Islamic Finance Project

Harvard Law School
Islamic Legal Studies Program

Islamic Finance Panel Discussion
Harvard Law School - November 18, 2009

Islamic Finance, Petrodollar Recycling, and Economic Development:
A Report On The Panel Discussion

The Islamic Finance Project organized a panel discussion on November 18, 2009, held at Harvard Law School, entitled "Islamic Finance, Petrodollar Recycling, and Economic Development." The goal of the discussion was to expand the dialogue on Islamic Finance to include a more critical analysis of its effect on the global economy and how its role may evolve in the future to address modern development issues. To facilitate a holistic discussion, experts from various fields were invited to share their perspectives and cross-comment on the speaker's report. The ensuing debate featured a lively exchange of ideas between the panelists and the engaged audience.

The focal point of the discussion was a paper presented by Mahmoud El-Gamal, Professor and Chair of the Department of Economics at Rice University. El-Gamal's report was based on the findings of his previous book, Islamic Finance: Law, Economics, and Practice (Cambridge University Press, 2006), as well as research he is currently conducting to develop into a forthcoming book and multiple papers. Drawing on the historical correlation he has observed between petrodollars and credit crises, El-Gamal believes we are currently at a vital crossroad for determining the future of Islamic Finance in the international economy, as rates of population growth are poised to outstrip the capacity for oil. He argued that Islamic Finance, though based on noble objectives in principle, is reduced to legal arbitrage in practice. The approach historically taken towards Islamic Finance, which he terms "the Arab-Pakistani model," is concerned with morally regulating the operations of individual businessmen rather than promoting economic growth at the macro-level and distributing resources in accordance with Islamic principles of social justice.

To avoid the credit crises this approach has twice led us to in the past, El-Gamal emphasized the need for economic cooperation amongst Middle Eastern states. As the region with the most potential to drive global economic growth, he demonstrated that Islamic Finance practiced through the "Malaysian model" could facilitate economic growth by encouraging otherwise divergent economies to coordinate their long-term industrial plans. This regional cooperation would include differentiating national exports in order to integrate, counter-investing funds so that growth is not procyclical, and creating credit unions through the RoscA model of lending similar to that of Grameen Bank.

To provide a broader perspective on El-Gamal's report, the moderator, Samuel L. Hayes, III, Jacob H. Schiff Professor of Investment Banking, Emeritus of Harvard Business School, invited the three guest panelists to comment on the information and ideas presented. The panelists included Professors Jahangir Sultan, Eric Chaney, and Baber Johansen. Together, they brought a wealth of knowledge, practical experience, and academic research rarely assembled but always necessary in forums such as this.

Jahangir Sultan, Gibbons Professor of Finance at Bentley University, agreed that regional industrialization is vital for growth and that Islamic Finance has been poorly catered toward this goal; however, he believes the fault is with policymakers rather than financial institutions or the system inherently. To improve Islamic Finance so that it promotes economic growth, Sultan suggested that shari'a standards be made more standardized and universal so that products extend beyond the "Islamic wrap" and make economic sense, and that national governments focus on promoting industrialization and designing innovative products so that their investments do not divert scarce resources away from the region.

The next panelist to comment on El-Gamal's report was Eric Chaney, Assistant Professor of Economics at Harvard University. Chaney noted that there is scant evidence evaluating the effect of Islamic banking on development and provided alternate explanations besides oil for the boom in Islamic Finance. He also posed the question of whether the current system is being driven by supply side or demand economics. To make Islamic Finance work for development, Chaney suggested that the incentive structure be realigned so that the field's theoretical objectives are achieved and that the people—rather than just bankers—gain from its benefits.

Baber Johansen, Professor of Islamic Religious Studies at Harvard Divinity School and Affiliated Professor of Law at Harvard Law School, was the third panelist to speak. His commentary reflected on what he deemed the primary difficulties facing Islamic Finance, particularly the competing definitions of what Islamic Finance is amongst states and legislatures. El-Gamal thanked the panelists for their constructive criticism and responded to their concerns, making sure to clarify that his interpretation of Islamic Finance is not restricted to what the Malaysian model labeled it; that indeed, any commodity can be an "Islamic" product but should act as more than a label to abide by shari'a standards.

After the panelists spoke, the moderator opened the floor to questions and comments from audience. Over 50 guests attended the presentation, many being current and future members of the industry. The group demonstrated its vast knowledge of Islamic Finance and interest in the field with insightful comments and thought-provoking questions. Indeed, the sharpest critique and strongest challenges to El-Gamal's assertions came not from the panelists, but from the audience.

The first audience member to comment expressed his concern with El-Gamal's correlation between Islamic Finance and economic development, arguing that Islamic Finance was an insignificant part of Malaysia's and the GCC countries' development; instead, Islamic Finance had been used as a strategy for cooperating and coexisting with the West.

Another attendee continued this challenge of El-Gamal's treatment of Islamic Finance, arguing that economic development was not the stated objective of the Islamic Finance industry and that it was not proper to criticize the industry for failing to achieve regional development objectives. The attendee further argued that El-Gamal's categorization of Islamic Finance into Arab-Pakistani and Malaysian models was inappropriate because all regions are trying to harmonize their Islamic banking practices in line with common shari'a standards as codified by AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) and IFSB (Islamic Finance Services Board). The attendee stated that Malaysian Islamic Finance is based on Islam Hadhari which uses an approach of co-existence with the West. This approach seeks to find areas of mutual cooperation and support in the West and should be emulated in other fields to build more bridges of mutual cooperation and co-existence with the West and Islam. Additionally, Malaysian Islamic banking products have evolved into innovative products that are becoming increasingly popular in the Gulf region just as Gulf based products are finding a good market in Malaysia. Because of the regulated nature of the industry, Islamic banks have to compete with conventional products where their market share remains less than ten percent. The attendee concluded his remarks with a comment on regulation, saying that it is regulatory pressure which forces Islamic products to comply with conventional regulatory standards leading to shari'a arbitrage issues. By showing compatibility with Basel standards, shari'a scholars have demonstrated that modern Islam can co-exist with Western values and standards and that, hopefully, this cooperation can extend beyond the field of finance into other areas.

From the audience, a member commented that Islamic Finance would more appropriately be termed "socially-responsible" or "faith-based" finance to account for its current practices and include a broader gamut of activities, and additionally suggested that many of the problems in the industry stem from a shortage of talent and a need to better incorporate female bankers. Additionally, various attendees probed El-Gamal for his opinion of takaful and sukuk in the field, to which El-Gamal replied that the products are not themselves Islamic or un-Islamic but rather their structure and what is done with them determines how Islamic they are.

One audience member complimented El-Gamal on his criticism of current practices, stating that academic criticism such as this discussion has helped to address many of the issues facing the industry. The audience member further stated that in addition to academic criticism, self-regulation of legal arbitrage also exists. He gave the example of when Justice M. Taqi Usmani announced that a majority of sukuk were not abiding by shari'a, later issuances were structured in a way to avoid the critiques he had stated. Another example quoted was the change in the use of tawarruq. It has been cited that 70% of Islamic finance business in Saudi Arabia was comprised of tawarruq until the OIC (Organization of Islamic Conference) Fiqh Academy deemed it impermissible, which caused the use of tawarruq to dramatically reduce. In the end, he left El-Gamal with the question of whether he made a distinction between ordinary practitioners and agents working to improve the industry from the inside.

After the enlightening exchange between the speaker and audience members, Samuel Hayes asked the panelists to share their concluding comments. Chaney emphasized that our focus should be on who the beneficiaries of the system of Islamic finance are; if not the poor, then it's not functioning as the Prophet Mohammed would have wanted. Sultan reiterated that Islamic Finance is still in its infancy and requires a standardization of shari'a interpretation to promote the growth of industry and direct resources to where they are needed. Agreeing with Sultan on the need to refine the definition of Islamic Finance, Johansen also pointed out that the standards of what constitutes "Islamic" business need to be acceptable to the clientele buying into it. The conference was brought to a close with El-Gamal's final remark, quoting Ibn Khaldun, "what matters in the end is the outcome"; if the outcome of Islamic Finance isn't growth with justice, then it's not Islamic.