at n.3.

