produced the prevailing orthodoxy on matters of capital requirements, harmonization of rules and procedures, derivatives regulation, risk management and cooperation among financial regulators. Because of its makeup, it is the ideal forum for discussions among regulators and practitioners and for consensus-making. Its membership is a who's who of leading financial institutions, central bankers and mainstream economists.[17] It also works in close cooperation with the main trade groups and regulatory associations.[18]

The Bank for International Settlements, created in 1930 and based in Basle, Switzerland, is the oldest international financial organization, and perhaps the most mysterious.[19] The bank is primarily owned by the central banks of industrialized countries. Until recently, the bank's Board was made up of representatives from 11 countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States). In 1996–7, it extended its membership to nine emerging countries. Those nine countries, however, are not equal partners: they may join in some discussions, but may not attend G10 meetings unless invited. Yet the BIS has business and advisory relations with considerably more than its shareholding central banks because some 120 central banks and international financial institutions use it as their bank. The total of the currency deposits placed with the BIS amounted to about US$113.1 billion at the end of March 1997, representing around 7 per cent of the world's foreign exchange reserves. Furthermore, the central banks or official monetary institutions of all but a few countries throughout the world are regularly represented at the Annual General Meeting of the BIS each June.

As with other international organizations such as the World Bank and the IMF, the power of the BIS grew with the successive financial crises of the 1980s and 1990s. In 1982 for example, when the debt crisis erupted, the BIS, at the request of the leading central banks and with their support (in the form of guarantees), helped provide bridging finance to a number of central banks, mainly in Latin America and Eastern Europe, pending the disbursement of conditional credits granted by Western governments, the IMF and the World Bank.

Of special interest to us is the Basle Committee on Banking Supervision which was created by the central bank governors of the G10 countries plus Switzerland and Luxembourg in December 1974, in the aftermath of the failures of Franklin National Bank in New York and Bankhaus Herstatt in West Germany. Although formally distinct, the BIS and the Basle Committee are often confused with one another. Indeed, the Secretariat of the Basle Committee is provided by the BIS, and the activities of the two organizations overlap considerably. Under the aegis of the Basle Committee, cooperation among bank supervisors has steadily increased. The first International Conference of Bank Supervisors was held in 1979.

The Basle Concordat of 1975 – revised in 1983 and 1990 – clarified the sharing of supervisory responsibilities among national authorities with respect to banks' foreign establishments, the aim being to ensure effective supervision of banks' activities worldwide.[20] It is by virtue of those rules that bank regulators acted in concert to close down the Bank of Credit and Commerce International (BCCI) in 1991. In 1988 the Basle Committee reached an agreement designed to achieve international convergence in the measurement of the adequacy of banks' capital. The so-called Basle ratios (also known as the Cooke ratios) have been clarified and amended on a number of occasions. In 1997, the Basle Committee issued its 'Core Principles for Effective Banking Supervision'.

In addition to issuing papers and detailed compendia on implementation of sound supervisory standards, the Basle Committee and the BIS have been increasingly involved in the dissemination of global banking norms. There are frequent meetings of central bank economists and other experts on a variety of matters, such as economic and monetary issues of interest to central banks (monetary policy techniques, operating procedures and netting arrangements) and on specialized topics (data bank management, security, automation, internal management procedures, collection of international financial statistics). The BIS also participates with the European Bank for Reconstruction and Development (EBRD), the World Bank, the International Monetary Fund (IMF) and the Organization of Economic Cooperation and Development (OECD) in the 'Joint Vienna Institute', a training institution set up in 1992 to offer courses for central bankers and other economic and financial officials from economies that are 'in transition' from central planning to free markets. In 1998, the BIS announced the creation, in association with the Basle Committee on Banking Supervision, of an Institute for Financial Stability. Its purpose is to organize high-level seminars directed at key policy-making officials in central banks and supervisory agencies, to provide training for the officials in charge of implementation, and to act as a clearing house for the coordination and provision of technical assistance by central banks and supervisory bodies.[21]

A web of global regulation involving banking, securities and insurance regulators has thus taken shape and is continually gaining in size and scope. A number of principles govern this web: home-host cooperation, information sharing, lead regulator principle, transparency, disclosure, etc. How are those norms enforced? Initially, the Basle Committee had no formal authority since its agreements were carried out on a voluntary basis by the member countries. Today, however, it has considerable power due to the new, albeit mostly indirect, powers of enforcement of private, public and international organizations. Adopting certain norms – such as the new capital ratios or the comprehensive home supervision requirement – is now a pre-condition to being part of the global financial system. The

countries whose legislation inspired (in the case of the United States), or were inspired by, the Basle norms would not permit the operation on their territory of banks from countries that did not endorse such rules. Thus, in 1991, in the wake of the BCCI and Banca Nazionale del Lavoro (BNL)[22] scandals, the US Congress enacted the Foreign Bank Supervision Enhancement Act (FBSEA), which added a new layer of control to its regulatory framework. The centrepiece of the legislation was the requirement that a foreign bank show that it is subject to 'comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country' before any application to open a US office, or to significantly expand its business in the US, can be approved.[23] As for the 'Core Principles for Effective Banking Supervision', their implementation is to be monitored by the IMF as part of its regular surveillance procedures. More generally, and especially since an increasing number of countries are now rated by international ratings agencies such as Standard and Poor's and Moody's, any refusal to apply the new norms is likely to result in being sanctioned or even 'ostracized' by the international markets.

10.5 Recent Developments in Global Financial Regulation

This section focuses on three sets of recent developments: the new rules on capital and risk management, the Core Principles for Effective Banking Supervision, and the liberalization of trade in financial services.

10.5.1 Capital Standards and Risk Management

The Basle Accord concluded on 12 July 1988 was a landmark regulatory agreement. For the first time, regulations affecting banks in many different countries were jointly established: banks operating internationally had to have a minimum capital-to-assets ratio of 8 per cent; and the capital was divided into three tiers, each subjected to different definitions and rules.

The idea of imposing strict ratios was related to the banking problems in the United States in the early 1980s, in the wake of deregulation, and as a result of bank exposure to the international debt crisis. In 1984 and 1985, the Federal Reserve Board and the Federal Deposit Insurance Corporation issued new capital guidelines, forcing banks to choose between raising new capital or reducing their assets. The underlying logic was that in order to be able to weather bad economic times, banks needed a high ratio of capital to assets. In January 1987, an agreement between the United States and the United Kingdom extended the principle of uniform rules to the two countries.[24] The ostensible goals were to reduce the risk of the international banking system and to minimize competitive inequality arising from differences among national bank-capital regulations. A more political explanation was that it attempted to eliminate the funding-cost

advantage that had allowed Japanese banks to capture more than one-third of international lending for much of the 1980s.[25] Even before the 1992 deadline, 33 countries besides the Group of 10 had chosen to adopt the 8 per cent rule, arguing that it helped them establish credibility.[26] As of 1998, virtually all countries had officially changed their capital requirements to conform with the Basle ratios.[27] In other words, although aimed initially at banks from the industrialized world that operated internationally, the standards soon became universal. In addition to the 8 per cent rule, the Basle Committee on Banking Supervision devised a risk-based capital framework: different asset classes (both on and off-balance sheet) had to be weighted according to their riskiness. Five weights – 0%, 10%, 20%, 50% and 100% – were attached to different types of assets (cash, OECD and non-OECD government debt, secured and unsecured loans, etc.).[28] Increasingly, following the lead of the United States and the 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA), a two-tiered regulation system appeared in many countries: institutions that were well-capitalized would be subjected to a rather light, if not lax, regulatory regime, whereas the others would be subjected to tight controls.

A number of drawbacks appeared over the years, which modifications in the Basle standards attempted to address. Capital requirements moved from being simple mechanical rules to becoming sophisticated risk-adjusted models. For one thing, the world of finance had changed considerably with new financial instruments being devised every day. The Basle ratios concentrated almost exclusively on credit risk, while other risks were ignored. Also, at least in the United States, the financial sector had recovered its health, following a difficult decade (1982–92) and had become more assertive and politically influential.[29] The new paradigm, propounded in particular by the Group of Thirty, became that of 'self-regulation': the largest financial institutions would develop their own risk-management models and tools, and regulators, rather than micro-managing risk, would have to be satisfied that those models were accurate and that internal risk controls and disclosure policies were adequate. In an influential report, the Group of Thirty argued that:

> [T]he fundamental responsibility of ensuring financial stability of financial institutions, and thereby limiting systemic risk, rests with the Board and management of global institutions themselves. It also implies that supervisors will be readier to rely on institutions that they supervise, and that the institutions themselves will accept the responsibility to improve the structure of, and discipline imposed by, their internal control functions.[30]

From 1988, new guidelines on derivatives and off-balance sheet items were issued on a regular basis, as a new orthodoxy on risk management took shape. Each firm had to have a thorough understanding of the risks it

faced. In addition to the credit risk (the risk that a counterparty will fail to perform on an obligation to the institution), other risks had to be covered, with procedures drawn up for each category.[31] As of January 1998, internationally active banks in G10 countries must maintain regulatory capital to cover market risk (the risk to an institution's financial condition, resulting from adverse movements in the level or volatility of market prices of interest rate instruments, equities, commodities and currencies). Market risk is usually measured as the potential gain or loss associated with possible price changes over a specified time horizon. This is typically known as value-at-risk (VAR). Banks must set aside capital to cover the price risks inherent in their trading activities. A standardized measurement framework to calculate market risk for interest rates, equities and currencies is provided, but certain institutions that meet the criteria laid out by the Basle Committee can use their internal models.[32] Other risks include legal risk (the risk of loss because a contract cannot be legally enforced, for example because of insufficient documentation or insufficient authority of the counterparty), liquidity risk (the possibility that the firm may not be able to fund its financial-trading activities or to resell its products on the secondary market), and operational risk (the risk of unexpected losses due to deficiencies in information systems or internal controls, which may be caused by human error, system failure or inadequate procedures and controls).

The new regulatory framework thus focuses on an institution's risk control strategy, with risk control defined as the entire process of policies, procedures and systems an institution needs to manage prudently all the risks resulting from its financial transactions, and to ensure that they are within the bank's risk appetite. To avoid conflicts of interests, risk control had to be separated from and sufficiently independent of the business units which execute the firm's financial transactions.

In order to comply with the new rules, most firms devised checklists: who formulates the firm's guidelines and policies? What type of financial instruments may the firm use? Are the products and their implications understood by all concerned? How are the financial instruments valued? Is there a limit system in place? What are the major risks resulting from financial instruments? How is the information communicated to managers and shareholders? Firms also devised lists of approved financial instruments, where each instrument would be clearly described together with an analysis of its usefulness in relation to other activities and the firm's financial condition, as well as reasons for its use. A continuum of financial instruments distinguishes between non-derivative (cash instruments such as fixed-rate bonds), plain vanilla derivatives (such as currency swaps), exotic products (more complex instruments such as lookback options), hybrids (for example, fixed-rate bonds with options embedded in them) and leveraged derivative products (a specific type of derivative financial

instrument containing formulas or multipliers, which for any given change in market prices, could cause the change in the product's fair value to be several times what it would otherwise be). In every instance the amount at risk would be different. With traditional instruments such as loans, bonds or foreign exchange, the amount which the counterparty is obliged to repay is the full or principal amount of the instrument. In the case of derivatives, the risk is not equal to the principal amount of the trade, but rather to the cost of replacing the contract if the counterparty defaults. This replacement value fluctuates over time and is made up of current replacement and potential replacement costs.

Ironically, less than a year after the rules came into effect, the hedge-fund debacle of the summer of 1998 showed that the much-vaunted risk models of large financial institutions were woefully inadequate.[33]

10.5.2 The Core Principles of Bank Supervision

In 1992, the first minimum standards for cross-border supervision established four main principles: (1) All international banks should be supervised by a home country that is capable of performing consolidated supervision; (2) The creation of a cross-border banking establishment should receive the prior consent of both the host country and the home country authority; (3) Home country authorities should possess the right to gather information from their cross-border banking establishments; (4) If the host country determines that any of these three standards is not being met, it could impose restrictive measures or prohibit the establishment of banking offices.

With the proliferation of banking crises worldwide, the G7 pressed the Basle Committee to issue more detailed guidelines. Indeed, from 1995, G7 summit communiqués had repeatedly called for measures to strengthen banking regulation and supervision, in particular deeper cooperation among supervisors of global firms to 'promote the development of globally-integrated safeguards, standards, transparency and systems necessary to monitor and contain risks', and improved supervision in the emerging market economies.

In 1997, the Basle Committee issued for comment a draft of its '25 Core Principles for Effective Banking Supervision'. Among those principles are the following: all banks must have comprehensive risk-management systems as well as management information systems that enable management to identify concentrations within their portfolio; supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers; they must also determine that banks have adequate policies, practices and procedures in place, including strict 'know-your-customer' rules that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or

unintentionally, by criminal elements; and regulators must be able to supervise the banking group on a worldwide consolidated basis.

According to the press release, the Principles 'were drawn up by the Basle Committee in close collaboration with the supervisory authorities in fifteen emerging market countries and have benefited from broad consultation with many other supervisory authorities throughout the world'. They were 'intended to serve as a basic reference for supervisory and other public authorities worldwide to apply in the supervision of all the banks within their jurisdictions'. Supervisory authorities throughout the world were 'invited to endorse the Core Principles, not later than October 1998'. The Principles were designed to be verifiable by national regulators, regional supervisory groups and the market at large. The Basle Committee would monitor the progress made by individual countries in implementing the Principles. In addition, the International Monetary Fund, the World Bank and other international organizations were asked to use the Principles 'in assisting individual countries to strengthen their supervisory arrangements in connection with their work aimed at promoting overall macroeconomic and financial stability'. The Basle Committee also announced it was preparing a three-volume Compendium of its existing recommendations, guidelines and standards.

As of October 1998, emerging countries were expected to review their current supervisory arrangements and set a timetable to make changes in order to conform with the Principles. If legislative changes were needed, national legislators were requested to give urgent consideration to the changes necessary to ensure the application of the Principles. Some in the banking profession have criticized those Principles for being too vague – in effect, for being guidelines and not strict rules. The Principles, say other critics, pay insufficient attention to several issues, such as the profitability, the quality of deposits (which is especially important in emerging markets) and earnings.[34] Implementation of the Principles was to be reviewed at the International Conference of Banking Supervisors in October 1998 and biennially thereafter.

10.5.3 Free Trade in Services

Financial services were left out of the Uruguay Round Agreement that created the World Trade Organization in 1994. At the time, countries such as South Korea, India and Brazil feared that an onslaught of foreign competition would endanger their national firms. This unfinished business was taken up by the newly created organization. In 1995, an agreement was arrived at, but was rejected by the United States on the grounds that it did not go far enough in the direction of liberalization. For a time, the talks seemed deadlocked. It is in part as a result of the Asian financial crisis of 1997 that the deadlock over the financial services agreement was broken. By

the end of that year, Asian countries had lost much of their bargaining power as they desperately needed the help of Western governments and international organizations such as the IMF.[35] And the US and other developed countries, worried about the ripple effects of the crisis, were intent on drastic reform. In their view, the fastest way to cure a sick financial system and to reform it is to open it to foreign competition. In the words of US Deputy Treasury Secretary, Lawrence Summers: 'Emerging markets' growing importance to the global economy gives the international community a particularly strong interest in strengthening their financial systems to insure against financial-sector crises like the one in Thailand'.[36]

In December 1997, an agreement was finally signed, with 102 countries pledging to open, to varying degrees, their banking, insurance and securities sectors to foreign competition. The agreement, effective as of March 1999, covers 95 per cent of the world's multi-trillion dollar financial services – which according to US negotiators involves $18,000 billion in global securities assets, $38,000 billion in international bank lending and $2,500 billion in worldwide insurance premiums. Like other World Trade Organization agreements, the financial services agreement covers not just cross-border trade but all the ways foreign suppliers can deliver services to a country's market, including the establishment of local subsidiaries and branches. The interests of foreign firms were to be protected by the rules of the world-trade body.[37]

The WTO stressed the benefits of the new agreement to developing countries. Increased international competition in financial services would force domestic companies to reduce waste, cut costs, improve management and become more efficient. Liberalization would improve service quality, and benefit consumers, depositors and investors. Open markets would encourage the emergence of new financial instruments, allowing companies to choose the optimal combination of equity, loans or commercial paper to finance their activities. In addition, according to the WTO, broadening the volume of transactions and the spectrum of services would reduce the volatility of markets and their vulnerability to external shocks.[38]

10.6 Applying the New Norms in the Islamic World

While elaborating the '25 Core Principles for Effective Banking Supervision', the Basle Committee negotiators initially considered having two sets of principles, to be applied respectively to developed countries and developing ones. In the end however, they settled for a single set of rules that would be applicable worldwide. As this section shows, most Islamic countries are ill-prepared to implement these reforms. Only two Islamic countries – Malaysia and Indonesia – were nominally associated with the

work of the Basle committee,[39] and both have since had their differences with the global financial community. At the time of the Asian financial crisis of 1997, both countries saw themselves as victims of speculative financial flows. Indonesia only reluctantly accepted the conditions imposed by the IMF in exchange for its rescue package. Malaysia, in the WTO negotiations, fought vigorously in favour of maintaining limits on foreign ownership of some of its financial firms. Indeed, one of the last-minute stumbling blocks concerned the new 30 per cent limit on foreign ownership of insurance firms as part of the 'Malaysianization' programme.[40] After the signing of the agreement, the conflict between Malaysia and the international financial community escalated. Prime Minister Mahathir blamed international speculators for the country's woes. In September 1998, Malaysia took drastic steps to insulate itself from the vagaries of the international markets. Still, Islamic countries are expected to comply with many of the new norms of global banking, despite institutional, cultural, political and religious obstacles.

Although most Islamic techniques have conventional counterparts, they do not always fit conveniently within existing regulatory regimes. The main financing techniques often imply specific contractual obligations and different levels of risk than their conventional counterparts.[41] From the standpoint of Islamic bankers, Islamic financial techniques are fundamentally different from conventional loans, and they should therefore not be subjected to the same prudential ratios and capital requirements as conventional banks.[42] The attitude of many Western regulators can be summed up in a famous statement by Robin Leigh-Pemberton, former governor of the Bank of England, to the effect that Islamic banking is 'a perfectly acceptable mode of investment, but it does not fall within the long-established and well understood definition of what constitutes banking in this country'.[43]

From the standpoint of ownership and control, many such banks cannot comply with the 'comprehensive consolidated supervision by the home country regulator' requirements. Indeed, the majority of Islamic financial institutions belong to, or are otherwise associated with, transnational groups such as Dar Al-Maal Al-Islami (DMI) or the Dallah Al-Baraka group. DMI, controlled by Prince Mohammed al-Faisal al-Saud, is headquartered in the Bahamas and runs its network of banks out of Geneva. Commercial operations extend throughout the Islamic world though not in Saudi Arabia. Similarly, the Dallah Al-Baraka group is controlled by Saleh Kamel, a Saudi citizen, but does not operate a bank in his home country. Ever since the collapse of the Bank of Credit and Commerce International (BCCI), which had used loopholes within the global regulatory system to engage in illegal practices, regulators have frowned upon such structures. In 1993, the Bank of England ordered the closure of Al-Baraka International Bank, the British subsidiary of the Dallah Al-Baraka Group,

on the grounds that the bank's true 'mind and management' were in Saudi Arabia although it did not operate as a bank there.[44]

Another set of issues faced by Islamic financial institutions is the new emphasis on internal risk management. Because of the religious injunctions against gharar,[45] financial institutions and their Shariah boards tread carefully around all issues involving risk,[46] including complicated financial instruments designed to control risk. Thus, although such products are supposed to control risk and reduce it (although as we saw, they sometimes have the opposite effect), they do not always pass muster with Shariah boards. Islamic banks have thus been lagging in their efforts to devise the risk management techniques required by regulators.

Other regulatory complications are posed by the nature of interest-free banking. In the United States for example, Islamic financial institutions have found it hard to comply with the Truth-in-Lending Act, the federal regulation that governs full disclosure of terms and costs in lending transactions. The law requires the use of the term 'annual percentage rate'. Even replacing it, as some have suggested, by a 'profit participation rate' would be tricky since it would mean the endorsement of the 'fixed, predetermined rate' concept to which many Islamic scholars object.

One of the flaws of the principle of global and compulsory norms is that it ignores the fact that banking structures are embedded within a religious, institutional, political and cultural context that cannot, international prodding notwithstanding, be changed overnight. Consider for example the new norms of banking supervision: arms'-length relations between banks and their customers, 'know-your-customer' rules,[47] limits on sizable exposure to a single client or to a group of connected clients; disclosure and transparency, etc. It is unrealistic to expect the successful implementation of such principles in countries where the business community is small and enjoys close ties with the political elite.

Matters of disclosure and transparency also have a cultural dimension. The openness with which Americans discuss financial matters – such an executive's salary or an individual's net worth – contrasts sharply with the way such matters are discussed (or the fact that they are not discussed at all) in other cultures. The opacity extends to issues such as bank ownership, where the use of 'fronts' is common and does not necessarily imply sinister intent. In the first high-profile instance of application of the 1991 Foreign Bank Supervision and Enhancement Act (FBSEA), Saudi Arabia's National Commercial Bank, the largest bank in the Middle East, was accused of helping the Bank of Credit and Commerce International conceal its ownership and financial condition, and was ordered by the Federal Reserve Board to close its New York branch. In a compromise, it eventually chose a 'voluntary liquidation', and a $170 million penalty was levied against its former head, Sheikh Khalid Bin Mahfouz.[48] His attorney Laurence Tribe, the Harvard University constitutional law expert, undertook to

rehabilitate him by arguing that the case highlighted a lack of cross-cultural understanding and an international financial and regulatory system more adapted to pursuing and controlling corruption than to defending individual rights.[49]

10.7 The Supervision of Islamic Financial Institutions

10.7.1 Prudential Regulation

Left to its own devices, the financial industry is prone to various excesses and types of fraud. These in turn undermine confidence and can shake the economy to its foundations.[50] A central function of the regulators is 'prudential' – making sure that financial institutions operate in a prudent manner. Confidence is instilled by establishing the right safeguards and enforcing strict supervision. A number of monitoring mechanisms – prudential ratios, accounting, auditing and disclosure rules – are available and have far-reaching implications. The sudden liberalization of finance has revealed the predicament of regulators. On the one hand, they are dedicated to a free market and strive to encourage financial dynamism and innovation. But on the other hand, a free-wheeling climate is highly conducive to fraud, in particular to speculative bubbles and 'pyramid' schemes – whereby institutions pay dividends from new deposits, rather than from profits generated by legitimate business operations. In Egypt in the 1980s, billions of dollars 'evaporated' and the fact that the IMMCs operated under the veil of Islam was particularly damaging.[51]

Islamic financial institutions present special problems. Due to the lack of suitable Islamic investments, many banks have been prone to placing their excess liquidity in risky places. Insofar as they do not usually purchase Treasury Bonds, and frequently place their assets overseas, regulators are often unable to properly monitor the bank. Another potential problem has to do with profit-sharing ratios and the bank's relation to its depositors. Typically, 70 per cent of these profits go to depositors and 30 per cent to bank owners, but at times of low profits, banks sometimes choose to subsidize profit distributions to depositors out of the bank owners' share of profits, which is clearly unsustainable in the long run.[52]

10.7.2 The Question of Dual Regulation

Countries having a dual – conventional and Islamic – financial system must contend with a dilemma: should both types of banks be subjected to the same rules and regulations (on capital adequacy ratios, liquidity provisions, depository reserves, accounting and auditing standards, etc.)? And should they be supervised by the same supervisory authorities? Given the current emphasis among international regulators on comprehensive regulation, a

strong case can be made in favour of a single regulator that would be in a position to see the 'big picture' of the financial system. Regulators may not accomplish their mission if a whole segment of the industry is beyond their reach.

Most Islamic banks however favour separate treatment. Their argument can be divided into two parts: a religious argument, based on the belief that religious factors should be paramount; and an economic argument, to the effect that Islamic operations are fundamentally different from conventional ones. It is unfair, in their view, to treat the main Islamic financing techniques – mudaraba, musharaka and murabaha – as conventional loans since many such operations do not constitute lending, but merely financing, or even sales. Also, as they lobby in favour of special treatment, Islamic banks argue that only by being treated separately could they be in a position to develop their identity and in turn create new products.

A related issue is that of discrimination – whether positive or negative. Conventional banks have repeatedly decried the 'special privileges' enjoyed by their Islamic counterparts, which in their view amount to unfair competition. Conversely, at times Islamic institutions have complained about not having the same prerogatives as their conventional competitors. Consider for example the case of Faisal Islamic Bank of Egypt. Created in 1977 by a special law, it was given countless privileges that went far beyond the already considerable advantages provided to foreign investors by 1974 (Law Number 43). The new bank was exempted from foreign exchange controls, corporation regulations, credit control (except for credits in local currency), labour laws and social legislation, and customs duties. Also, for a period of 15 years, it would not be subject to income, corporate or real estate taxes. It was further given ironclad guarantees against nationalization or seizure of deposits. And it was placed above the law since any conflict between the bank and any other party would be resolved solely by the bank's board of directors. Such an array of privileges (some of which were later rescinded) led to accusations that the bank would become a 'state within the state'.[53]

Similar criticisms were levelled at Turkish 'Special Finance Houses'[54] which were, from their inception, subjected to lower reserve requirements than their conventional counterparts.[55] In 1996, during the rule of Islamist Prime Minister Necmettin Erbakan, the six Islamic institutions were given a further boost when their performance bonds were deemed acceptable in state tenders. At the same time however, Islamic institutions were arguing that they were in fact the ones discriminated against. As proof that they were victimized by a political vendetta led by the military-dominated political establishment, they put forth the following evidence: the authorities had made it nearly impossible for them to expand their branch network; an earlier increase in reserve requirements had already slowed down the flow of deposits; and they were more thoroughly inspected by the Treasury and

the Central Bank than the conventional banks.[56] But soon after the Islamic Prime Minister was forced to resign in 1997, new legislation brought Islamic financial institutions under the jurisdiction of the banking law.

Worldwide, the current trend in bank regulation and central banking is towards 'independence', meaning that regulators ought to be technocrats insulated from political pressures. A case can be made that such insulation is more difficult to achieve in the case of Islamic banks, as regulatory considerations are more likely to be overridden by political, and of course religious, considerations. Another issue is that of experience. The regulation of Islamic financial institutions requires an understanding of both Islamic and conventional finance. If anything, the novelty of Islamic financial products calls for greater vigilance, especially as rapid growth and competitive pressures are likely to lead financial institutions to take on greater risks.

Within the Islamic world, the dilemma of dual regulation has generally been resolved in one of two ways: by establishing, within the central bank, a division dealing with Islamic banking, or by coordinating the supervision of the respective banks. Bahrain has chosen the first path: the Bahrain Monetary Authority has its own Shariah advisers who oversee matters of concern to Islamic institutions. In Kuwait, on the other hand, the regulation of Islamic institutions (the International Investor and the Kuwait Finance House) is conducted not by the Central Bank but by the Finance Ministry, although both types of banks are subjected in practice to the same general rules. The Central Bank and the Finance Ministry coordinate their supervision, and there is an implicit understanding that, should the Islamic institutions run into difficulties, they would receive the same kind of support as conventional banks.

10.7.3 Deposit Insurance and the Lender of Last Resort Issue

Another unresolved issue is that of deposit insurance. In most countries, if a bank fails, a government agency, drawing on a special fund, steps in to reimburse depositors. The underlying philosophy is that certain types of deposits and certain groups of people deserve to be protected – in effect insulated from the ups and downs of the economic cycle. In the United States, deposits are insured by the Federal Deposit Insurance Corporation (FDIC), up to $100,000. Customers, in exchange for the protection, accept a lower remuneration. Banks pay a premium and agree to strict controls by the FDIC.

Insofar as Islamic banking is supposed to be primarily based on profit-and-loss sharing, deposit insurance should not normally apply. Depositors are shareholders of sorts, whose fortunes are tied to the institution's fate (or to the fate of the specific investment being financed). Only if the institution (or the investment being financed) makes a profit will they be

entitled to a share of the profit. Potential losses carry a heavy political and economic cost. Typically, the government is likely to step in. No consensus exists among Islamic banks which are caught in a dilemma: the logic of PLS accounts does not lend itself to deposit insurance; yet human psychology is such that depositors want to have it both ways – sharing in the profits and being insured against losses. The absence of a 'fixed, predetermined' interest rate complicates the determination of premiums, and of course such protection has the unfortunate consequence of discouraging the typically Islamic profit-and-loss sharing accounts in favour of conventional demand deposit ones.

In reality, the share of PLS transactions has been very low.[57] On a number of occasions, Islamic banks (and thus indirectly their depositors) had to be rescued, usually as a result of losses on commodities and foreign exchange markets and sometimes as a result of fraud. In most instances, there was one of three outcomes (or a combination thereof): temporary takeover by the Central Bank (it happened temporarily for Egypt's International Islamic Bank for Investment and Development [IIBID]), injection of funds from the government (it happened in 1984 with the Kuwait Finance House), or emergency funds from consortia of Islamic banks, usually led by the Islamic Development Bank (IDB) (it happened with the Dubai Islamic Bank in 1998).

There is everywhere, therefore, at least implicitly, some deposit insurance scheme and a lender of last resort. When South Africa's Islamic Bank Limited was recently liquidated, the South African Reserve Bank announced that, although the country does not have deposit insurance protection, it would compensate all depositors up to 50,000 rand ($11,000) each. The decision was taken 'in the interest of financial stability of the country'. The announcement also stated that '[t]his arrangement should not be seen as creating a precedent'.[58]

Such a caveat was to be a reminder that expecting bail-outs can lead to reckless behaviour – one example of the all-pervasive moral hazard, which extends to many aspects of financial supervision. The concept, which originated in the insurance industry, is that certain rules and practices tend to encourage reckless behaviour. For example, once a business has obtained fire insurance, it may be inclined to reduce its expenditures on fire safeguards and prevention, thus increasing the likelihood of a fire as well as the size of the losses that the insurer may incur.[59] By the same token, insured depositors care little about the financial health of their bank, while unscrupulous financial operators may be invited to gamble with the public's money. For a slightly higher interest rate on insured deposits, a weak or even insolvent financial institution can obtain almost unlimited funds.[60] A similar incentive to engage in risky behaviour occurs when management operates without substantial net worth or stockholder capital. Indeed, US legislation aimed at allowing S&Ls (Savings and Loans) to

diversify their investments beyond financing home purchases, combined with lax supervision and an increase in the insured deposit amounts, turned out to be an invitation to gamble with the insured public's money through real-estate speculation or junk bonds.[61]

By the same token, announcing that the government will be a lender of last resort can encourage risky behaviour. In most instances, there is an implicit 'too big to fail' policy – an unspoken guarantee against failure given to the largest institutions for fear of either run contagion or a gridlock shutdown of the payment or banking system. The predicament of regulators in a free-enterprise system is that they must act as if such a safety net did not exist – or else they would invite customers of small banks to transfer their deposits to largest banks – yet be ready to rescue those institutions whose collapse is likely to trigger a domino effect.[62]

A related question is that of the resources of a central bank in an interest-free setting. Assuming no deposit insurance scheme, where would the resources of the central bank come from? One suggestion was that Islamic Central Bank acquire some equity in the commercial banking sector, giving it access to the resources necessary for it to act as lender of last resort.[63]

10.8 Conclusion

In the early years of Islamic finance, national regulators enjoyed wide autonomy. Islamic regulators could devise rules and practices with minimum interference from the outside world. This chapter has explained why this is no longer the case. Today, they are urged to comply with new international rules, as well as to liberalize and open up their financial sector to foreign competition. Islamic regulators thus face a daunting task to which they are singularly ill-prepared: they must engage in consolidation and reform in the face of considerable obstacles before domestic banks confront the onslaught of foreign competition. As one analyst remarked:

> The terrible truth is that supervisors in developing countries, capable and well intentioned though they may be, typically lack the resources, independence and clout to do their jobs properly. As a result, the banks in their care are often able to expand recklessly, lend carelessly and run themselves unwisely. To make things worse, supervisors sometimes come under pressures to turn a blind eye to the imprudent practices of some bankers.[64]

At a time of harmonization of regulatory practices, the interest-free Islamic regulators have a hard time achieving convergence with interest-based conventional regulators. Interest rates have been an essential (and convenient) tool of regulation and control. By raising or lowering a variety of rates, regulators can influence the money supply and achieve specific

policy goals. In an interest-free system, such a tool cannot in theory be used. Advocates of Islamic banking argue that other tools can be used – such as modifying reserve requirements for banks, injecting liquidity into the system (for example by manipulating surpluses or deficits), or imposing new 'lending ratios' (the proportion of demand deposits that commercial banks are obliged to lend out as interest-free loans) or 'refinance ratios' (the central bank refinancing of a part of the interest-free loans provided by the commercial banks).[65] Original solutions have been offered to deal with issues such as deposit insurance or the ability to be lenders of last resort.[66] It remains to be seen how such schemes can fit with new approaches to bank regulation as promulgated by the Basle Committee, or be 'harmonized' with the prevailing practices of other regulators.

The main problem with one-size-fits-all approaches is that they ignore the fact that different countries have different institutional frameworks and regulatory cultures. To be sure, there are a number of escape clauses,[67] and the makers of the new global norms usually pay lip service to the notion that differences across regulatory systems should be part of rule-making. Clearly, the timetables and expectations of the new global regulations are unrealistic. It remains that, given the firm deadlines associated with the implementation of the 'Core Principles' and the WTO Agreement, and given the various surveillance and enforcement mechanisms discussed earlier, there is little doubt that the new norms – openness and transparency, free flow of capital, internal controls, better informed and more consistent supervision – will define, if not the extent of change, at least its direction. As countries build legal and regulatory infrastructures – especially in regard to nascent stock and financial markets – they will be bound by the new rules.

Notes

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2. Mohammed Ariff (ed.), *Monetary and Fiscal Economics of Islam*, Jeddah: International Centre for Research in Islamic Economics 1982.
3. Ibrahim Warde, 'Financiers flamboyants, contribuables brûlés', *Le Monde diplomatique*, July 1994.
4. Ibrahim Warde, 'Regulatory Cultures', IBPC Working Papers 1998.
5. Itzhak Swary and Barry Topf, *Global Financial Deregulation: Commercial Banking at the Crossroads*, Oxford: Blackwell 1992.
6. Kathleen Day, *S&L Hell: The People and the Politics Behind the $1 Trillion Savings and Loan Scandal*, Norton 1993; Martin Mayer, *The Greatest-Ever Bank Robbery*, Scribner's 1991.
7. *The Economist*, 19 September 1992.
8. John Gerard Ruggie, 'International regimes, transactions, and change: embedded liberalism in the postwar economic order', in Stephen D. Krasner (ed.), *International Regimes*, Cornell University Press 1983.

9. John Zysman, *Governments, Markets and Growth*, Cornell University Press 1983.
10. Susan Strange, *Casino Capitalism*, Manchester University Press 1997.
11. See Chapter 5.
12. Claude E. Barfield (ed.), *International Financial Markets: Harmonization versus Competition*, Washington: The American Enterprise Institute Press 1996.
13. François Chesnais, *La mondialisation financière: Genèse, coût et enjeux*, Paris: Syros 1996.
14. Ibrahim Warde, 'Les remèdes absurdes du Fonds monétaire international', *Le Monde diplomatique*, February 1998.
15. The G7 and the G10 refer respectively to the seven and the 10 most industrialized countries. The G7 should more accurately be called the G8 since it now formally includes Russia.
16. Ethan B. Kapstein, *Governing the Global Economy: International Finance and the State*, Harvard University Press 1994.
17. In 1998, its chairman was Paul Volcker, the former Chairman of the Federal Reserve Board, and its members included prominent international regulators (including Andrew D. Crockett, General Manager of the Bank for International Settlements, Jean-Claude Trichet, Governor of the Banque de France, and Jacob A. Frenkel, Governor of the Bank of Israel), major financial firms (such as Morgan Stanley, Merrill Lynch and Dresdner Bank) and leading economists (such as Princeton's Peter Kenen and the Massachusetts Institute of Technology's Paul Krugman).
18. Based on a variety of Group of Thirty publications, and on information from its website.
19. It was initially created upon the adoption of the Young Plan, which was designed to settle the problem of German reparations after World War I, at the Hague Agreements of 20 January 1930. Initially, it was owned by six European central banks and an American financial institution. The United States, although an active participant, did not formally become a shareholder until 1994. The history of the bank has left it many quirks: although owned by central banks, its shares are trades on stock exchanges in Paris and Zurich; its also has its own 'currency', the gold franc.
20. Miroslava Filipovic, *Governments, Banks and Global Capital: Securities Markets in Global Politics*, Aldershot: Ashgate 1997, p. 175.
21. Based on publications, press releases and the website of the Bank for International Settlements.
22. The Atlanta (Georgia) branch of the Banca Nazionale del Lavoro had made illegal loans to the Iraqi government.
23. Raj K. Bhala, *Foreign Bank Regulation after BCCI*, Durham, N.C.: Carolina Academic Press 1994.
24. Filipovic, p. 180.
25. John D. Wagster, 'Impact of the 1988 Basle Accord on International Banks', *Journal of Finance*, September 1996.
26. *Global Finance*, November 1992.
27. Ibrahim Warde, *The Regulation of Foreign Banking in the United States*, San Francisco: IBPC 1998.
28. Basle Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards', Basle 1988.
29. Kevin Phillips, *Arrogant Capital: Washington, Wall Street and the Frustration of American Politics*, Boston: Little Brown 1995, pp. 121–8.
30. The Group of Thirty, 'Global Institutions, National Supervision and Systemic Risk', Washington 1997.

31. John C. Braddock, *Derivatives Demystified: Using Structured Financial Products*, New York: Wiley 1997; Lillian Chew, *Managing Derivative Risks: The Use and Abuse of Leverage*, New York: Wiley 1996.
32. The Basle Committee on Bank Supervision, 'Amendment to the Capital Accord to Incorporate Market Risks', Basle 1996.
33. Ibrahim Warde, 'LTCM, un fonds au-dessus de tout soupçon', *Le Monde diplomatique*, November 1998.
34. David Fairlamb, 'Beyond capital adequacy', *Institutional Investor*, August 1997.
35. *The Wall Street Journal*, 15 December 1997.
36. *Far Eastern Economic Review*, 2 October 1997.
37. *Financial Times*, 15 December 1998.
38. *Far Eastern Economic Review*, 2 October 1997.
39. The countries outside the G10 are Chile, China, the Czech Republic, Mexico, Russia and Thailand, Argentina, Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore.
40. *The Wall Street Journal*, 10 December 1997.
41. See Chapter 7.
42. Chibli Mallat, *Islamic Law and Finance*, London: Graham and Trotman 1988.
43. *Financial Times*, 28 November 1995.
44. *Financial Times*, 3–4 April 1993.
45. Chapter 3.
46. Nabil A. Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, gharar and Islamic banking*, Cambridge University Press 1986.
47. The 'know-your-customer' rule is primarily designed to make sure that the bank is not a conduit for illicit funds, such as those obtained from money laundering. Banks are expected to report suspicious transactions to regulators.
48. Ibrahim Warde, *Foreign Banking in the United States*, San Francisco: IBPC 1999.
49. *Financial Times*, 10 January 1995.
50. See the episodes described in James Grant, *Money of the Mind: Borrowing and Lending in America from the Civil War to Michael Milken*, New York: Farrar, Straus Giroux 1992, and John Kenneth Galbraith, *A Short History of Financial Euphoria*, New York: Viking 1990.
51. See Chapter 4.
52. Frank E. Vogel and Samuel L. Hayes III, *Islamic Law and Finance: Religion, Risk, and Return*, The Hague: Kluwer Law International 1998, p. 8.
53. Michel Galloux, *Finance islamique et pouvoir politique: le cas de l'Egypte moderne*, Paris: Presses universitaires de France 1997, p. 57.
54. Turkish legislation did not allow the use of the word Islamic in either the name of the financial institution or the description of their operations.
55. Conventional banks must keep 8 per cent of all deposits and 11 per cent of all foreign exchange with the Central Bank. Islamic houses must keep 10 per cent of their current accounts held before June 1994 in cash and another 10 per cent with the Central Bank, among other requirements. *The Wall Street Journal*, 8 January 1998.
56. *The Wall Street Journal*, 8 January 1998.
57. See Chapter 7.
58. Agence France-Presse, 21 November 1997.
59. Kenneth E. Scott and Barry R. Weingast, *Banking Reform: Economic Propellants, Political Impediments*, Stanford: Hoover Institution Press 1992, p. 2.
60. Scott and Weingast, p. 3.
61. Michael Lewis, *Liar's Poker: Rising Through the Wreckage on Wall Street*, 1989, p. 218.
62. Scott and Weingast, pp. 8–9.

63. Mohammed Uzair, 'Central banking operations in an interest-free banking system', in Mohammed Ariff (ed.), *Monetary and Fiscal Economics of Islam*, Jeddah: International Centre for Research in Islamic Economics, 1982.
64. Fairlamb, August 1997.
65. See Mohammed Ariff (ed.), *Monetary and Fiscal Economics of Islam*, Jeddah: International Centre for Research in Islamic Economics, 1982, especially Mohammed Ariff, 'Monetary policy in an interest-free Islamic economy – nature and scope'; Mohammed Uzair, 'Central banking operations in an interest-free banking system'; and Mohammed Siddiqi, 'Islamic approaches to money, banking and monetary policy: A review'.
66. Uzair, 'Central banking operations …', in Ariff (ed.).
67. Article 21 of the World Trade Agreement (WTO), for example, allows members to take trade actions to protect their 'essential security interests'.

11

ISLAMIC FINANCE AND POLITICS: GUILT BY ASSOCIATION

Any sweeping generalization about political Islam is likely to be misleading, if not downright wrong. Different, contradictory strands have co-existed at all times. One can find numerous examples of Islam as an ideology of protest against social injustice and a means to defend the rights of the disinherited and oppressed, or of Islam as the religion of the establishment, used to justify the status quo, or as an entirely non-political ideology.

A complicating factor is that relationships between religion and politics are fluid, dynamic, and dependent on contingent factors as well as external events. While it is easy to think of a government's relations with Islamist groups in terms of simple dichotomies – opposition/loyalism, co-optation/repression, etc. – the reality is more complex. Governments often apply successively, and sometimes simultaneously, contradictory policies. At times, governments fight Islam with Islam, co-opting Islamist groups as a way of keeping them under control. A complicating factor is that such policies often backfire. When the otherwise secular Zulficar Ali Bhutto tried to exploit Islam, he became all the more vulnerable to Islamic opposition groups and their charges of hypocrisy.[1] Similarly, Anwar Sadat carefully cultivated his image of 'believer-president' and patron of Islam. In conjunction with his overtures towards the Muslim Brothers, he amended Article 2 of the Constitution in 1971 and then again in 1980 – at a time when he was aggressively fighting Islamic fundamentalists – to proclaim that 'the Islamic Shariah is the principal source of the Constitution'. This did not prevent extremist groups from launching a 'jihad' against him, and from assassinating him in 1981.[2]

Opinions differ as to the political impact of Islamic finance. Some see in it a 'democratizing' and a 'moderating' factor, arguing that by legitimating certain forms of modern business, it may strengthen civil society against the arbitrary rule.[3] In the words of Clement Henry:

> While Islamic bankers do not necessarily share any commitment to Western-style liberalism or democracy, their drive for markets and profits may indirectly contribute to a more competitive politics. Their economic success sets the stage for greater democracy by encouraging popular participation in financial activities, by shifting the

> political weight within popular Islamist movements in favor of 'responsible' business elements ready to coexist with the capitalist order, and by accumulating finance capital, helping to consolidate the structural power of the commercial banking system and the autonomy of the private business sector.'[4]

As noted earlier, banks, by virtue of being part of the existing power structure, have a strong status quo orientation. There are however exceptions to that general rule. And as the next pages show, the benign view is not widely shared among authoritarian leaders who often see financial Islam as a destabilizing force.

This chapter addresses the connection between Islamic finance and politics in domestic and international contexts. Following a general discussion of the relation of money and politics, it compares the evolution of financial Islam in Saudi Arabia, Iran, Turkey, Egypt, the Sudan and Indonesia. It later discusses the role of Islamic finance in the New World Order, arguing that Islamic financial institutions are all too often 'guilty by association'.

11.1 Business, Finance and Politics

The connection between money and politics is well-established. One can think of the old saying that 'money is the sinew of war', or of California politician Jesse Unruh's famous dictum that 'money is the mother's milk of politics', or of the advice given by mysterious informant 'Deep Throat' to the journalists investigating the Watergate affair: 'Follow the money'. No wonder Islamic financial institutions have on occasion been suspected of having a political agenda, domestically – working to establish a fundamentalist Islamic regime – or internationally – financing or serving as a conduit for 'international Islamic terrorism', or even for the development of an 'Islamic bomb'.

Such claims, casually if sometimes hysterically made, have seldom been subjected to systematic scrutiny. It is important to distinguish what has been inadvertent from what was intended, and what is exceptional from what is the norm. Thus, it is probably true that the Islamic banks of the Sudan facilitated the advent of an Islamic state in that country. The significant issues are, first, whether it was the intended outcome of the creation of the Faisal Islamic Bank, and second, whether such a scenario is likely to be replicated elsewhere.

Also, on occasion, Islamic financial institutions have been suspected of involvement in subversive activities. The most frequently cited example is that of the 'Afghan warriors'. Generously funded by Saudi Arabia and trained and organized by the US Central Intelligence Agency (CIA), a number of volunteers from Islamic countries fought, along with Afghan Mujahideen, the Soviet forces in Afghanistan throughout the 1980s. The

support was part and parcel of the Saudi effort to promote Islam worldwide by funnelling aid, sometimes via Islamic banking networks, to a wide variety of Islamist groups, some of which turned out to be, or became, radical and subversive.

Helping the Mujahideen was part of the US-led effort to overthrow the Communist regime of Kabul. Both Saudi Arabia and Pakistan, two 'fundamentalist' yet pro-US countries, played an active part in that effort. Unwittingly, the resistance movement sowed the seeds of a transnational anti-US and anti-Saudi political movement. Indeed, with the Soviet withdrawal, some of the non-Afghan Islamic volunteers – the so-called 'Afghan Arabs' – found themselves in the position of hardened rebels without a cause, and ended up involved in a number of terrorist actions. The irony of course is that such attacks, which include anti-tourist attacks in Egypt, the bombing of the World Trade Center in New York in 1993, the Khobar Attack on US Marine barracks in Saudi Arabia in 1996, and the bombings of the American embassies in Nairobi and Dar es-Salam in 1998, were aimed at the terrorists' former patrons. Saudi Arabia belatedly discovered that indiscriminate religious proselytizing could on occasion backfire, and has since modified its policy.

11.2 Domestic Politics: The Power of Islamic Business and Finance

Are Islamic financial institutions part of an Islamic 'civil society' working to de-legitimize governments? Are Islamists in business and finance bankrolling subversive activities? Are they tied to, or are they used by, radical groups? In every country, the answers to these questions are different. This section considers the political aspects of Islamic finance and the ties between Islamic financial institutions and political movements in Saudi Arabia, Turkey, Iran, Egypt, the Sudan and Indonesia.

11.2.1 Saudi Arabia: Islamic Finance and the Possible Delegitimation of the State

Saudi Arabia is justifiably preoccupied by any challenge to its religious legitimacy. As the birthplace of Islam and as a country whose king requested in 1986 to be identified as the 'Custodian of the Holy Shrines' (Khadim al-Haramayn al-Sharifayn), it has been vulnerable to criticisms expressed over the years about the compatibility of its policies with Islamic ideals.[5] The ruling family was stunned when, in late 1979, the Great Mosque of Mecca was seized, for a few weeks, by Muslim fundamentalists. Underground opposition groups have since grown increasingly visible and vocal, calling for the overthrow of a regime accused of squandering the oil wealth, being too closely aligned with the United States and the West, allowing (since the

Gulf crisis of 1990) the stationing of foreign troops on its territory, and more generally of being un-Islamic.

The ruling family's legitimacy is based on its Islamic credentials but the management of the economy and the banking system are based on Western practices. One can therefore understand why the Saudi Arabian regime is so touchy on the subject of Islamic banking. The government plays up the fact that the inter-governmental Islamic Development Bank is headquartered in Jeddah, yet the two largest Islamic banking groups, Dar Al-Maal Al-Islami and Dallah Al-Baraka, both owned by prominent Saudis, cannot obtain licences to operate commercial banks in the kingdom. And when the Al-Rajhi Banking and Investment Company was authorized in 1985 to engage in interest-free banking, it was on the condition that it did not use the word Islamic in its name.[6]

Saudi Arabia does not recognize the concept of Islamic banking. The logic is that if one bank is recognized as an Islamic institution then all others, by implication, would be un-Islamic. The official line is that all banks operating in Saudi Arabia are by definition Islamic. In addition, the country's vast bank deposits and foreign holdings generate substantial interest income, and thus the Saudi authorities tread carefully around the issue of riba.[7] Saudi banks for example report interest income as 'special commission income', as 'service charges' or as 'book-keeping fees'.[8]

11.2.2 Turkey: the 'Dangerous Relationships' between 'Finance Houses' and Islamic Fundamentalists

Alone among Islamic countries, Turkey has since 1924 adopted a staunchly secular political system. Despite strict rules against the political use of religion, Islamist groups have in recent years become increasingly visible. In 1996, for the first time in its history, Turkey had an Islamist prime minister. Necmettin Erbakan, leader of the Refah (or Welfare) party, ruled for less than a year.[9] Throughout his long political career, Erbakan had advocated such measures as outlawing interest rates and replacing the Turkish lira with a vaguely defined 'Islamic dinar'. Yet as Prime Minister, he proved quite pragmatic. He was nonetheless forced to resign in 1997 under pressure from the military-dominated National Security Council, Turkey's highest decision-making body, which considered itself the guardian of Ataturk's ideal of secularization. The new government has since engaged in a crackdown on all forms of Islamism, particularly in business and finance.

Although certain segments of the business community have at certain times and in certain areas been associated with Islamic militancy,[10] the Islamicization of business is a rather recent phenomenon. Ironically, Islamic finance had officially come to Turkey during the very secular Ozal years in the early 1980s.[11] At a time when the need for cash was pressing and

the Islamist danger appeared remote, Turkey welcomed investments from oil-rich states and their citizens. Islamic institutions, under the name of 'Special Finance Houses', and with capital from Saudi Arabia and Kuwait, were given special privileges.

The election of a Welfare party mayor in Istanbul marked a turning point. Small engineering, service and contracting concerns which stressed their Islamic character won the business of the city. Islamic business networks grew bigger and more assertive.[12] In 1996, with the advent of an Islamist-led government, secularist groups led by the military launched an unrelenting campaign accusing the government and its allies of trying to establish an Islamic state. In the all-out war against Islamist groups, business and financial groups were a central target. By certain estimates, Islamic companies held $2.5 billion in investments in Turkey in textiles, media, chemicals, automobiles, food, tourism and transportation. The Islamist Independent Businessmen's and Industrialists' Association, also known as Musiad, founded in 1990, had 3,000 members by 1997, most of them small or medium businesses based in the Anatolian heartland. Military spokesmen alleged that 100 major businessmen controlling 1,000 companies were financing fundamentalists, undermining the 'regime' and 'planning to buy privatized companies'. Six of the businessmen were said to be worth more than $700 million each. Kombassan, a 35-company provincial cooperative that has grown rapidly on promises of a better-than-25 per cent return on investments, saw its bank accounts frozen. Hasim Bayram, the head of the cooperative, responding to accusations that he was running a pyramid scheme, declared: 'This is not about ideology. It's political. This is about the old system, and old monopolistic capital, keeping the others out.'[13] As for the Finance Houses, they were accused of having 'a dangerous relationship' with the Islamists.[14]

The subsequent crackdown on Islamism included banning the Welfare party, increasing penalties against the opponents of secularism, establishing new bodies in every province to guard against Islamic fundamentalism, and stepping up government control over schools. The army issued a blacklist of 100 prominent capitalists associated with Islamist groups, and all 3,000 members of Musiad. Islamic companies were subjected to harassment and punitive audits. Corporations identified as contributing to Islamic causes were prevented from receiving public contracts or subsidies, and new legislation brought the Special Finance Houses under stricter control and eliminated their special privileges.[15]

11.2.3 Iran: The Historical Ties between the Bazaar and the Ulema

In Iran, the business community has long-standing ties to the clergy. The alliance of the Bazaar (literally, the marketplace, a reference to the traditional merchants) and the ulema goes back to the nineteenth century.

Both groups were allied against the Qajar monarchy which they accused of being a puppet of foreign powers. When in 1890 the Shah granted a British company a monopoly over the sale and export of tobacco, a nationwide boycott and strikes ensued, led in large part by merchants and clerics. The formative events of the development of Iranian nationalism, the Tobacco Protest (1891–2) and the Constitutional Revolution (1905–11) consolidated the alliance of Bazaaris and ulemas. The symbiosis was based on a mutually beneficial alliance: the clergy could afford its political autonomy thanks in large part to the zakat paid directly to them by the merchants; mosques and shrines located close to the Bazaar provided refuge for individuals and groups that feared governmental arrest or harassment.[16]

Such ties persisted over time, and in the years preceding the Islamic revolution, the Bazaaris proved to be among the most effective opponents of the Shah. Economic factors – in addition to religious and other grievances – again figured prominently in this alliance. The land reform, which was a part of the Shah's White Revolution in the early sixties, deprived the clergy of substantial land holdings. And the Bazaaris saw a steady erosion, in relative terms, of their economic power. While they benefited from the oil boom of 1973–4, they felt marginalized in an economy increasingly dominated by foreign investors, the immediate entourage of the Shah and a 'new class' of secular and pro-Western entrepreneurs and professionals.

Soon after the Islamic revolution, the clergy became an economic force in its own right. The new regime nationalized large segments of the economy, including banks. But the religious establishment also controlled a number of 'foundations', the most important of which – the Bonyad-e Mostazafan (Foundation of the Oppressed) – was established with funds confiscated from the Shah's family and entourage. Although ostensibly created to help the poor, it was also a massive business enterprise – in fact Iran's largest holding company – controlling some 1,200 firms worth hundreds of millions of dollars.[17]

11.2.4 Egypt: The Tensions between Secularism and Islamism

The Egyptian case is in one way unique: it is one of few Islamic countries where the top religious establishment has approved of interest-based lending.[18] Yet from the standpoint of government suspicions about Islamic finance, the country is quite typical: the government worries about the potential of the Islamic sector, despite its heterogeneous and decentralized nature,[19] to destabilize the state.

Faisal Islamic Bank of Egypt (FIBE), the largest financial institution, represents the dominant model. From its inception, it strove for inclusiveness and political respectability. Prince Mohammed al-Faisal al-Saud attempted to include among the bank's founders and shareholders the widest possible array of political, economic and religious figures, ranging

from Prime Minister Abd al-Aziz Hijazi (who later became a leading proselytizer of Islamic economics), to the most prominent infitah businessman, Uthman Ahmed Uthman, to leading Islamist figure Tawfiq Mohammed al-Shawi. Most revealing were Prince Mohammed's efforts to include the Waqf ministry among the shareholders.[20]

The greatest political clash occurred with Islamic Money Management Companies (IMMCs).[21] Unlike the Islamic banks, they were unregulated entities working outside of the official channels and thus escaped government control. Most serious analyses of the phenomenon show that with very few exceptions, the IMMCs, just like other Islamic financial institutions, shied away from partisan politics. One notable exception was Al-Sharif, the oldest IMMC, whose owner had ties to the Muslim Brothers.[22] The Muslim Brothers also controlled Al-Taqwa ('Piety'), a bank registered in the Bahamas, but which was denied permission in 1988 to operate as a commercial bank in Egypt.[23] The IMMCs were nonetheless repeatedly accused by the government, particularly during the 1987 elections (which saw a strong showing of the alliance between the Wafd party and the Muslim Brothers), of political meddling. Their meteoric growth caused concern. Not only did they have the resources to influence the electoral outcome, but the dynamic they had created and the symbolism they were using were considered dangerous. The advertising slogan of the Al-Rayyan group, the largest IMMC – 'the blessings behind success' ('al-baraka wara al-najah' – see Chapter 8) – was a subtle reminder of the rallying cry of the Muslim Brothers and other Islamist groups ('Islam is the solution').

Authoritarian governments tend, usually for good reason, to have a nagging suspicion that agitation is occurring underground, and that it has the potential to turn into a groundswell. The operative word is potential. The vast network of private voluntary organizations, given its size and resources has the potential to challenge the state. In Egypt, low-cost clinics and social-welfare centres have been providing essential services to areas that have been all but abandoned by the government. The Islamic 'civil society' was in a position to challenge the government to reform itself and open itself to greater democratization.[24]

The paranoia was fed by selective evidence. Thus the name of Sheikh Omar Abdul-Rahman, the spiritual adviser of Tanzim al-Jihad – the group accused of assassinating Anwar Sadat – and alleged mastermind of the 1993 World Trade Center bombing, has surfaced on a couple of occasions. He had been employed by one of the IMMCs as a middleman in a major business deal.[25] He was also one of the dozens of nominal 'founders' of the Faisal Islamic Bank of Egypt.[26] Such 'evidence' of course proves nothing other than the need for financial institutions to surround themselves with religious figures as a means of asserting their religious legitimacy. Yet as the following pages will show, such isolated facts are on occasion dredged up to 'prove' that Islamic financial institutions have ulterior political motives.

11.2.5 The Sudan: Islamicization of Politics, Politicization of Finance

When the Faisal Islamic Bank was licensed by President Nimeiri in 1978, it was under circumstances very similar to the licensing of the Faisal Islamic Bank of Egypt. In both countries, the bank obtained significant tax and regulatory breaks. But the evolution of the Sudanese bank was driven by the country's political and economic context. It quickly became the second largest bank, and developed close ties with Hassan al-Turabi (who had previously spent a number of years in exile in Saudi Arabia) and his National Islamic Front (NIF), playing a key role in promoting Islamic businesses and Islamic causes. By certain accounts, 'Turabi virtually controlled the bank'.[27]

The Islamicization of the entire banking sector in December 1983 further upset the country's delicate political, economic and religious balance.[28] The Khatmiyya, a sufi sect which, since colonial rule, had enjoyed considerable power among petty traders, was increasingly displaced economically and politically by the Muslim Brothers. According to one analysis,

> The investment pattern [of Islamic banks] encouraged the growth of small and medium sized businesses, and has effectively ensured support for the Muslim Brothers from the middle and lower strata of urban entrepreneurs. This has led to conflict with the traditional export-import merchants, mostly linked to the Khatmiyya order, who had previously dominated this sector and whose members have little access to Islamic bank financing.[29]

Both under Nimeiri and under his successors, tremendous economic privileges were enjoyed by the Muslim Brothers, and businessmen close to them. They benefited from preferential allocations of bank loans, customs exemptions, and foreign currency for imports. They were the main beneficiaries of the privatization programmes, and were given advance notice of currency devaluations.[30] Members of the Khatmiyya, unable to obtain bank loans, resorted to trading foreign currency to maintain their business operations. The government crackdown on 'black market' currency traders (which included the death penalty for offenders) was justified by the need to curb inflation, but it was also interpreted as a way of maintaining the Islamic banks' (and by implication the Muslim Brothers') monopoly on commercial lending.[31]

In a bid to regain their monopoly of the country's retail trade and financial system, the Khatmiyya established the Sudanese Islamic Bank in 1982. But Nimeiri used both his ties to Saudi financiers and the domestic support of the Muslim Brothers to reconfigure the economy. By 1983, the Muslim Brothers were among Nimeiri's few remaining supporters[32] and his decision to Islamicize the financial system was designed to benefit them.[33]

One of the consequences of the Islamicization of finance was a forced Islamicization of economic, political and social life. Indeed, an aspiring

businessman, to qualify for an Islamic bank loan, had to provide references from an already established businessman with a good record of support for the Muslim Brothers. 'This has led to almost comic attempts on the part of many in the urban marketplace to assume the physical as well as religious and political guise of Islamists'.[34] In sum, the Muslim Brothers initially obtained economic privileges for political reasons. This allowed them to become a state within the state, and in due course to overtake the state.

11.2.6 Indonesia: Co-optation and Pre-emption

It had long been assumed that Indonesia would not be hospitable to Islamic finance.[35] Although the country is inhabited by some 190 million Muslims (who account for some 90 per cent of the population), it had a strong secular and multi-ethnic tradition. Full-scale Islamicization did not occur until the fifteenth century. The Indonesian brand of Islam, introduced primarily by merchants and imbued with sufi influences, blended easily with local traditions and customs. Due to their somewhat diluted and syncretic beliefs and to the low level of religious practice, Indonesians have often been referred to as 'nominal Muslims'. In the political and economic system, the *primubis* (the ethnic or 'native' Indonesians, most of them Muslims) historically played a marginal role.[36] Since the days of the Dutch occupation (1678–1942), economic power has belonged to the Chinese. To this day, although the Chinese constitute only about 3 per cent of the population, they own most of the leading conglomerates, and have maintained such close ties with the Suharto family that Indonesia has come to epitomize 'crony capitalism'.[37] Comparable in numbers, the Indonesian Christians have been disproportionately represented in the government and the military.

The delicate ethnic, religious, political and economic balance was maintained through a system of 'religious secularism'. The Indonesian constitution affirms the belief in 'One, Supreme Divinity' as the first of its 'five principles' (*pancasila*) but it does not mention Islam or even Allah.[38] The system whose motto is 'unity through diversity' emphasizes the importance of consensus (*mufakat*), which is also used as a justification for authoritarianism.

For most of the rule of President Suharto (1965—98), neither the Islamic religion nor its leaders played any significant political role. But with the rise of Islamist opposition, Suharto started courting religious leaders and made openings to the more devout segment of the population. He gave his blessing to the creation of the Association of Moslem Intellectuals (ICMI), an influential grooming ground for leaders, founded by B. J. Habibie (who became in 1998 Suharto's successor). The government relaxed restrictions on Islamic dress. The Suharto family made a widely publicized pilgrimage to Mecca. Islamist groups such as Nahdathul Ulama and the Muhammadiyah,

both partisans of a moderate and non-political Islam, and focusing instead on the expression of religious faith through social programmes, education and moral guidance were increasingly co-opted, in part as a way of undercutting extremist groups. A number of Christian figures in the army and in government were replaced by Muslims.[39]

Thus Suharto became a patron of Islamic banking. Soon after the Indonesian Ulemas Council (MUI), the country's highest Muslim authority, resolved in August 1990 that an interest-free banking system should be established, it was the Amal Bhakti Muslim Pancasila Foundation (of which Suharto was chairman) which gave the MUI an interest-free loan of Rp3 billion; this was as a deposit to establish Bank Muamalat Indonesia (BMI) and support its banking licence application. Suharto also offered the presidential palace in Bogor in West Java as a venue for the sale of shares to the public. When the bank opened in 1992, it had shareholder commitments totalling Rp106 billion, an amount exceeding the paid-up capital of any Indonesian bank at the time. BMI was also to become the catalyst in the development of an Islamic financial sector. And indeed, soon afterwards, a number of rural Islamic banks and credit cooperatives were established. In 1994, together with the MUI and the Association of Indonesian Muslim Intellectuals, the bank launched the country's first Islamic insurance company, Syarikat Takaful.

The name Muamalat comes from the Arabic word *amal* ('work'), connoting the performance of good deeds. True to the country's developmental orientation, BMI's mission was to help the government in the process of national economic development, particularly in relation to small- and medium-scale entrepreneurship. Interestingly however, BMI's articles of association do not limit its shareholders to Muslims, and a significant segment of its clientele consists of non-Muslims.[40]

11.3 Islamic Finance and International Politics

A recent book about Islam and the West suggested that the principal purpose of Islamic banks was to fund terrorism.[41] Such perceptions are not uncommon, even among bankers[42] and policy-makers. Indeed, Islamic bankers have found themselves in the crossfire of the 'war against terrorism' that started a few years ago. Before dealing with this issue, a digression into the 'Islamic threat' and the 'New World Order' is necessary.

11.3.1 'The Islamic Threat' and the New World Order

Fears over global Islam started with the Iranian revolution, and were later greatly amplified with the demise of Communism and the search for a new enemy. John Esposito offers a useful summary of the Western mindset in the wake of the revolution:

> Amid the hysteria of the postrevolutionary period, assessing the Iranian threat, separating fact from fiction, proved difficult if not impossible for the West and its allies. The shock of a revolution which had made the unthinkable a reality resulted in an overcompensation that saw both Iranian domestic politics and foreign policy through the lenses of Islamic radicalism and extremism.'[43]

The collapse of Communism made things worse. In January 1991, columnist William Pfaff wrote: 'There are a good many people who think that the war between communism and the West is about to be replaced by a war between the West and Muslims.'[44] Indeed, the 'threat vacuum' made Islam the most likely candidate for 'global enemy'. Shortly after the fall of the Berlin Wall, columnist Charles Krauthammer had warned of an 'unnoticed but just as portentous global intifada … an uprising spanning the Islamic world'.[45] Islam was all the more threatening in that most influential pundits and academics posited a fundamental incompatibility between Islam and Western values. Thus, Amos Perlmutter, a professor at Washington's American University, wrote: 'There is no spirit of reconciliation between Islamic fundamentalism and the modern world – that is, the Christian-secular universe.'[46]

The theme of Islam as new global enemy soon dominated foreign policy thinking.[47] The influential journal *Foreign Affairs,* published by the Council on Foreign Relations, carried a debate: 'Is Islam a Threat?' (Judith Miller answered 'yes', Leon Hadar answered 'no').[48] The debate was given, if not theoretical and historical depth, at least academic cachet when Harvard University's Samuel Huntington wrote his famous *Foreign Affairs* article, 'The Clash of Civilizations?', which argued that future conflicts would break out along civilizational lines, with Islam and Confucianism epitomizing those 'civilizations' that were inherently hostile to Western values. According to the journal's editors, the article generated more discussion than any article since George Kennan's 1947 piece 'The Sources of Soviet Conduct'. Writing under the by-line 'X', Kennan had provided the intellectual foundation for the containment policy, which dominated foreign policy thinking throughout the cold war. For many, 'The Clash of Civilizations?' would do the same for the post-cold-war era.

Huntington later expanded the article into a book, which was more thoughtful and more nuanced, yet in the policy debate the appealing sound bite remained: it is all about 'the West against the rest'.[49] In its simplicity, the thesis was appealing to foreign policy experts who since the end of Communism had been frantically looking for a new foreign policy doctrine. A few fringe Islamist groups who have 'declared a jihad' against the United States or the West suddenly became a threat comparable to that posed by Soviet Communism during the cold war… Playing up the threat was convenient to intelligence agencies and other organizations who needed to justify their funding, indeed their existence. In April 1995, the

director of the Central Intelligence Agency (CIA) testified that Islamic terrorism posed the 'single greatest threat' to American interests.[50] In the same way that countries played the anti-Communist card to obtain US aid, many governments in the Islamic world had an interest in exaggerating the threat posed by 'fundamentalist' groups. The 'threat' made good copy and was taken up, as earlier quotes have shown, by journalists who were quick to relay, and even amplify it, and 'experts', many of whom made a career out of 'explaining' its roots.

The scenario of an 'Islamic Internationale', a 'Khomintern', or a 'Tehran–Khartoum' axis has since become a fixture of the foreign policy debate. Kevin Phillips, publisher of the *American Political Report*, sees a 'minaret curtain' replacing the 'iron curtain'. He argues that the West is on 'five distinct collision courses with Islam':

> The explosive Muslim immigrant ghettos could disrupt half the major cities in Europe; US troops have been put in the line of ancient hatreds in Bosnia; war threats in the biblical lands smack of fire drills for Armageddon; the suppression of oil prices to 25-year lows strikes at Muslim economies from Nigeria to Indonesia; and financial colonialism is a provocation.

Borrowing another theme from Huntington, that of an Islamic–Sinic alliance uniting non-Western civilizations, Phillips builds an ominous scenario:

> China, the other demographic Goliath, has been a frequent ally in areas such as nuclear nonproliferation, and the two cultures make a good fit: Chinese commercial skills with the fervent radicalism of the Muslims. Together, the two groups are predicted to have 30 percent of the world's population in 2010, with just 12 percent for the West. Compare that to 1920, when the West had 48 percent and the Sino-Muslim nations 20 percent.'[51]

Such analyses are founded on a number of dubious yet oft-repeated axioms: Islam is a monolith and all Muslims are united in action; and all Islamists, perhaps even all Muslims, are at heart radical and anti-Western. As has been shown throughout this book, Islam is extremely diverse and fragmented. To be sure, there are a number of pan-Islamic organizations whose rhetoric emphasizes cooperation if not unity. Most are in fact allies of the United States. In addition to groups such as the Organization of the Islamic Conference (OIC) or the Arab League, there are a number of sub-groupings onto which superficial observers find it is easy to project unity of purpose and action. In 1997, an initiative by the Prime Minister of Turkey, Necmettin Erbakan, designed to fight poverty and establish a 'just world order', led to the first meeting of the 'Developing 8' – Turkey, Pakistan, Indonesia, Iran, Bangladesh, Egypt, Malaysia and Nigeria; countries with

little in common, other than their Islamic character. From the outset, representatives disagreed on all major issues, reflecting variations in ideology, global outlook and economic priorities, yet the meeting ended with the requisite pledge of cooperation in several economic fields, including industrial development, research, banking and agriculture.[52] Similarly, a meeting of the newly formed 10-country Organization of Economic Cooperation (OEC) brought together representatives from Turkey, Iran, Pakistan, Azerbaijan, Afghanistan, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan.[53] Pledges of economic cooperation were overshadowed by deep political differences. Perhaps more striking were the religious differences between the Iranian leaders and the Afghanistan's Talibans. The two countries, both claiming a return to true Islam, were in 1998 on the brink of war and engaged in the familiar process of mutual excommunication.

Even less significant yet more worrisome in the eyes of the proponents of a 'global Islamic threat' are the periodic meetings of radical and anti-Western groups from the Islamic world. One such meeting in Khartoum in April 1995 brought together 300 delegations from 80 countries. Fiery denunciations of the West and calls for a holy war are mostly posturing, empty rhetoric and inconsequential palaver, yet they receive wide coverage and become positive proof of the existence of a grand Islamic conspiracy. In many respects, the Western paranoia about global Islam mirrors the conspiracy mindset within the Islamic world. In his book *The Hidden Hand: Middle East Fears of Conspiracy*, Daniel Pipes argues that conspiracy theories have five basic assumptions in common: 'conspiracies drive history, everyone seeks power, benefit indicates control, coincidences don't happen, and appearances deceive'.[54] Edward Said has observed that '[t]he Islamic threat is made to seem disproportionately fearsome, lending support to the thesis (which is an interesting parallel to anti-Semitic paranoia) that there is a worldwide conspiracy behind every explosion'.[55] Yet a belief that any action is part of a big and sinister plot breeds suspicion, and, as noted by Pipes, 'acting on [such] beliefs then alters the course of events. Ironically, fears of conspiracy also directly lead to the proliferation of actual conspiracies'.[56] Designating, as President Clinton did in 1998, Usama bin Laden as 'America's public enemy number one' no doubt reinforced both bin Laden's stature within radical Islamist groups and his commitment to a 'jihad' against the United States.

Hostility to Islam in the West is also fed by the feeling that the 'enemy' is deeply 'infiltrated', and that political, indeed terrorist, movements hide behind the facade of religion. It is not rare to find newspaper headlines claiming that 'terrorists use US to fund attacks' or that 'America is a home away from home for terrorists', or articles arguing that 'the nation is the enemy as well as an international cash cow [terrorists] can milk for various operations', that 'there are many ways – from charity to crime – in which this country has become a cash cow for terror', or that 'America has long

been the immigrant's golden land and today, terrorists are exploiting that gold to finance their operations around the world'.[57]

Anti-Islamic punditry has become something of a cottage industry. Steven Emerson, who bills himself as 'an expert on militant Islam', gained fame when, soon after the Oklahoma City bombing, he rushed to insist that only Muslims could be the perpetrators of the worst act of terrorism in American history. He said that Oklahoma City was a 'natural' target because of the number of mosques in and around the area and that the bombing was 'done with the intent to inflict as many casualties as possible. That is a Mid-Eastern trait'.[58] (The perpetrator turned out to be Timothy McVeigh, an American with ties to white supremacist militias.) Similarly, in a plea to 'stop aid and comfort for agents of terror', Emerson claimed that Hamas 'operate[d] an extensive network of front groups, from San Diego to Houston to New York City, under religious, charitable and human-rights monikers'. He cited a 1995 statement by Admiral William O. Studeman, then acting CIA director, to Congress: 'Several [terrorist] groups have established footholds within ethnic or resident alien communities here in the U.S. These communities offer terrorists financial support and a source for new recruits'.[59]

Emerson also argued that militant Islamic religious organizations 'deliberately commingle legitimate activities with illegitimate ones' as they 'raise tens of millions of dollars a year – much of it through tax-exempt charitable organizations – which in turn transfer the money to overseas militant Islamic groups or which directly fund militant Islamic activities in the U.S.'[60] The corollary to the idea that Islamic organizations 'commingle' funds dedicated to charity and proselytizing and funds dedicated to terrorism is that any religious or charitable organization can automatically be suspected of pursuing a political agenda. A 1995 presidential order froze $800,000 in funds for a list of terrorist organizations. In a high-profile investigation, the US Customs Service looked into the World and Islam Studies Enterprise foundation (WISE), a Tampa, Florida-based organization linked to a Saudi Arabian-financed think tank called the International Institute of Islamic Thought (IIIT), which allegedly raised funds for 'organized terrorist groups' under the guise of collecting money for orphans and the families of 'martyrs' of the Islamic cause.[61]

Just as any charitable organization can be suspected of serving as a front for a political, indeed a terrorist, agenda, moderate Islamists can be assumed to be radicals hiding their game for tactical reasons. In her book on 'militant Islam', *New York Times* journalist Judith Miller saw in the political evolution of Sudanese leader Hassan al-Turabi a more general pattern:

> Turabi had been tolerant in opposition when a democratic outlook was useful. Out of office, Turabi had spoken the language of reform and pluralism; … ruling, however, was something else. Martin Kramer, the Israeli analyst of militant Islam, argued that as a rule, an Islamic

> militant's 'moderation' was inversely correlated to his proximity to power; the farther away from power Turabi had been, the greater his so-called moderation. Bernard Lewis, another fierce critic of Islamic absolutism, had put it this way: 'Moderation', or 'pragmatism' in a radical fundamentalist movement usually reflected a lack of alternatives. An Islamic 'moderate', he quoted Arab friends as saying, was one who had 'run out of ammunition'.[62]

Other examples could have led to the opposite conclusion: Islamic extremists often turn into moderates. In Malaysia, Anwar Ibrahim, the one-time deputy Prime Minister, had in his youth spent two years in prison for his association with radical Islamist groups. Following his sacking and arrest by Mahathir Mohammed, he became a symbol of modernity and liberalism.[63]

The implication of the preceding arguments is that Islamic countries are bound to have a common foreign policy, which in due course would lead to a jihad against 'the West'.[64] Since 1972, when Pakistan launched its nuclear programme, and especially when during the 1974 Lahore summit it used the argument of Islamic solidarity to obtain financial help from Libya, the 'Islamic bomb' has been at the forefront of doomsday scenarios.[65] The wording is itself revealing – since one seldom hears of a Christian, Jewish or Hindu bomb – but more significantly, theory, history and all the available empirical evidence suggest that, despite the rhetoric, there is no such thing as an Islamic foreign policy, which would presumably be led by countries such as Iran. Examples abound of the inability of Islamic countries to unite in the face of major crises. Relations between and among 'fundamentalist' states – Saudi Arabia, Pakistan, Iran, Sudan, Afghanistan – are anything but harmonious. At the time of the Gulf War, most Islamic countries sided with the US-led coalition against Iraq, while Iran abstained. Perhaps most dramatically, as we saw, the relations between Iran and the Afghani Talibans are marked by open hostility. History is replete with examples of Muslim rulers uniting with 'infidels' to fight co-religionists. The great Abbasid caliph Harun al-Rashid, whose reign is remembered as a golden age of Islamic achievement, carried on a friendly correspondence with his Christian contemporary Charlemagne, at a time when the latter was engaged in hostilities against the Umeyyad rulers of Spain. Later, in medieval Spain, alliances of Muslim princes with Christians, such as El Cid, against other Muslims, became quite commonplace.[66] Edward Mortimer, in challenging 'the notion of the house of Islam as a single community of believers, whose members owed solidarity to one another in any conflict with outsiders', noted that even in the nineteenth century, 'expressions of solidarity were generally a matter of lip-service rather than statements of serious intent to take risks or make sacrifices where one's own interests were not directly threatened'.[67]

Indeed, most students of international relations argue that national interest considerations trump ideological or religious affinities among states.[68] Similarly, students of comparative politics have observed that the

foreign policies of revolutionary states go through two phases. During an initial stage, revolutionaries are likely to be outcasts intent on exporting their revolution and reshaping the international system. But at some later stage, they end up being accepted in the international community, if not defenders of the status quo.[69] In that respect, Iran is confirming the patterns established by the Soviet and the Chinese revolutions: following a phase of 'lawlessness', it has been moving towards moderation and a more 'responsible' role in the international community.

11.3.2 Saudi Finance and Sudanese Politics

In the Sudan, Islamic finance played an important role in bringing about political Islamicization. Lest one be tempted to draw sweeping generalizations based on that case, one should keep in mind the specific context of Sudanese Islam, more specifically the facts (1) that the Nimeiri regime had moved from Nasser-style Arab socialism to establishing an Islamic state, (2) that for many years (roughly until 1993) the Islamic regime had been dominated by free-market, pro-American policies, and (3) that the leading Islamic figures, especially Hassan al-Turabi, were moderates and friendly to the West. Turabi was warmly supported by the Reagan Administration for his staunch anti-Communism. He visited the United States in 1992, and it was only in 1993 that the Sudan was added to the list of countries supporting terrorism.[70] Even after that date, the Sudan was on occasion helpful in the fight against global terrorism: it delivered terrorist Illich Ramirez Sanchez ('Carlos') to France, and expelled Usama bin Laden from its territory.

Many writers have conflated and compressed a complex series of events to show that Islamic banks were instrumental in bringing about a 'rogue state'. The role of the Faisal Bank of the Sudan bolstered the argument that money collected in the name of Islam is in the final analysis used for political ends, and that even conservative, pro-Western regimes promote radical Islam. Thus Judith Miller concludes that 'Saudi and Gulf support, though diffuse and often ostensibly donated to cultural and charitable Islamic causes, has been equally, if not more, consequential for Islamist groups [than Iranian funding].'[71]

In reality, arguing that the Saudi regime wanted to create the kind of regime that exists today in the Sudan would be tantamount to arguing that the United States conspired to create the rabidly anti-US 'Afghan Arabs'. The point is that unintended consequences should be distinguished from conscious agenda. Saudi Arabia has attempted to deal with the unwitting fall-out from its indiscriminate generosity by enacting in 1993 and 1994 a number of changes in its proselytizing efforts. It set up a Supreme Council of Islamic Affairs, headed by Prince Sultan, to consider aid requests from Islamic groups, and banned the collection of private money within the kingdom for charitable Muslim causes without Interior Ministry permit.

11.4 Guilt by Association

11.4.1 Rogue States, Rogue Banks and Rogue Financiers

Although couched in neutral terms and stressing the need to depoliticize banking, the new norms of global banking are eminently political insofar as they are inextricably linked to the New World Order that came into being with the end of the cold war. 'Rogue' states are outcasts within that system, and acts of defiance can bring forth economic and financial sanctions.[72] Following the 1988 terrorist bombing of Pan Am Flight 103 over Lockerbie, Scotland, the United Nations Security Council imposed sanctions on Libya (resolutions 748 and 883). And in May 1998, following nuclear testing by India and Pakistan, both countries were immediately subjected to financial sanctions, and deprived, among other things, of IMF loans. Other countries such as Iran, Libya, Iraq or the Sudan, often appear on the US State Department's list of countries supporting terrorism and have also been subject to similar sanctions.

A related trend is extraterritoriality and secondary boycotts. In 1996, the Iran and Libya Sanctions Act was approved without dissent by both the US House and Senate and signed into law by President Bill Clinton. The legislation passed requires the president to impose sanctions against any foreign person or company that invests $40 million or more in a year in Iran's or Libya's petroleum or natural gas sectors. Among the possible sanctions are the following: denying Export-Import Bank loans, denying export licences, barring US banks from making loans of more than $10 million a year to sanctioned parties, barring sanctioned financial institutions from being primary dealers of US government bonds, etc.

Insofar as these 'rogue' countries are part of regional banking networks, banks from Islamic countries have on occasion felt pressure to modify their ownership or management structures. In 1995, Abdullah Saudi, the long-serving and highly regarded president of the Arab Banking Corporation (ABC) – whose main shareholders include the Kuwaiti finance ministry, the Abu Dhabi Investment Authority and the Central Bank of Libya – was forced to resign under US pressure because of his Libyan citizenship.[73]

In addition to 'rogue' states, there are 'rogue' banks and 'rogue' financiers within the system. Until its closure in 1991, the Bank of Credit and Commerce International (BCCI) – nicknamed in intelligence circles the Bank of Crooks and Criminals International – epitomized the rogue bank. A number of guerrilla groups and terrorist organizations took advantage of its large, loosely regulated and transnational network.[74] It was also one of the banks through which Pakistan was able to acquire nuclear weapons.[75] Then there are 'rogue financiers', whose emblematic figure is now Usama bin Laden. In the wake of the African embassy bombings of August 1998, bin Laden was no longer perceived as simply a freelancer who had

'internationalized and privatized' terrorism, but as the centre of a vast network keen, among other things, on acquiring the nuclear bomb. A newspaper headline said it all: 'A Global, Pan-Islamic Network; Terrorism Entrepreneur Unifies Groups Financially, Politically'.[76] In the wake of the bombings, the names of two Islamic banks kept surfacing, thus lending credibility to a conspiratorial view of Islamic finance. One was Al-Shamal Islamic Bank in Khartoum, a joint effort by NIF and Usama bin Laden, who had allegedly invested $50 million in the venture.[77] The other was the Islamic Bank, in Tirana, Albania, an investment bank that had opened in 1994 with financing by Kuwaiti and Saudi interests, and which had been used for money-transfer purposes by a terrorist organization.[78]

11.4.2 The Impact on Islamic Finance

Do Islamic banks have a domestic or international political agenda? Do they play a part in promoting radical Islam and international terrorism? The short answer is that they usually do not, but their opponents point to their resources to show that they have the potential to cause mischief. The suspicions surrounding Islamic banks are implicitly justified by a syllogism: political Islam at the domestic and international level requires financial resources, Islamic banks are committed to Islam and have vast financial resources; therefore Islamic banks are likely to advance the political goals of potentially subversive Islamist groups.

At the international level, Islamic financial institutions are all the more likely to be scrutinized now that the 'war on terrorism', just like the 'war on drugs', is fought in large part on the financial terrain – figuring out the financial flows involved and tracking them nationally and internationally.[79] Consider for example the following quote by Steven Emerson:

> Terrorists have become very sophisticated in laundering and disguising their funds. They use a variety of financial vehicles – front companies, charitable organizations, third-party bank accounts – to disguise the location of their assets. Osama bin Laden's most impressive achievement has been his ability to shield from scrutiny and seizure his $300 million financial empire, held in a financial labyrinth of world-wide shell companies, co-investors, governmental entities, bank accounts, religious 'charities' and plain old blue-chip investments. A portion of Mr. bin Laden's 'portfolio' is held in U.S. and British banks under third party names and transferred to Islamic religious charities operating under false cover.[80]

The rationale for the financial focus of most recent anti-terrorist legislation is twofold. First, tracing financial flows can untangle money puzzles and yield a great deal of information about subversive and otherwise shadowy groups. Second, the use of economic and financial tools –

embargoes, asset seizures and the like – can starve terrorism. Although there is not much evidence that Islamic banks harbour more terrorism-related funds than conventional ones, Islamic banks are, for all the reasons discussed in this chapter, far more likely to be systematically suspected of having been a conduit for such activities.

Notes

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32. Nimeiri's 'September laws' imposing the Shariah to the country had been opposed by the sufi sect, on the grounds that it was politically divisive in a country where 40 per cent of the population was not Muslim.
33. See Chapter 6.
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12

RELIGIOUS ISSUES AND CHALLENGES: DEFINING ISLAM AND INTERPRETING THE SHARIAH

The battle to define the parameters of Islamic finance – and more generally the struggle over the authoritative use of the symbolic language of Islam – is not exclusively or even principally about religion. Indeed, one of the themes developed in this book is that religion cannot be separated from other factors – economic, political, cultural, ideological, historical, etc. Yet since political and economic struggles are fought on the religious terrain and expressed in religious terms, we need to be able to isolate, insofar as it is possible at all, religious issues. This chapter provides a framework for understanding the religious challenges faced by Islamic banks. It seeks to answer three questions: what are the mechanisms by which financial institutions interpret religion? What are the bases (scriptures, traditions) of the various possible interpretations? What interpretations are likely to prevail? The chapter begins with a discussion of Shariah boards and other mechanisms designed to interpret religion for banking purposes. It then broadens the discussion to contending views on religious interpretation, before adopting a comparative perspective designed to map the likely direction of change in religious interpretations.

12.1 Interpreting the Shariah

Since the aggiornamento of Islamic finance, one of the defining characteristics of an Islamic bank has been the existence of a 'Legitimate Control Body', or 'Shariah Board', whose purpose it is to ensure that the bank operates in conformity with the Shariah. Such a religious supervisory board enhances the credibility of the bank in the eyes of its customers, and bolsters its Islamic credentials. A Shariah board is a prerequisite for admission into the International Association of Islamic Banks (IAIB). The general characteristics of the Shariah board were described as follows in an IAIB document:

> It is formed of a number of members chosen from among Jurists and men of Islamic Jurisprudence and of comparative law who have conviction and firm belief in the idea of Islamic Banks. To ensure freedom of initiating their opinion the following are taken into

> account: (a) They must not be working as personnel in the bank. That means: They are not subject to the authority of the board of directors. (b) They are appointed by the general assembly as it is the case of the auditors of accounts. (c) The general assembly fixes their remunerations. (d) The Legitimate Control Body has the same means and jurisdictions as the auditors of accounts.[1]

The exact characteristics and roles of Shariah boards differ from one institution to another, and a number of controversies have occasionally plagued them. A recent survey of 30 Shariah boards has revealed their diversity.[2] In our sample, numbers of members varied from one to nine. (Odd numbers are preferred as a means of breaking possible deadlocks.) All members were trained in Islamic law or religious studies, and about half of them also held degrees in business and economics. Most boards met quarterly; a few met monthly and some annually. Their recruitment, pay conditions, and conditions of employment were usually decided at shareholders' meetings, although in a few cases, such decisions were made by the bank's management.

In theory, the Shariah board's opinions are authoritative in that their refusal to endorse a product should automatically result in the bank scrapping that product. Also in theory, Shariah boards perform a religious audit of all accounts. The reality however is more complicated. Interviews revealed that in many cases the review is perfunctory, with boards 'rubber stamping' decisions already made by the bank's management or shunning controversial issues. The model for the role of the Shariah board is that of the account auditors. Although remunerated by the bank, their members should retain their independence. Like the auditors, they 'certify' at the end of the year that the bank's operations were in conformity with religious teachings. They review the institution's products and policies and issue fatwas as needed and as requested by the institution or its customers. For example, they decide whether a new financial instrument is religiously acceptable, or whether a fee charged by the bank could be assimilated to riba.

A number of issues have been raised in connection with Shariah boards. One is about their independence. Insofar as they derive what is frequently their principal income from their membership in a Shariah board, some scholars may legitimate the most dubious operations. The debate on 'fatwas for sale' raged in Egypt, especially at the time of the Islamic Money Management Companies (IMMCs).[3] The debate was ideological, political, and of course financial, as much as it was religious. It pitted 'private clerics' in the employ of IMMCs and Islamic banks against 'public clerics', functionaries of the state who were critical of these companies. In those 'fatwa wars', each side had its backers. Some argued that in a country where, from the days of Muhammed Ali (1805–49) to those of Gamal Abdel Nasser (1952–70), clerics were an appendage of the state, allowing private

sector income would enhance their independence.[4] Others argued that clerics were in effect becoming mercenaries, ready to offer tailor-made fatwas that would legitimate certain practices on the most tenuous religious grounds in exchange for money. In 1989, the Egyptian press mentioned that some clerics were receiving a monthly stipend as high as $4,000. The implication was that bank clients were cheated in two ways: it was their money that was being siphoned off to make excessive payments; and the religious validity of fatwas that were essentially 'bought' was in doubt.[5]

A related issue is the varying degrees of leniency of Shariah boards. As a general rule, Shariah boards in Southeast Asia tend to be more lenient than those of the Arab Middle East. Indeed, many fatwas issued in Malaysia or Pakistan are not recognized in the United Arab Emirates or Kuwait. One obvious factor is the different religious and historical traditions and practices. Another variable though may be the intensity of competition. The Kuwait Finance House is known for its strict rulings. Under the presidency of Mufti Abdel-Latif Batayban, it has rejected all forms of hiyal (ruses) and various types of murabaha, and has consistently prodded the bank's management into increasing profit-and-loss sharing arrangements.[6] Insofar as the Kuwait Finance House was for most of its existence the sole Islamic bank in the country, thus enjoying a monopoly of sorts on a lucrative segment of the market, it could afford stricter religious rules.[7] So it may be that, at a time of heightened competitive pressures, banks try to compete on the basis of the leniency of their Shariah boards.

Another criticism is that Shariah advisers are not truly necessary, and may be a drag, financially and competitively, on the operations of the financial institution. Insofar as most bank employees are versed in Islamic law and practices, and insofar as the largest banks have in-house research departments that study matters of religion and economics, Shariah boards are perceived by some as being all the more superfluous in that, in the era of e-cash, Internet banking and exotic derivatives, religious scholars may not be up-to-date on state-of-the-art strategic or technological matters. The typical retort of religious advisers is that the religious experience of bank staffers is insufficient and that religious rectitude should prevail over considerations of profitability and competitiveness. They invoke a merchant-faqih tradition in Islam and a quote by Abu Hanifa (founder of the Hanafi school), stating that 'every merchant must be accompanied by a faqih whose advice will allow him to avoid riba'.[8]

From the standpoint of Islamic banks as a collective group, the major criticism is that the practice of banks having their own Shariah boards adds to the fragmentation of Islamic finance, making it difficult to arrive at a consensus on products and procedures, which in turn complicates the task of developing a secondary market for Islamic products. Different boards have different interpretations of the Shariah, and no uniform rules apply to the industry as a whole. Hence the attempts, at the national and trans-

national levels, to develop common standards. To avoid fragmentation and the reliance on the opinions of lone scholars, since the first aggiornamento 'group Ijtihad' has been encouraged, through international conferences, symposia and convocations as well as through permanent new bodies such as fiqh academies. A number of research institutes have been involved in research projects on Islamic finance – among them the International Center for Research in Islamic Economics at King Abdul Aziz University in Jeddah, the Islamic Foundation in Leicester (UK), the Islamic Research and Training Institute of the Islamic Development Bank in Jeddah, and the International Institute of Islamic Thought in Cairo and the Harvard Islamic Finance Information Program in Cambridge, Massachusetts. Increasingly, the old principle of 'ijmaa' (unanimous agreement)[9] was modified to signify broad consensus or even simple majority.

The most prestigious transnational body is the Islamic Fiqh Academy created by the Organization of the Islamic Conference (OIC) in Jeddah. Its members are appointed by governments belonging to the OIC. It holds annual meetings in various locations where reports of specialized experts on a specific issue are discussed. Following debates, a decision by a majority vote states the Academy's position on the issue. The fatwas, debates and reports are published in the *Fiqh Academy Journal*.[10] Despite its multinational membership, the Islamic Fiqh Academy remains closely identified with Saudi Arabia. Other fiqh academies are associated with other countries and other fiqh traditions.

The International Association of Islamic Banks (IAIB) has attempted to promote uniformity in the implementation of Islamic finance by appointing a Higher Religious Supervisory Board of Islamic jurisprudents, whose interpretations would be normative for all member banks.[11] This worked, to some degree, in the early years of Islamic finance. Since the 1980s however, the IAIB's role has steadily diminished. For one thing, a growing number of financial institutions have stayed out of the association, and are thus not bound by its decisions. In addition, the IAIB was weakened by dissension within the Islamic banking community. One instance was the highly publicized conflict between Ahmed al-Najjar, the long-time director of IAIB, and Prince Mohammed al-Faisal al-Saud. Another was the growing rivalry between the Dar Al-Maal Al-Islami of Prince Mohammed and the Dallah Al-Baraka group of Sheikh Saleh Kamel. The Al-Baraka group, rather than following the rulings of the Higher Religious Supervisory Board of the IAIB (which was closely identified with Prince Mohammed and his banks), has tended to adopt its own, more liberal, interpretations of the Shariah.[12]

As for national level coordination, many Islamic countries have appointed Shariah advisers to their central banks. One of the most significant attempts at national harmonization occurred in Malaysia where a National Syariah (Shariah) Board was established in 1997 to harmonize financial

practices and review the compatibility of new financial products with religion, as well as advise the Central Bank on religious matters. The goal was to adopt a liberal, modernist bent that would be consistent with the developmental goals of the government.[13]

One of the risks faced by the Islamic banks and investors may be called the 'religious risk', or the risk of being challenged on religious grounds. On occasion, bankers have been forced, under religious pressure, to change course. Instances where Shariah board decisions led to strategic changes are rare, but they do exist. In 1987, the Faisal Islamic Bank of Egypt had to put an end to its forward contracts in foreign exchange markets.[14] The same year, the Islamic Development Bank changed its practice of charging a fixed service fee of 2.5 to 3 per cent after an Islamic Fiqh Academy fatwa stated that fees should not be fixed arbitrarily, but based on the bank's real costs.[15] In addition, Shariah boards have been pressuring banks to phase out certain mark-up contracts – in particular 'synthetic murabahas' – and to increase profit-and-loss sharing activities.

12.2 Religious Diversity

Religious diversity is a mixed blessing for Islamic banks. On the one hand, it provides flexibility and suggests that new Islamic institutions and products will gain faster acceptance. On the other hand, it casts doubt on the religious validity of certain decisions, and makes a consensus among all religious institutions even more elusive. This section explores the sources of those differences.

Both the exponents of modern interpretations of Islam and those of traditional interpretations can draw on selected scriptures and precedents to bolster their views. Most debates on what the religion truly commands boil down to a few basic questions: 'What is Islam?', 'Who is a true Muslim?', 'How does God Speak?', and 'Who speaks for God?'[16]

Different communities of Muslims have different answers. The literal definition of Islam is 'submission' (to God). The prescribed duties of Muslims are limited to the 'five pillars' of the religion (shahada, prayer, fasting, zakat, pilgrimage). There is no Vatican-like Church that imposes rules and proclaims dogmas. The process of conversion requires no certification of religious knowledge. Thus, beyond a few basics, it is difficult authoritatively to assess religious rectitude. All this leaves significant room to accommodate many interpretations, each claiming authenticity. Furthermore, the Islamic tradition posits the absolute equality of all Muslims, with the degree of piety (which can only be assessed by God) being the only differentiating factor.

Every major belief system has contradictory strands. Ideologues and theologians find coherence through exegesis, but they still disagree amongst themselves on issues of 'essence' and original meaning. In Islam,

one can choose to focus on the Prophet's original role as political ruler and military conqueror, and on the role of holy wars in Arab conquests and in the propagation of Islam. Or one can choose to concentrate on the peaceful, tolerant side of the religion, on the Koranic verses saying that there is no compulsion in religion (2:256),[17] that diversity in religious beliefs is part of God's overall plan (10:99),[18] or that relations with non-Muslims should be marked by kindness and equity (60:8).[19]

A wide spectrum of intellectual, moral and theological traditions is still in existence today. Different strands of Islam can claim lineage from leading Islamic figures. In addition to the concept of 'shura' (consultation) which is mentioned in both the Koran and the Sunna, early Islamic thinkers devised a number of concepts designed to control political power. Al-Mawardi (d. 1058) advanced the concept of separation of functions via delegation from the ruler (tawfid).[20] The philosopher Abu al-Walid Ibn Rushd, known to the West as Averroes (1126–98), developed the theory of tawil or allegorical interpretation, placing reason above all other considerations. He argued that religious texts have an exoteric and an esoteric meaning. If the exoteric meaning is at variance with reason, the text must be interpreted according to reason. Following Aristotle, Averroes gave priority to demonstrative proof (burhan), the highest form of certainty, over the dialectical and rhetorical arguments of theologians. In his lifetime, he lost his intellectual battle. He was tried for kufr (unbelief), his books were burned, and he was banished to his village. Centuries later, the publication in Cairo in 1925 of Ali Abd al-Raziq's *al-Islam was-usul al-hukm* the best-known advocacy of strict separation of the religious and the secular realm, was followed by violent attacks on the book. The author was defrocked by Al-Azhar. This stifled the debate for years to come. Such fates were no different from those of Galileo and countless other Church dissidents. Amazingly (considering common stereotypes about Islam being about 'din wa dawla' [fusion of mosque and state] while Christianity is supposedly inherently secular[21]) Averroes' ideas were used in the West to propound the separation of church and state. More specifically, Frederick II (1194–1250), Emperor of Germany and King of Sicily, ordered the translation of Averroes' works so that he could use his arguments in his war against the religious authorities.

Averroes' views were in line with the Islamic tradition of awareness (waii) which implies that Muslims should be exerting a permanent effort of education and reasoning 'so that their knowledge can be applied for the benefit of society, including the economic order'.[22] The flourishing cultural and intellectual life of Baghdad and Spain had kept science and rationalism alive during Europe's Dark Ages, and medieval Islam was a vital link between the ancient world of Greece and Rome and the Renaissance.

The other, traditional, puritanical, and literalist strand is epitomized by Ibn Taymiyya (1268–1328), who spent his life trying to strip Islam of alien

accretions and influences. In recent decades, a number of Islamic revivalists embarked on similar crusades.[23] Both Abul Ala Mawdudi (1903–79), who created the Jamaat-i Islami in India in 1941, and Egyptian Muslim Brother Sayed Qutb (1906–66) associated modern society with the Jahiliyya, the pre-Islamic society, with its connotations of ignorance and paganism.[24] Qutb's views were radicalized following his imprisonment and torture by the Egyptian government (he was later executed). In his influential book *Maalim fi al-Tariq*, he set up a stark dichotomy: a political system could be either Islamic (nizam Islami) or pagan (nizam Jahili). A syllogism of sorts followed: since it is the duty of devout Muslims to establish an Islamic government, it is also their duty to wage a holy war (jihad) against all other governments.[25] The notion of takfir (which could be translated as excommunication) is central to his and his radical followers' thinking. The group Jamaat al-Jihad (Holy War), which assassinated Anwar Sadat on October 6, 1981, maintained that jihad was the sixth pillar of Islam, and that it was the religious duty of Muslims to wage holy war against Egypt's un-Islamic state and its leader.[26]

Often the same Koranic verse, or even the same word, is open to contradictory interpretations. As regards differing interpretations of certain words, the best example is jihad (usually followed by 'in the path of God').[27] Some adopt a militaristic interpretation – that of a holy war against enemies. Others adopt a spiritual interpretation – that of the jihad of the soul. Another ambiguous term is towhid. For some it is a strictly theological concept about the 'oneness' of God (often used in contrast to the Christian doctrine of the Trinity). For others, it is an all-encompassing concept meaning that religion, politics, economics and society should all be one.[28] For others still, it refers to the unification of mankind.[29]

By the same token, the notion of hukumiyya (sovereignty or power) has elicited contradictory interpretations. The fundamentalist slogan 'la hukma illa li-Llah (sovereignty belongs to God alone) was first used by the Kharijites, a marginal and secessionist sect, when they opposed Ali's decision to seek arbitration in the conflict with Muawiyah, the founder of the Umeyyad dynasty. Nowadays, it can be used either to justify a theocracy, or on the contrary to separate temporal and spiritual matters. In Iran, the roles of the velayat-e Faqih, of the Council of Guardians, and of the Assembly of Experts reflect the view that clerics should hold high political offices to keep control over the political system. The view was opposed, at the time of the Iranian revolution by many leading clerics.[30] Indeed, the Iranian Shia tradition had both a strong anti-political element (since unlike the mainstream Sunnis, they rejected the political system that followed the death of Ali, the fourth Caliph) and a Messianic one. Many clerics argued that in the absence of the hidden Imam, no religious leaders were entitled to claim his mantle. (In that respect, their views resembled those of a minority of ultra-Orthodox Jews who opposed Zionism on the

grounds that the return to Israel would be legitimate only if led by the Messiah.) It took the Ayatollah Khomeini's remarkable rhetorical and political skills to impose his interpretation, whereby the supreme jurist would assume power pending the return of the Imam.[31]

Throughout the Islamic world, there are also well-established traditions that regard the state not as a direct expression of Islam but as a secular institution whose duty is to uphold Islam.[32] Other strands, deriving mostly from sufi perspectives, and paralleling similar Christian strands, are decidedly apolitical, if not anti-political. They claim that authenticity lies within the soul of the individual and that it manifests itself in righteous behaviour within the Islamic community. Insofar as temporal power is perceived as inherently violent and corrupt, it should be shunned. Islam would then be circumscribed to a personal and social ethos.[33] A related argument is that Islamic rule cannot be imposed on a society that is not yet Islamicized or permeated by Islamic values, or that an Islamic government can only exist when virtue prevails.[34]

The question of 'who speaks for Islam?' (or whose interpretation is authoritative) is not easily answered either. Edward Mortimer wrote:

> Is it the ruler, who holds power by God's grace? But rulers also fall from power and are replaced by others with different opinions. Does Islam change with every coup d'état? Surely not. Then is it the ulema – those who have devoted their lives to studying Islam and its law? Many believe so, particularly among … the ulema themselves. But are the ulema infallible, even when they all say the same thing? The example of the ban on coffee suggests that they are not;[35] and anyway infallibility is an attribute of God. To attribute it to a group of human beings, even the wisest, may involve the cardinal sin of shirk – associating others with God.[36]

One should add that most contemporary fundamentalist movements, starting with Al-Afghani, have been characterized by revolts against established ulema, who were accused either of distorting the faith or of being too closely associated with the existing political–economic order.[37] Paradoxically, many revivalists have invoked independent reasoning as a weapon against the status quo. They posited that it was up to the individuals themselves to conduct their own ijtihad and make up their mind using their own conscience and intelligence under God's guidance. (Once in a position of power, though, such revivalists have usually suspended that right of individual interpretation.)

On a number of occasions, this somewhat 'Lutheran' approach to the interpretation of the scriptures was used by leaders such as Libya's Moammar Qaddafi. He rejected the ulema's interpretation of Islam by stating: 'As the Muslims have strayed from Islam, a review is demanded. The [Libyan revolution] is a revolution rectifying Islam, presenting Islam

correctly, purifying Islam of the reactionary practices which dressed it in retrograde clothing not its own'.[38] He also instructed the 'popular committees' of the Libyan 'Jamahiriyya' to seize the mosques and rid them of 'paganistic tendencies' and of religious leaders who have been 'propagating heretical tales elaborated over centuries of decadence and which distort the Islamic religion'.[39] But Qaddafi then imposed his own idiosyncratic interpretations of the Koran, with the most controversial decision being changing the Islamic calendar so that it would start in AD 632, the year of the death of the Prophet. He even called for the Sunna to be disregarded on the grounds that it had been corrupted and misinterpreted.[40]

Similarly, Sudan's Hassan al-Turabi in his opposition days had stated that it was up to ordinary Muslims to conduct their own independent reasoning.[41] He also expressed the difficulty of finding an appropriate and applicable political model: 'Muslims themselves sometimes don't even know how to go about their Islam. They have no recent precedent of an Islamic government'.[42] Not surprisingly, once in power, he tried to impose his own Islamic vision, and even to export it. Indeed, every government that calls itself Islamic tends to view its own interpretation of Islam as being the correct one. This has resulted in a greater diversity of beliefs worldwide, but also in authoritarianism at home. Indeed, linking religion and politics is not without certain political advantages for an authoritarian regime. In Iran, the criterion of Islamic rectitude has been more likely 'to verify political reliability and loyalty rather than faith and piety'.[43] As was noted in connection with the Zia regime in Pakistan, when the regime is linked to religion, 'any deviation becomes both a religious heresy and treason against the state … political rebellion and religious dissent become indistinguishable'.[44]

To use Max Weber's categories, religion has been reinterpreted by saints, scholars and warriors. And to use Ibrahim Karawan's typology, monarchs, mullahs and marshals have claimed religious rectitude, attempting to discredit if not 'excommunicate' rival regimes. One of the most enduring rivalries has been that of Iran and Saudi Arabia. In a famous statement, the Ayatollah Khomeini attacked Saudi Islam as 'the Islam of money and power … deception, compromise, and captivity, the Islam of the sovereignty of capital and capitalists over the oppressed … in a word the American Islam.'[45]

12.3 Finance and Religion in Comparative Perspective

In order to predict the likely evolution of Islamic finance, it is useful to consider the ways older but related religions have evolved over time. Will Islam – the youngest of the Abrahamic religions – evolve in the same way as did Judaism and Christianity in political and economic matters and more specifically, with regard to money and finance? Needless to say, all comparisons can be treacherous. Not only can areas of convergence and

divergence be equally significant (thus confusing as much as enlightening), but superficial resemblance often hides fundamental differences. Consider for example the notion of clergy as intermediary between God and the faithful. All clerics preach and interpret the word of God. But there are wide variations in the exact role, importance and status of clerics. The primary function of Catholic priests is to administer sacraments, whereas Protestant ministers are predominantly preachers, Jewish rabbis are more akin to moral teachers and Islamic ulema are essentially legal scholars. Another complication arises from variations within a specific faith and over time. Even broad generic categories (for example, dividing the Jewish faith as Orthodox, Conservative and Reform) can hide significant differences within each category. Yet the opposite position – because no comparison is ever perfect means that all comparative endeavours are futile – limits our understanding.

Perhaps the most enduring cliché in discussions about Islam is the alleged difference between the essence of Christianity, which is said to accommodate, even encourage secularism and separation of church and state, and Islam, which cannot. Hence the formulation of Huntington: 'In Islam, God is Caesar'.[46] The general argument has been summarized by Bernard Lewis as follows: 'The notion of church and state as distinct institutions, each with its own laws, hierarchy, and jurisdiction, is characteristically Christian, with its origins in Christian scripture and history. It is alien to Islam'.[47] For some reason, the early Islamic experience is supposed to be 'indelibly stamped'[48] on the mind of every Muslim. It is true that Christianity and Islam started under sharply differing circumstances. Early Christians placed themselves outside of the existing political order, preaching a message antithetical to existing Judaic and Roman practices. Unlike Jesus, Mohammed was a military and political leader. Under his rule and that of his four immediate successors, political, military and religious leadership were not differentiated. But even in the early days of both religions, the religious position on matters of politics was sometimes comparable. Consider for example Paul's injunction:

> Every person must submit to the supreme authorities. There is no authority but by act of God, and the existing authorities are instituted by him; consequently anyone who rebels against authority is resisting a divine institution, and those who so resist have themselves to thank for the punishment they will receive.

Or his statement that '[The authorities] are God's agents working for your good.'[49] They are not fundamentally different from the Koranic injunction to 'obey Allah and obey the Messenger and those in authority from among you' (4:59). The three religions have tended to evolve over time. In the words of John Esposito: 'The Judaeo-Christian tradition, while once supportive of political absolutism, was reinterpreted to accommodate the

democratic ideal. Islam also lends itself to multiple interpretations; it has been used to support democracy and dictatorship, republicanism and monarchy'.[50]

It is true however that modern concepts of secularism appeared in the Christian West. The seeds of such thinking were introduced with the sixteenth century Reformation. A more systematic political and theoretical formulation occurred during the Enlightenment and, starting in the late eighteenth century, such views started to be implemented in much of the Western world. Since that time, the principle of separation of church and state has by and large become the norm. The word 'secularism' is seldom used in the Islamic context. Also, a certain amount of intellectual intimidation (the equation by radical fundamentalists of secularism with unbelief) has somewhat chilled the debate. For one thing, the concept – as are the categorization of religious traditions and the 'naming of other religious systems or isms' – is a creature of the post-Enlightenment West.[51] The argument that Islam cannot accommodate secularism is more about language than about history and praxis. As we saw, the practice of early Islamic societies often provided for a separation of mosque and state. But despite linguistic and rhetorical differences, secularism does have its Islamic 'functional equivalents'. Some leading intellectuals such as Egypt's Mohammed Said al-Ashmawi have argued that 'Islamism was against Islam'.[52] Others have argued in favour of a sort of 'religious secularism' that would keep institutionalized religion outside the political structure, while developing policy in the context of Islamic values.[53] In Indonesia, the constitution provides for a broad religious framework, but separates the state from any specific faith. Turkey is the most famous case of explicit, assertive secularism. Even there though, secularism was justified in religious terms. In 1924, the same year he abolished the caliphate, Mustafa Kemal in a speech to the Turkish Assembly expressed the need to 'cleanse and elevate the Islamic faith, by rescuing it from the position of a political instrument, to which it has been accustomed for centuries'.[54]

The essentialist analysis conveniently omits what happened between the fourth century and the advent of modern secular states. Indeed, with the Christianization of the Roman Empire, church–state relations were fused. Since AD 379, the obligatory judicial coincidence of Christian and Roman citizenship was established.[55] Whether one looks at the last Roman emperors, at the Byzantine emperors, at the symbiotic relations between pope and emperor in the Holy Roman Empire, or at the 'divine rights of kings' in Western states, one sees that separation of church and state was not the norm, and that theocratic (the subordination of political authority to religious ones) and Caesaro-papist (the subordination of religious authorities to political ones) tendencies alternated for most of the history of Christianity. The paradigmatic jihads (holy wars) were the Crusades, which were perceived by Muslims at the time in much the same way as many

manifestations of 'radical Islamic fundamentalism' are perceived nowadays in the West.[56]

The advent of secularism was neither swift nor peaceful. It took centuries of religious wars and intellectual debates before the issue of separation of church and state was resolved. An essentialist reading of religion ignores the evolution of ideas and interpretations. The scriptural basis for the separation of the two realms is Jesus' famous saying: 'Then render unto Caesar what is due to Caesar, and render unto God what is due to God' (Matthew 22:21). But as was noted by Charles Butterworth, 'Not until sometime after Marsilius of Padua (c. 1275–1342) were Paul's strictures and the famous advice offered by Jesus about distinguishing between the things belonging to Caesar and those belonging to God raised to the elevated rank it occupies today.'[57]

In Islam the evolution was almost opposite. The early tradition as well as recent 'radical fundamentalist' movements do not distinguish the religious from the political realms. Yet historically, since the Umeyyad empire, some measure of secularization started appearing,[58] and over the centuries, the power of the Caliph became increasingly nominal. Olivier Carré has argued that the 'long tradition of Islam' was one characterized by some measure of separation of the two realms (though not by a Western-style secularism).[59] Only with the Islamic revival that started in the late eighteenth century and persists to this day, did Islamist regimes resort to the 'deviant orthodoxy' based on a return to the 'ideal' of Islam – that of Mohammed and the four 'rightly-guided caliphs'. It is Carré's hope that a return to this great tradition, which is commonly accepted by traditional Islamic jurisprudence in both Sunni and Shi'i doctrine could open the way to what he calls a 'post-Islamist Islam'.

This section and the historical and comparative discussions in Chapters 2 and 3 have shown that Islam, like other successful religions, has undergone significant change and proved capable of adjusting to evolving circumstances. In terms of the traditionalist/modernist dichotomy, traditionalist backlashes are possible in response to certain political, economic or financial developments, but they are likely to be short-lived. The long-term trend in Islamic finance is clearly towards increased pragmatism and the prevalence of modernist interpretations.

Notes

1. Ahmed Abdel Aziz El-Nagar, *One Hundred Questions & One Hundred Answers Concerning Islamic Banks*, Cairo: International Association of Islamic Banks 1980, p. 20.
2. Ibrahim Warde, *The Role of Shariah Boards: A Survey*, San Francisco: IBPC Working Papers 1998.
3. See Chapter 4.
4. Michel Galloux, *Finance islamique et pouvoir politique: le cas de l'Egypte moderne*,

Paris: Presses Universitaires de France 1997, pp. 39–45.
5. Galloux, p. 46.
6. Ibid., p. 59.
7. Ibrahim Warde, 'Comparing the Profitability of Islamic and Conventional Banks', San Francisco: IBPC Working Papers 1997.
8. Galloux, p. 47.
9. Based on the saying of the Prophet: 'My community will never agree on an error.'
10. *Majallat Majmaa al-Fiqh al-Islami.*
11. Nicholas Dylan Ray, *Arab Islamic Banking and the Renewal of Islamic Law*, London: Graham and Trotman 1995, p. 7.
12. Ray, p. 8.
13. See Chapter 6.
14. *Al-Ahram al-iqtissadi*, 3 March 1987.
15. Hamid Algabid, *Les banques islamiques*, Paris: Economica 1990, p. 126.
16. Daniel Brown, *Rethinking Tradition in Modern Islamic Thought*, Cambridge University Press 1996.
17. Koran 2:256 'There is no compulsion in religion – the right way is clearly distinct from error – So whoever disbelieves in the devil and believes in Allah, he indeed lays hold on the firmest handle which shall never break. And Allah is Hearing, Knowing'.
18. Koran 10:99 'And if thy Lord had pleased, all those who are in the earth would have believed, all of them. Wilt thou then force men till they are believers?'
19. Koran 60:8 'Allah forbids you not respecting those who fight you not for religion, nor drive you forth from your homes, that you show them kindness and deal with them justly. Surely Allah loves the doers of justice'.
20. Gudrun Kramer, 'Islamist Notions of Democracy', in Joel Beinin and Joe Stork, *Political Islam: Essays from Middle East Report*, University of California Press 1997, p. 77.
21. See Chapter 1.
22. Rodney Wilson, Economics, *Ethics and Religion: Jewish, Christian and Muslim Economic Thought*, New York University Press 1997, p. 115.
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CONCLUSION

Any objective assessment of Islamic finance can only be mixed. Islamic finance is a success, considering that it is no longer an uncertain experiment, but a reality: it is now a $200 billion industry that is likely to keep growing at a rapid clip as the 'money revolution' continues, and as more countries authorize and even encourage the creation of Islamic institutions.

But it is also a failure insofar as it did not fulfil its original promise of becoming an original and innovative system, based on risk sharing, that would bring social and economic benefits to the Islamic world. Indeed, profit-and-loss sharing (PLS) transactions, initially the raison d'être of the industry, only account for about five per cent of the operations of Islamic financial institutions. Most now prefer to engage in trade finance and markup activities. Such modes of financing, while accepted by Islamic scholars – albeit without great enthusiasm – do not bring significant social and economic benefits to the community, and tend to mirror conventional finance. Even the promise of interest-free finance has not been fulfilled, since interest-like mechanisms have been devised, and since many Islamic institutions have been deriving substantial income from interest-bearing balances in foreign banks. More ominously, scandals and other problems have plagued a number of institutions, raising serious ethical and religious issues.

By not embarking on a path of true financial innovation, Islamic institutions raise the inevitable question: is Islamic finance necessary? Arguably it is, since it can still fulfil its original objectives. And at a time when Islamic countries are overhauling their regulatory systems and entering the global economy, it can provide a much-needed ethical framework as well as useful correctives to the excesses of contemporary finance.

The gap between promise and performance can be attributed to the youth of the industry. Islamic finance only came into existence in the 1970s, and it would be unfair to judge it severely, since many venerable institutions have not proved, in today's financial jungle, to be exemplars either of probity or of financial success. From that perspective, many of the shortcomings of Islamic finance can be looked at as unavoidable growing pains – part of the trial-and-error process that may yet lead to the fulfilment of original goals.

In the early years of Islamic finance, mark-up operations and other religiously neutral transactions were seen as desirable only to the extent that they would ensure the financial viability of the first Islamic banks. Such short-term, low-risk financing mechanisms would provide them with the necessary resources to grow, establish themselves, and expand throughout the Islamic world. The danger today is that mechanisms that were once intended to be provisional have become institutionalized, causing more desirable and more authentic financing modes to fall by the wayside. The way in which many institutions responded to their initial forays into profit-and-loss sharing is in that respect revealing. Rather than learning from their mistakes, they decided to abandon such operations altogether. A more fruitful approach would of course have been to undertake an improvement of procedures.

But any quest for solutions can only begin with a clear assessment of the problem. And this is one of the many areas where the literature on Islamic finance can be found wanting. By insisting on painting a rosy picture (or by simply wallowing in abstraction and irrelevance), researchers did a disservice to Islamic financial institutions; they encouraged the perpetuation of the status quo, and prevented the kind of research that would have fulfilled the original aims of the industry.

This book has attempted to unveil a more complete picture of Islamic finance by presenting its many facets, by placing it in the context of the global economy, and by exploring it from empirical, comparative and historical perspectives. The agenda for future research is daunting and includes topics that many analysts, steeped in literal and legalistic interpretations, have shunned. Yet identifying the moral economy, and addressing issues of culture, Islamic moral hazard, etc., is more useful than parsing medieval contracts, or engaging in irrelevant apologetics. This book has sought to address such issues and introduce heretofore neglected areas in the hope that it will stimulate the kind of research that will be relevant in the global economy.

GLOSSARY

Adl: justice.
Alim (pl. **ulema**): learned man or religious scholar.
Al-wadia: safekeeping.
Awqaf (sing. **waqf**): religious endowments.
Ayatollah: honorific title given to leading Shia clerics in Iran (literally, 'sign of God').
Bay muajjal: deferred-payment sale.
Bay salam: pre-paid purchase.
Bidaa: innovation.
Daawa: missionary activities (literally, 'call').
Darura: overriding necessity.
Faqih (pl. **fuqaha**): jurist, expert in Islamic law.
Fatwa: legal opinion, religious edict.
Fiqh: jurisprudence.
Fuqaha: see faqih.
Gharar: deception, hazard, speculation, uncertainty, risk (literally, peril or hazard)
Ghosh: fraud.
Hadith: stories about and sayings (specific pronouncements, deeds, or approvals of other people's actions) of the Prophet.
Haj: pilgrimage.
Haja: necessity.
Halal: lawful or permissible (see haram).
Haram: unlawful or forbidden (see halal)
Hisbah: an office which in traditional Islam supervised markets, provided municipal services and settled petty disputes.
Hiyal: (sing. **hila**): ruses, used in reference to crafty ways of circumventing the prohibition of riba.
Hudud: punishments such as dismemberment and death by stoning.
Ijara: leasing.
Ijmaa: consensus.
Ijtihad: devout and careful reflection and effort; use of independent judgment or original thinking in interpreting the Koran and the Sunna.
Infitah: open-door policy pursued by Anwar Sadat in the early 1970s.
Islah: reform.
Israf wa taraf: luxury activities; profligacy.
Istisna: commissioned manufacture.
Jahiliyya: pre-Islamic era (literally, state or age of ignorance).
Jahl: ignorance, or lack of knowledge.

Jihad: holy war or spiritual exertion.
Koran: Islam's holy book.
Madhab: school of religious and moral interpretation.
Manfaa: usufruct.
Maslaha: the general interest.
Maysir: a game of chance condemned by the Koran.
Mudaraba: trustee finance, or commenda partnership.
Mudarib: managing trustee.
Mufti: chief religious cleric, usually government-appointed.
Muqarada: loan participation.
Murabaha: contract whereby a financial institution buys goods or commodities on behalf of a borrower and then sells it on a deferred basis at a mark-up.
Musharaka: joint venture between a financier and an entrepreneur.
Qadi: judge.
Qard hasan: interest-free loan usually given for charitable purposes (literally, 'good loan').
Qirad: see mudaraba.
Qiyas: reasoning by analogy or by logical inference.
Rabb al-mal: beneficial owner or sleeping partner.
Riba: interest or usury (literally, increase or addition).
Sadaqa: pious work of charity.
Salaf: the 'pious ancestors', usually includes the Prophet Mohammed and the first four 'rightly guided' caliphs.
Salam: advance purchase.
Salat: prayer.
Shahada: proclamation of faith.
Shariah: Islamic law.
Shirka: see musharaka.
Shura: consultation by the ruler of the community notables.
Sunna: practices and rulings deduced from the deeds, utterances and unspoken approvals of the Prophet and his companions.
Tajdid: renewal.
Takaful: mutual guarantee.
Taqlid: imitation.
Ulema (sing. **alim**): learned men or religious scholars.
Umma: community of believers or nation of Islam.
Urf: custom
Usul el fiqh: principles of Islamic jurisprudence.
Waqf (pl. **awkaf**): charitable trusts; property endowed to Islam for the benefit of Muslims.
Zakat: voluntary almsgiving (literally, 'purification')

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