Limits of Shari‘a Arbitrage and Unrealized Potential of Islamic Finance

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Outline

• Market for Sharí<e Arbitrage
• Nature of Sharí<e Arbitrage
• Mechanics of Sharí<e Arbitrage
• Dynamics of Sharí<e Arbitrage
• Sounding the alarm
• Alternative to Sharí<e Arbitrage
• How Islamic is “Islamic Finance”?
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 Sharī‘a Arbitrage

• In medieval jurisprudence books, contract $A$ is allowed and contract $B$ is forbidden based on juristic analogy ($qiyās$)
• Contemporary “ijtihād” 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 Sharī<sup>a</sup> Arbitrage I

Crucial Phase II: Layering (or degrees of separation)

- **Ribā**: cash now for cash later – forbidden
- **<i>ínah</i>**: credit-sale followed by cash resale
  - Al-Shāfi<sup>i</sup> 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 <Uthaymín required legitimate third (fourth?) party
- **Muråba°a**: In fact, the final cash-sale may be ignored, characterizing only the cash purchase from A followed by credit-sale to B as **Muråba°a-to-order or Muråba°a-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 Sharī‘a Arbitrage II

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 Sharī’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...”

- **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’āmalat* [jurisprudence of financial transactions]”
Dynamics of Sharī'a Arbitrage

- 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 accommodating 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 Sharí<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°a and >Îjâra)

• 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 Sharí<\textit{\textasciitilde}\textgreater{}a Arbitrage

- 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 Sharí<\textit{\textasciitilde}\textgreater{}a 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 Ribâ 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
  - Ribâ = “trading in credit”, using a commodity as mu‘allil is still ribâ!
  - Gharar = “trading in risk”, ignoring dubious “gifts” and tabarru<
- Financial institutions can avoid Ribâ 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 fatwâ)
  - 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 Sharí<a Arbitrage opportunities: minimal support from jurists, lawyers, and bankers
- Positive: avoids religious peddling, protects reputation