



Making an ethical stand

Islamic finance has come under attack from some 'neo-con' quarters. Erroneous claims about links to violence and terrorism are addressed and sharply dismissed in this rebuttal by Shahzad Siddiqui of Toronto-based Shahzad Siddiqui Professional Corporation.

What are the ethical principles behind Islamic finance that have attracted both the Vatican and encouraged governments in the West? There are both qualitative and quantitative principles. With regard to qualitative concerns, Shari'ah-sensitive investors cannot invest in certain sectors. There are the usual suspects like alcohol, pork, gambling, and interest-based financial institutions (like many of the banks which have collapsed in the current crisis). However, there are Abrahamic screens like the one developed by Ittihad Securities in Toronto and Lightstone Capital in New York, which have also started to include more catholic considerations like child labour and environmental records.

Meanwhile, quantitative considerations include a focus on profit and loss sharing and thresholds for acceptable amount of debt in investee companies (which also sheltered many Islamic institutions from debt-ridden companies that have gone insolvent in the crisis).

Given the accolades and the convergence of ethical thought in the arena of Islamic finance, it is in-

structive to return and read alarmist articles like David Yerushalmi's paper entitled "Shari'ah's Black Box," published in the *Utah Law Review*. Yerushalmi is general counsel to the Center for Security Policy, a neo-conservative think tank run by Frank Gaffney Jr.

Gaffney, who is a strong proponent of the war in Iraq and has accused Barack Obama of "embracing the agenda of the Muslim Brotherhood", wrote a series of follow-up articles in the *Washington Times* in late 2008, condemning the US Treasury's interest in Islamic finance and insisting there is a connection between Shari'ah-compliant finance and violent Jihad. Yerushalmi is also the president and founder of the Society of Americans for National Existence (SANE), a group that has advocated prisons terms for Americans that have an "adherence to Shari'ah."

The original paper by Yerushalmi attacked stalwarts of the Islamic finance world, including professors at Harvard University, Shari'ah scholars like Shaikh Taqi Usmani and legal advisors like Michael McMillen.

Some of the major issues in the paper were that Islamic finance is a deception and may be subject to lawsuits alleging misrepresentation, that Shari'ah scholars advising companies

conducting Islamic finance are calling for the violent overthrow of Western governments and that monies donated to charity pursuant to the purification of "impure income" within Islamic finance portfolios is a source of terrorist funding.

In his seminal book, *Introduction to Islamic Finance*, Usmani dealt with the issue of deception, in the context of comparing financing vehicles like Murabaha with equity vehicles like Musharakah. Usmani forcefully stated:

Originally, murabahah is a particular type of sale and not a mode of financing. The ideal mode of financing according to Shariah is mudarabah or musharakah...However, *in the perspective of the current economic set up, there are certain practical difficulties in using mudarabah and musharakah instruments in some areas of financing*. Therefore, the contemporary Shariah experts have allowed, subject to certain conditions, the use of the murabahah on deferred payment basis as a mode of financing. But there are two essential points which must be fully understood in this respect:

1. It should never be overlooked that, originally, murabahah is not a mode of financing. *It is only a device to escape from "interest" and not an ideal*

instrument for carrying out the real economic objectives of Islam. Therefore, this instrument should be used as a **transitory step**...and its use should be restricted only to those cases where mudarabah or musharakah are not practicable.

2. The second important point is that the murabahah transaction does not come into existence by merely replacing the word of “interest” by the words of “profit” or “mark-up”. Actually, murabahah as a mode of finance, has been allowed by the Shariah scholars with some conditions. Unless these conditions are fully observed, murabahah is not permissible. In fact, it is the observance of these conditions which can draw a clear line of distinction between an interest-bearing loan and a transaction of murabahah. If these conditions are neglected, the transaction becomes invalid according to Shariah. [Emphases added].

In his clarification on Sukuk in late 2007, Usmani spoke forcefully again on the need to improve upon transitory products. He stated:

Undoubtedly, Shari’ah supervisory boards, academic councils, and legal seminars have given permission to Islamic banks to carry out certain operations that more closely resemble stratagems than actual transactions. *Such permission, however, was granted in order to facilitate, under difficult circumstances, the figurative turning of the wheels for those institutions when they were few in number [and short of capital and human resources]. It was expected that Islamic banks would progress in time to genuine operations based on the objectives of an Islamic economic system and that they would distance themselves, even step by step, from what resembled interest-based enterprises.* What

is happening at the present time, however, is the opposite. Islamic financial institutions have now begun competing to present themselves with all of the same characteristics of the conventional, interest-based marketplace, and to offer new products that march backwards towards interest-based enterprises rather than away from these. *Oftentimes these products are rushed to market using ploys that sound minds reject and bring laughter to enemies* [Emphasis added].

This clarification had a deep impact on the global Sukuk market and demonstrates the risk of trying to adapt conventional frameworks to the Islamic paradigm in a liberal fashion. However, to date, there is not been a single lawsuit alleging misrepresentation on the Shari’ah compliance

of Sukuk that were the target of the critique. This is likely due to the fact that the issue of the Shari’ah vis-à-vis secular law has already been litigated in cases like *Shamil Bank v. Beximco*. In that case, an Islamic bank entered into a Murabaha loan transaction with two Bangladesh-based entities. The borrowers defaulted on the loan and when the bank demanded repayment of the balance of the loan, the borrowers declined to settle the balance. They went to court on the basis that the contract was a disguised interest-bearing transaction.

The choice of law clause in the contract stated that, “Subject to the principles of the Glorious Sharia’a, this Agreement shall be governed by and construed in accordance with the law of England.”

At appeal, counsel to the borrow-



Columbus discovers Shari’ah

In the mid-1480s, Christopher Columbus made a pitch to Queen Isabella I of Castille. In return for funding his voyages to seek the riches of Asia, he offered her the bulk of his profits on the venture. Columbus was initially rebuffed but in order to keep him from taking his ideas elsewhere, the Castilian royal family gave Columbus an annual allowance and, in 1489, furnished him with a comfort letter ordering all towns in the realm to provide him food and lodging at no cost. After a few years of “due diligence,” the Queen finally made a deal with Columbus: he would get 10 per cent of the profits, five per cent of the gold, all expenses paid in advance and title of Admiral of the Ocean Sea.

The deal was documented by Muslim lawyers, who were experts in the partnership contracts of the time and the deal was completely Shari’ah-compliant: there was no interest component to the royal profit and loss partnership and the financing was used to fund a Shari’ah-compliant activity: exploration. The net result of the deal was unique and well-known: a massive rate of return from two continents.

Some 520 years later, at the beginning of March 2009, there was an extraordinary moment: the Vatican, seat of Roman Catholicism, gave Islamic finance its full endorsement. As reported in the Vatican newspaper, *L’Osservatore Romano*, “The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service.”

The Vatican offered Sukuk as a panacea to the ailing car industry and potential source of funding for the Olympic Games in London. Islamic finance houses took the former suggestion seriously. Kuwait-based investment firm, Rasameel Structured Finance, proposed a Musharakah Sukuk (see *Islamic Business & Finance*, April 2009, p.29). The Rasameel plan would have averted bankruptcies in the US and allowed Middle East investors to make strategic investments to save American jobs and manufacturing icons.



ers conceded that there could not be two separate legal systems governing the contract. After analyzing the contract and choice of law provisions, the Court of Appeal agreed with the lower Commercial Court in holding that:

...the words are intended simply to reflect the Islamic religious principles according to which the Bank holds itself out as doing business rather than a system of law intended to 'trump' the application of English law as the law to be applied in ascertaining the liability of the parties under the terms of the agreement. English law is a law commonly adopted internationally as the governing law for banking and commercial contracts, having a well-known and well developed jurisprudence in that respect which is not open to doubt or disputation on the basis of religious or philosophical principle. I share the [Commercial Court] judge's view that, having chosen English law as the governing law, it would be both unusual and improbable for the parties to intend that the English court should proceed to determine and apply the Sharia in relation to the legality or enforceability of the obligations clearly set out in the contract.

Furthermore, from a religious perspective, there is a strong strand of thought amongst Islamic scholars that difference of opinion is actually a mercy. Therefore, even though Usmani took great issue with current offerings, investors would be wary of suing Murabaha providers or Sukuk issuers on grounds of non-compliance with the Shari'ah because they implicitly accepted Shari'ah compliance, which is subject to difference of opinion, when they entered into the Murabaha or invested in the Sukuk.

With regards to Shari'ah scholars calling for violent overthrow of the government, Yerushalmi begins to get more far-fetched. He asks:

Would a reasonable post-9/11 investor consider the connection between Shari'ah and SCF important to his or her decision to invest? In other words, would a reasonable investor, looking to invest in something promoted as "Shari'ah compliant," want to know what Shari'ah and its "rules and principles" say about constitutional government, treatment of infidels, the Law of Jihad, the use of suicide-homicide bombers, and other acts of terrorism?

In the post-911 environment, investors are quite familiar with acts of terrorism done in the name of Islam. However, Muslims and non-Muslims alike continue investing in Islamic finance in large numbers. These investors are investing in Sukuk and other Shari'ah-compliant instruments, *despite* knowledge about acts of terrorism by those who call themselves Muslim. The investors may well also be aware of contributions that the Muslim world had made to the modern world: from algebra to the verse of Rumi, the cheque to the novels of Khalid Hussein.

Finally, with regards to monies donated to charity pursuant to portfolio purification, there are two potential levels: at the institutional level, any Islamic finance company in North America would be extremely careful about its charitable contributions and would comply with relevant regulations under Fincen, Fintrac and the Patriot Act. Furthermore, contributions would generally be made to local charities with local activities, like soup kitchens and non-denominational orphanages. If

decisions about charity are left to individual investors, which is increasingly rare, those investors are going to be mindful of lawsuits like *Burnett v. Baraka* and ensure that their charities are also registered and compliant with relevant laws.

Islamic finance represents one of the Muslim world's great contributions to the modern era and is a bridge between the world's major cultures including the Middle East, the West and emerging China. Influential figures would seem to agree, given the Vatican pronouncement, UK government support and recent books like Joe DiVanna's *Understanding Islamic Banking: The Value Proposition that Transcends Cultures*. The last word ought to go to Frank Vogel, a Christian of European extraction who is also the Custodian of the Two Holy Mosques Chair in Islamic Legal Studies at Harvard Law School, "It's very much in our interest that it [Islamic finance] succeed, yet I'm afraid that we're going to be against it, that we're going to make all these snotty remarks. Time is running out for healthy, happy experiments like this."

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He currently advises organisations as diverse as Ittihad Securities, an Islamic investment bank in Toronto, First Global Data Corp., a Shari'ah-compliant global money remittance company, the Chinese Muslim Association of Canada and Islamic wealth management teams at HSBC Securities and Blackmont Capital, a top-tier Canadian investment bank.