



*Limits of Shari'ca Arbitrage  
and Unrealized Potential of Islamic Finance*

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# Outline

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- Market for Shari'ah Arbitrage
- Nature of Shari'ah Arbitrage
- Mechanics of Shari'ah Arbitrage
- Dynamics of Shari'ah Arbitrage
- Sounding the alarm
- Alternative to Shari'ah Arbitrage
- How Islamic is “Islamic Finance”?

# The market for Shari'ah Arbitrage

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## BMA Governor, February 2004:

- “Islamic banks have grown primarily by providing services to a captive market, people who will only deal with a financial institution that strictly adheres to Islamic principles”
- “If the Islamic sector is to continue to grow and to become a powerful force in international financial markets, it must also be able to attract the business of those persons who might prefer to use Islamic banks, but are also prepared to deal with conventional banks and other financial institutions”

# The nature of Sharí<a Arbitrage



- In medieval jurisprudence books, contract  $A$  is allowed and contract  $B$  is forbidden based on juristic analogy (*qiyās*)
- Contemporary “*ijtihad*” deems  $\tilde{A}=A+C$  permissible
- Economic analysis shows that  $\tilde{A}$  and  $B$  are identical or near-identical in the Arrow-Debreu sense:
  - Of course,  $\tilde{A}$  costs more, at least due to jurist and lawyer fees
  - Still worth developing for “captive market” – regulatory arbitrage
- Dogmatic legal theory marginalizes economic reasoning:
  - Cannot forbid  $\tilde{A}$  based on economic equivalence (*qiyās-ul-shabah*)
  - Cannot permit  $B$  based on economic equivalence (*qiyāsun <alā qiyās*)
  - Those who argue for forbidding  $\tilde{A}$  are accused of making life unnecessarily difficult for Muslims, while those who argue for permitting  $B$  are accused of being too lax, or worse
- Initially, home-grown institutions test the system, eventually large multi-nationals take-over the game (economies of scale)

# Mechanics of Shari'ah Arbitrage I



## Crucial Phase II: Layering (or degrees of separation)

- *Ribā*: cash now for cash later – forbidden
- *Īnāb*: credit-sale followed by cash resale
  - Al-Shāfi'ī test: is second contract stipulated in first?
- *Tawarruq*: cash purchase from A, credit-sale to C, cash resale to D (or A?) → C gets credit
  - Ibn 'Uthaymīn required legitimate third (fourth?) party
- *Murāba'ah*: In fact, the final cash-sale may be ignored, characterizing only the cash purchase from A followed by credit-sale to B as *Murāba'ah-to-order* or *Murāba'ah-facility*
  - Can always add more “layers” (SPVs, IBCs, etc.)
- **Theorem:** Any conventional financial product can be replicated with sufficient number of layers (laundering)
  - *Please*: no more “Islamic alternative to ...” sessions/conferences
  - *No contest*: Medieval juristic minds with limited experience vs. 21<sup>st</sup> Century legal minds, with regulatory-arbitrage experience, and assistance from contemporary jurists!

# Mechanics of Shari'ah Arbitrage II

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## Phases I and III: “Islamic” placement, and integration

- Classical *Murāba'a*: cost-plus sale of what you already own
- *Murāba'a*-to-order: purchase item, then sell it to customer
- Commission eventual buyer as agent to buy the property on bank's behalf, then as selling agent, to sell it to himself
- (Appeal to primitive notions of risk and guaranty)
- Use conventional banking funds to finance initial purchase (HSBC FAQ on auto financing; Feb. 3, 2003)
- Use conventional benchmark (LIBOR, etc.) to determine mark-up (HSBC FAQ; Feb. 3, 2003)
- Same procedure applied to lease financing, various bond issues (sale, lease-back, gift at maturity!!), etc.
- Create your own regulatory and accounting standards (AAOIFI, IFSB, etc.) to pre-empt government-driven prudential regulation, or set the agenda at the very least

# Mechanics of Sharí'a Arbitrage III



- **M. Taqi Usmani on *Murāba'a*:**

“If in cases of genuine need, the financier appoints the client his agent to purchase the commodity on his behalf, his different capacities (i.e. as agent and as ultimate purchaser) should be clearly distinguished. As an agent, he is a trustee...

After he purchases the commodity in his capacity as agent, he must inform the financier that, in fulfilling his obligation as his agent, he has taken delivery of the purchased commodity and now he extends his offer to purchase it from him.

When, in response to this offer, the financier conveys his acceptance to this offer, the sale will be deemed to be complete, and the risk of the property will be passed on to the client as purchaser. At this point he will become a debtor...”

Usmani, M.T. *An Introduction to Islamic Finance*, Karachi: Idaratul Ma'arif, 1998, p.152; repeated verbatim in Usmani, M.T. *An Introduction to Islamic Finance*, The Hague: Kluwer Law International, 2002, p.67

- **M. Taqi Usmani at IIFF, Dubai, March 2004:**

“What we have now is *fiqh-ul-°iyal* [jurisprudence of legal stratagems – to circumvent Islamic Law], not *fiqh-ul-mu'āmalāt* [jurisprudence of financial transactions]”

# Dynamics of Shari'ah Arbitrage

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- Stream of new sources of supernormal profits necessary to justify legal and supervisory/advisory boards
- Profitability invites competition from multinationals
- Competition drives down profit margins
- Take additional risks: gains trading to exploit conveniently accomodating AAOIFI standards, exploit “investment account” structure (neither debt nor equity)
- Seek new lines of business, chasing past returns (buy high, sell low), further eroding profitability
- Seek new “captive markets”, more layering and less transparency
- Cut legal costs by using offshore SPVs, IBCs, etc.
- Invite fee-hungry governments to establish lower-tier offshore (international) financial centers
- ➔ Vulnerability to criminal money laundering practices



# Sounding the Alarm



- Parallels between Shari'ah Arbitrage and money-laundering are not merely coincidental – the latter also utilizes regulatory-arbitrage mechanisms:
  - **Identification:** find the “captive market” to which you can market a conventional product for a fee
  - **Placement:** conventional funds are “Islamized” for social and political reasons (*irony*: whereas this is the weakest link in conventional money-laundering, it is the most celebrated phase of “Islamic finance”)
  - **Layering:** degrees of separation are created through SPVs, IBCs, mutual funds, real estate funds, etc.
  - **Integration:** Conventional benchmarking, co-mingling of funds (dual characterization for regulators: show regulators that this is nothing but secured-lending: OCC letters on *Murâba<sup>o</sup>a* and *Ijâra*)
- Reality check: The question is not *if*, but *when*, there will be another BCCI-size (or bigger) scandal → Well-intentioned Islamic work will be trapped in financial dragnet
- Tragedy: today’s “Islamic finance” replicates the most un-Islamic features of the conventional system, and mostly ignores social/religious goals

# Alternative to Shari'ah Arbitrage

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- Utilize logical analogy instead of juristic analogy: economic analysis of the Law to meet social objectives of Islam
- Follow the methodology of medieval jurists, but not their conclusions, which are largely based on (bad) medieval economics and outdated legal/regulatory environments
- Understand the Canonical religious Texts using state-of-the-art economics rather than bad medieval economics and vacuous rhetoric: “economic analysis of the law”
- Don’t be afraid to conclude that what was forbidden before should be permitted now, or vice versa, regardless of profitability to your employer – no more Shari'ah Arbitrage
- If it is necessary to mix religion and finance, make sure that the relationship focuses on ethics, social values, etc., rather than legalistic mechanics and modified medieval contracts

# How Islamic is “Islamic Finance”?



- Prohibition-driven: mainly *Ribā* and *Gharar*
- Mostly serving wealthiest Muslims, minimal social agenda
- An analysis of Islamic law and finance (need better analyses):
  - Finance is about allocation of credit and risk
  - *Ribā* = “trading in credit”, using a commodity as *mu°allil* is still *ribā*!
  - *Gharar* = “trading in risk”, ignoring dubious “gifts” and *tabarru*<
- Financial institutions can avoid *Ribā* and *Gharar* through mutualization, and prudential regulation of investments:
  - Community-based mutual-banking and risk-sharing institutions, development-oriented and not a “trade” (parallel-*salam fatwā*)
  - This can all be done within current regulatory framework
  - “Islamic” as in IDB, not as in “Islamic Beer” or “Hedge Fund”
- Negative: that would reduce Shari’<a Arbitrage opportunities: minimal support from jurists, lawyers, and bankers
- Positive: avoids religious peddling, protects reputation