Prepared Statement of
Mahmoud A. El-Gamal, PhD,
Chair of Islamic Economics, Finance and Management, and
Professor of Economics and Statistics, Rice University – Houston, TX

Islamic Finance in the Middle East

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"Money Laundering and Terror Financing Issues in the Middle East"

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Chairman Shelby, ranking member Sarbanes, and distinguished Members of the Committee: Thank you for inviting me to speak to you today about the modes, strengths and weaknesses of Islamic finance as practiced in the Middle East, narrowly defined.

The conclusion of my analysis, as presented below, is that there is no reason – in theory – to suspect that Islamic finance would be particularly immune or particularly vulnerable to abuse by money launderers or terrorist financiers. In this regard, it is important to recognize that Islamic finance utilizes relatively sophisticated financial methods – originally devised for regulatory arbitrage purposes – to synthesize modern financial practices from simple contracts such as leases and sales. The emergence of those sophisticated regulatory arbitrage techniques in the U.S. and other developed economies has prompted regulators and enforcement agencies in those countries to increase the level of sophistication of their staff (hiring PhD economists, MBAs, ex-bankers, etc.).

Unfortunately, regulators and enforcement officials in the middle-east may possess significantly lower levels of sophistication than Islamic finance

practitioners who utilize state-of-the-art regulatory arbitrage techniques. Moreover, the Islamic finance industry has been – thus far – largely self-regulating. This suggests that development of a comprehensive regulatory framework for Islamic finance, and training regulators and enforcement officials in the region, should be priorities for governments in the region, as well as international financial institutions and other governments providing technical assistance.

U.S. Treasury efforts to understand Islamic finance

Islamic finance has attracted increasing levels of interest and scrutiny in Washington recently, due to its phenomenal growth, but especially following the terrorist attacks of September 11, 2001. Shortly after those attacks, then Secretary of Treasury O'Neill and Under Secretary Taylor visited Bahrain – one of the main centers of Islamic finance in the Gulf Cooperation Council (GCC) region. They met with various leading practitioners of Islamic finance in the area at Citibank's facility in Manama. Needless to say, the primary concern that prompted interest at the time was fear that Islamic finance may invite disproportionate participation of terrorist financiers, and/or exhibit particular vulnerabilities to abuse thereby.

Having learned some of the basics about Islamic financial practices and regulation during the Secretary and Under Secretary's visit to Bahrain, U.S. Treasury organized an "Islamic Finance 101" workshop in April 2002, to educate Government as well as Capitol Hill staffers about this fast-growing industry. Also, Treasury Secretary Snow and then Under Secretary Taylor attended the Second

International Islamic Finance Conference held in Dubai, September 2003, where they gained additional information and understanding about Islamic finance.

Following that second visit, Treasury decided to create a post of "Scholar-in-Residence on Islamic Finance", which I had the privilege to occupy June through December 2004. During my tenure at Treasury, I provided more than a dozen workshops for staffers of U.S. Departments, Government agencies, regulators, and House staffers. In addition, we coordinated our staff efforts with those of World Bank and International Monetary Fund staffers, the latter having simultaneously and independently increased their involvement in Islamic finance. The interest of International Financial Institutions in Islamic finance aims – in part – to ensure the application of best practices in anti-money laundering and combating the financing of terrorism. Those efforts also aim to integrate Islamic finance within a regulatory framework that ensures systemic stability and economic efficiency at national, regional and global levels.

In the remainder of this written statement, I shall describe briefly the roots of Islamic finance, its current modes of operation in the Middle East, and its emerging regulatory framework in the region. Before I proceed, I need to highlight two limitations of my testimony before you:

1. I cannot quote any accurate figures regarding the size of this industry, or its rate of growth, mainly due to the lack of official and/or credible statistics from reliable and objective sources. Recent media reports quoted British Financial Services Authority estimates of assets under management in

Islamic finance in the range of US$200 to US$500 billion. Other semi-official statements by GCC officials suggested that "Islamic" deposits account for 10% to 20% of total deposits in those countries. However, with Islamic banking being practiced by dedicated Islamic banks as well as conventional banks, and with no official and publicly available data, one cannot rely excessively on those guesstimates.

2. I recognize that one of your objectives for this hearing is to obtain a better understanding of the implications of Islamic financial modes of operation and regulatory framework for efforts to combat money-laundering and terrorist financing worldwide. I shall try my best to answer your questions in this regard. However, I must admit that my understanding of this area, and any statements that I may make about the relative vulnerability or immunity of Islamic financial institutions to abuse by money launderers and terrorist financiers, must be – like myself – academic in nature.

Historical Roots of Islamic Finance

The Canonical Texts of Islam – echoing and elaborating on Biblical Texts – forbade "usury" under the name *ribā* (equivalent to the Hebrew term *ribīt*), classically interpreted as any interest charge on matured debts or loans. While some Islamic scholars have argued for more restrictive definitions of the forbidden *ribā*, the vast majority of contemporary Muslim jurists and scholars have equated the classical term "*ribā*" with "interest". This equation has led to paradoxical statements about Islamic finance being "interest-free". In fact, Islamic finance

replaces interest on loans and pure debt instruments (e.g. bonds) with interest characterized as rent in leases or price mark-up in sales.

As Islamic finance began to take shape in the mid 1970s, jurists also considered the more subtle prohibition of *gharar* (excessive risk or uncertainty), which impacts modern forms of insurance, management tools for credit and interest rate (rate of return) risks, derivatives, etc. Islamic finance as practiced today aims to mimic modern financial practices (banking products, insurance products, money and capital market instruments, etc.) with variations on classical (medieval) contract forms that were deemed devoid of forbidden *riba* and *gharar.*

The historical roots of Islamic finance date back to the 1950s and 60s, and the theoretical literature from that period continues to shape the industry's rhetoric to this day. Islamic finance was mainly envisioned by leaders of Islamist movements, such as Abu al-ʾAʿlā al-Mawdūdī, Sayid Quṭb, and M. Bāqir al-Ṣadr. They created a field of study known as "Islamic economics", which subsequently flourished particularly in Pakistani and Indian-Muslim areas, and coincided with political independence movements in various Muslim countries.

This literature gave rise to numerous hypotheses about how Islamic finance would operate within an "Islamic economy", one envisioned to thrive in an "Islamic society", ostensibly arising in newly independent nations like Pakistan. The main paradigm that emerged suggested that all finance would be interest-free, based on the sharing of profits and losses. In particular, bank-alternatives were envisioned to function on an equity basis, like mutual funds. Instead of

lending, Islamic banks were envisioned to engage in equity participations with their clients, thus sharing in their profits and losses. The bank's funds would in turn be raised through equity participation in the bank's portfolios of investments, thus "depositors" would share in the pooled profits or losses of the bank.

When the oil boom of the 1970s made Islamic banking a reality, emerging Islamic banks – following a series of reported losses on their financing – quickly learned to abandon profit and loss sharing in favor of debt-based forms of financing. Thus, conventional bank loans were replaced in Islamic banks with receivables from credit sales or leases. More recently, other assets of conventional banks (including corporate and sovereign bonds, asset backed securities, etc.) have been replicated through Islamized structures. On the liabilities side, however, Islamic banks have continued to maintain that "investment depositors" must share in the banks' profits and losses, and Islamic finance promoters have continued to speak of profit and loss sharing generally as "the ideal Islamic form of financing".

Contemporary methods of Islamic finance

Contemporary Islamic finance emerged in the mid 1970s, with funding from the oil-rich GCC region, following the first oil price shock of 1973 (the industry has been booming in recent years, mainly fueled by high oil prices). Among the first Islamic financial institutions were Kuwait Finance House, Dubai Islamic Bank, and Faisal Islamic Banks in Egypt and Sudan. The GCC region remains to-date the primary financier of Islamic finance world-wide. In addition, countries such as Saudi Arabia, which had originally resisted the growth of Islamic

finance within its own borders, have recently allowed the "Islamization" of some of their largest retail banks, including National Commercial Bank of Saudi Arabia.

Indeed, while some of the earliest Islamic banks were pioneered and funded by Saudis (Prince Muhammad b. Faisal Al-Saud and Sheikh Saleh Kamel), those pioneers were not allowed to operate Islamic banks within Saudi Arabia. The first Islamic bank in Saudi Arabia (and the largest in the Middle East) was Al-Rajhi, which was only allowed to operate on the condition of avoiding the use of "Islamic" in its name. In recent years, excess liquidity in Saudi Arabia (due to high oil prices and repatriation of funds after 9/11/2001) was migrating to Bahrain and Dubai – which established themselves as competing centers of Islamic banking in the region, attracting to Islamic finance international financial providers such as Citi, HSBC, Credit Suisse, UBS, etc. To retain those funds, Saudi Arabia finally allowed the current trend of Islamization of its banking system to emerge. Given contemporary Islamic banks' abilities to emulate most operations of conventional banks, it is likely that banking systems within the GCC will become mostly or completely "Islamized" within few years.

Financing modes – Murābaḥa (credit sale with mark-up)

As mentioned in the previous section, Islamic banks started from their earliest days in the late 1970s to mimic the asset structures of conventional banks. The instrument of choice to replace loans was *murābaḥa* (cost plus) financing. Under this arrangement, the bank would first purchase the property desired by its customer, and then sell it on credit at a mark-up price determined by market

interest rates (typically tied to the London Inter-bank Offer Rate – LIBOR; the industry in GCC is heavily staffed and influenced by London-trained bankers). Many innovations were introduced in this practice to eliminate the bank's risk exposure beyond normal banking risks (such as interest-rate, credit and liquidity risks). For instance, Islamic banks were permitted to obtain binding promises by virtue of which customers were obliged to buy financed properties from the bank once the latter acquired them – thus eliminating non-banking commercial risks.

In the early years of Islamic banking, this transaction was used mainly for financing the purchase of durable goods (e.g. automobiles, real estate, etc.), which made it tantamount to an elaborate form of secured lending.[1] However, the practice was soon utilized for trade financing, within which it can be used easily to synthesize conventional loans. For instance, a customer can obtain financing for the purchase of $10 million-worth of aluminum or diamonds (owing the bank, say, $11 million at a later date), and then sell the commodities to obtain cash – thus obtaining credit without formally violating the prohibition on interest-based loans.

Financing modes – Tawarruq (credit sale at markup followed by spot sale)

A retail banking variation on this multi-trade synthetic-loan transaction has emerged in recent years in GCC countries under the name of *tawarruq* (literally: monetization – of the traded commodity). Under this form, the bank

[1] Indeed, when this practice was applied in the U.S. by United Bank of Kuwait, the OCC interpreted both murābaḥa financing, and lease-based ijāra financing (discussed below) as forms of secured lending, see: OCC interpretive letters #806 of 1997 and #867 of 1999 at www.occ.treas.gov.

commonly performs all the necessary transactions to synthesize a loan: purchasing the commodity in its own name, selling it to the customer on credit, and then selling it on behalf of the customer for its cash price. Banks now have standing agreements with commodities dealers for repeated use of their commodities in this type of transaction, thus reducing transaction costs through large trading volumes/frequencies, and logistical economies of scale. In addition, agreements with dealers eliminate residual market risks (associated with commodity prices) to which banks and customers may be exposed in *murābaḥa* financing followed by independent cash-sale of the financed property.

It is noteworthy that *tawarruq* was only deemed acceptable by a small minority of Islamic jurists, most of whom later rejected its systematic use by Islamic banks. Despite that general rejection by the majority of jurists, this practice has been one of the fastest growing forms of retail Islamic finance in the GCC.

Financing modes – Ijāra (operating lease)

Responding to criticism of credit-sale financing as thinly veiled interest-based lending, Islamic bankers slowly migrated to lease financing as a favorite alternative form of secured lending. In some instances, operating lease forms adopted by Islamic financial institutions also provided tax benefits in western jurisdictions, where they were eventually used to structure corporate leveraged buyouts for subsequent private placement to GCC investors.

More recently, the volume of lease-based Islamic financing has also increased due to its potential for securitization. In this regard, the majority of

Muslim jurists have maintained that accounts receivable (e.g. from credit sales) represent debts, which may not be securitized or traded in secondary markets. In contrast, they argued, lease receivables represent rent based on ownership of underlying physical assets, and thus may be traded in secondary markets. The most significant application of this paradigm has been in the area of Islamic bond-alternatives.

Financing methods – Lease-based long-term bonds

The Monetary Authority of Singapore recently estimated that the outstanding volume of Islamic *ṣukūk* (an Arabic term meaning certificates or bonds) worldwide stood at US$30 billion at end 2004. Long-term bonds are obviously intended for trading on secondary markets, and thus the structure of choice is lease-based. For instance, the US$700 million issuance by the State of Qatar (Qatar Global Ṣukūk) in December 2003 was structured as follows: A special purpose vehicle (SPV) was created for the bond (ṣukūk) issuance. The SPV issued the certificates and used their proceeds to buy some land in a medical complex from the State of Qatar. The SPV then leased the land back to the State of Qatar, thus collecting principal and interest in the form of rent, which was passed through to the certificate holders. At lease-end, the SPV is obliged to give the land back as a gift to the State of Qatar. In other structures, the SPV is forced to sell the land back to the lessee. Similar bond structures have been used by the governments of Malaysia and Pakistan, the German State of Saxony-Anhalt, Dubai Civil Aviation Authority, World Bank, among other governments and corporations.

While such lease-based certificates may – in principle – have financial risks different from conventional bonds, the legal structures are typically constructed to eliminate all such differences. Thus, in their justification of the A+ rating that they granted the Qatar Global Ṣukūk discussed above, Standard and Poors analysts argued that the only relevant risk based on the ṣukūk's legal structure is the sovereign credit risk of the State of Qatar. In other words, despite the complicated structure, the end result is in fact replication of conventional bonds, on which the issuer (corporate or sovereign) pays the same interest it would have paid on regular bonds (or nearly the same, accounting for higher transaction costs).

Financing methods – Forward-sale-based short-term bills

For short term (bill-type) government bonds, the lease-based structure imposes excessive transaction costs. Thus, Bahrain Monetary Agency (BMA) has pioneered the issuance of sale-based bills known as *ṣukūk al-salam* (certificates of pre-paid forward sales). In those structures, BMA collects the proceeds of bill sales as pre-payment of a forward price for the purchase of some commodity (say aluminum). Ostensibly, BMA promises to deliver aluminum at the bill maturity date. However, BMA also promises to arrange for the aluminum to be sold on the ṣukūk-holders' behalf at a predetermined price (equal to the collected proceeds plus interest based on the appropriate LIBOR plus credit spread). Those bills have been traditionally held to maturity – mostly by Islamic banks looking for permissible instruments to manage liquidity. In its effort to develop a liquid

Islamic money market, BMA has recently announced the development of a repo (repurchase) facility structure that will allow for liquid trading of those bills.

Islamic mutual funds

Perhaps the easiest segment of the Islamic finance industry to develop was that of equity investment in mutual funds that shun certain types of stocks. Providers of those funds exclude stocks of "sin industries" (casinos, breweries, etc.), as well as other industries whose primary business is deemed un-Islamic (e.g. participating in certain types of genetic research potentially leading to human cloning). In addition, stocks of companies that pay or earn excessive interest are excluded through various screens (e.g. debt to moving average of market capitalization, or receivables as a percentage of revenues, exceeding certain thresholds).

Within the remaining universe of securities, conventional portfolio management techniques are utilized. It is interesting to note that despite the high publicity received by those Islamic mutual funds and their index-provider licensors (e.g. Dow Jones Islamic Indexes), the total volume of assets managed by those Islamic funds remains very small (compared, for instance, to the estimated US$1 trillion of Saudi funds being invested in U.S. assets). One traditional explanation of this phenomenon has been that customers who prefer "Islamic" structures may have relatively low levels of risk tolerance, and the bulk of high net worth individuals and institutional investors (with more tolerance for financial risks) in the GCC are too sophisticated to participate in costlier "Islamic finance"

(for instance, the most famous Saudi investor, Prince Al-Walid b. Talal, is not known to have shown much interest in the industry).

Islamic investment banking

More sophisticated investors with an appetite for Islamic finance often invest in U.S. and other western equities through investment banking and private equity boutiques. Those Islamic investment bankers often operate independent or semi-independent branches in the home countries of target companies, and use "Islamic" forms of leverage (e.g. lease-based as discussed above) in their acquisitions. Their generated assets are then privately placed through their GCC-based home institutions and networks of investment advisors.

Advanced financial structures

To address the high level of risk aversion among retail GCC Islamic investors, Islamic financial practitioners have developed complicated financial structures to replicate payoffs that normally require trading in derivative securities (which is not permitted by the vast majority of Muslim jurists). For instance, Al-Rajhi and National Commercial Bank in Saudi Arabia both provided protected-principal index participation structures to their clients in the early 2000s.

Those structures involved a partner or advisor, who is typically a conventional investment bank, with no qualms about trading in derivative securities. The partner or advisor provided investors full or partial protection of their principal (which is tantamount to a put option), and was compensated with a portion of returns and/or returns above a certain threshold (which are

tantamount to call options). In some instances, call options were also directly synthesized from earnest-money-like down-payment trades known as *ʿurbūn*, and used in those protected-principal structures. In all cases, providers highlighted the fact that the principal was not "guaranteed" by the provider, and thus positive returns did not represent forbidden ribā.

With investment bankers pursuing fees from new structures, Islamic finance providers have most recently begun marketing "Islamic hedge fund" structures that promise "absolute returns". It has been interesting to note that some of the indirect publicity associated with one of those "Islamic hedge funds" has been – purposefully or otherwise – playing on the confusion caused by the misnomer "hedge fund" (translated literally as *ṣanādīq al-ṭaḥawwuṭ*). In one web article and at two conferences in the middle-east, I have witnessed two jurists associated with an "Islamic hedge fund" actively providing examples of hedging, and arguing that "hedge funds" are vehicles for investors to hedge their market exposure.

Insurance alternatives

The majority of jurists deem conventional insurance contracts to be impermissible due to two reasons. First, the high-quality debt instruments in which insurance companies normally invest their premiums (e.g. bonds, mortgage backed securities, etc.) are deemed forbidden based on *ribā*. Second, the insurance contract itself is deemed by those jurists to be a form of gambling (since the insured pays a premium, but knows not whether he will ever file a claim), and hence forbidden based on the canonical prohibition of *gharar*.

To solve both problems, providers of a cooperative insurance form – known by the Arabic name *takāful* – have emerged. To solve the first problem, premiums are invested in Islamic variations on bonds, asset-backed securities, etc., like the ones discussed earlier. To solve the second problem, the relationship between insurer and insured is not viewed as a commutative financial contract (in which the uncertainty associated with claims would deem the contract impermissible). Instead, the takāful company is said to pay claims based on voluntary contribution (*tabarruʿ*), as a form of social cooperation. Paradoxically, none of those companies ostensibly providing cooperative insurance are in fact structured in a mutual corporate form. Instead, the companies are commercially owned by stockholders, but offer binding promises to policyholders that they will make "voluntary contributions" whenever valid claims are filed by an insured party.

Investment account holders at Islamic banks

A number of thorny issues regarding corporate governance have been raised by the quasi-equity position of investment account holders at Islamic banks. The most important issue, which has been under study in a working group of the recently created Islamic Financial Services Board (IFSB, based in Kuala Lumpur, Malaysia) relates to protection of those investment account holders (IAHs). In this regard, IAHs lack the protections of fiduciary depositors (who are creditors and first claimants on the Islamic bank's assets, but earn no interest), but also lack the protections of shareholders (who are equity holders represented on the bank's board of directors).

Paradoxically, the solution through mutual corporate structures (e.g. as used by mutual savings banks and credit unions in the U.S.) has not been a subject of serious discussion in the industry, despite having been utilized in the earliest days of Islamic finance in Pakistan in the 1950s. One explanation is that growth in Islamic finance has been driven by profitability of providing financial products to a trapped market segment with minimal competition, while mutual structures are oftentimes implemented in non-profit settings.

Issues related to criminal financing

Investment account holders' liability

For the purposes of this hearing, one must address two aspects of Islamic bank liability structure that relate to potential criminal financial abuses, especially in the aftermath of the 9/11/2001 terrorist attacks: (1) Are investment account holders to be deemed owners of the Islamic financial institutions; and if so, how responsible can they be held for any criminal financial activities in which the institution may engage? (2) In case of dissolution of an Islamic bank (perhaps due to its prior engagement in criminal financial activities), what is the seniority of investment account holders' claims on the bank?

The answer to the second question is a difficult one that has been the subject of intense study at the Islamic Financial Services Board. It is clear that IAHs theoretically have lower seniority than fiduciary depositors (who receive no return on their deposits), but higher seniority claims relative to shareholders. However, since management determines the magnitudes of profits or losses disbursed to the

IAHs, and consequently the amounts assigned to the residual claimant shareholders, it is not clear how liquidation would in fact take place. The Islamic Financial Services Board and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) have attempted so far to reduce this problem by setting transparency standards for the mechanisms used to assign profit and loss distributions. However, the final standards have yet to be set on issues of ownership, control and seniority of claims to Islamic bank assets.

The answer to the first question may seem at first to be rather straight forward: Since investment account holders lack operational control of the bank's activities (even if in some cases they can earmark their funds for investment in specific sectors), it would seem most unlikely that they can be held responsible for the bank's illegal or criminal activities. On the other hand, complications might arise from differences of views on what constitutes criminal financial activities. For instance, an Islamic bank may be known to disburse charitable contributions on behalf of its customers in certain venues. In this regard, it is no secret that certain charitable organizations and destinations of funding thereof were (and in some cases may continue to be) viewed differently by different governments and different bankers.

This issue is clearly relevant for all Islamic banks' and Islamic financial providers' customers (mutual funds may also disburse charitable *zakat* contribution on behalf of investors). Moreover, it is also a valid concern for most Muslims whose charitable contributions are disbursed by specialized institutions.

Solutions to this problem require addressing the thorny issue of harmonizing standards of anti-money laundering and terrorist financing agencies worldwide, and establishing clear criteria upon which Islamic charities and financial institutions can rely in their future dealings. Significant convergence has occurred over those issues, but some confusion continues to this day.

Relative vulnerability to abuse

It seems rather naïve to think that a group intent on committing criminal activities would favor Islamic financial venues, especially since they are likely to come under closer scrutiny in that domain following the terrorist attacks of 9/11. On the other hand, it is natural to ask whether the mechanics of Islamic finance make it particularly vulnerable to abuse by money launderers and terrorist financiers. In this regard, one cannot escape the fact that regulatory-arbitrage methods used in Islamic finance to camouflage interest and other factors deemed forbidden by the industry (an activity that I have labeled Sharīʿa-arbitrage) bear striking resemblance to methods used in criminal financial activity in recent years. The "asset (or commodity)-based" nature of Islamic finance, which the industry advertises as its main virtue, may in fact be viewed as a source of weakness, since multiple-hop commodity and asset trading at losses or profits is a standard method used to hide the source (in money laundering) or destination and transmission route of funds (in terrorist financing).

Of course, one must remember that this is merely a historical accident. The most sophisticated methods used by Islamic financiers to hide debt and by

criminal financiers to hide sources or destinations of funds, as well as the routing of those transactions through offshore financial centers, are simply methods of the regulatory-arbitrage structured-finance revolution of the 1980s, meant initially to capitalize on various tax and regulatory advantages. Due to the increased utilization of those methods, bankers, regulators and law enforcement officials have grown more sophisticated in analyzing such dealings, and uncovering the underlying objectives of their parties. With offshore centers also applying increasingly better prudential standards, the risk of abuse has been diminished greatly, though obviously not eliminated.

In this regard, one must admit that regulators and law enforcement officials in the Middle-East are relatively unsophisticated in dealing with those complicated financial structures, at least compared to their western counterparts. In this regard, technical assistance through direct inter-government interactions, indirect private sector initiatives of multinational banks, and involvement of the World Bank and International Monetary Fund, have all contributed to increased awareness.

On the other hand, with the possible partial exception of Malaysia, I am not aware of any country that has a *comprehensive* regulatory framework for Islamic financial institutions. Such a comprehensive framework would have to take into account peculiarities of Islamic finance: e.g. assets and commodities used as degrees of separation in purely financial dealings, resembling "layering" methods of criminal financiers. Laws passed for regulation of Islamic banks in GCC (e.g. in

Kuwait, Bahrain, etc.) appear to be simple augmentations of conventional bank regulations, with the additional provisions of appointing a religious "Sharīʿa supervisory board", etc. However, conventional bank regulators in those countries generally lack the sophistication required to understand complicated financial dealings fully.

There may not be major cause for concern, since central bankers in the GCC region, where the bulk of Islamic finance takes place, are among the most sophisticated in the Middle East. That being said, regulatory standards and talents in the region continue to lag behind those in advanced countries, and Islamic finance does exist in a number of countries with inferior regulatory infrastructures, and does operate across borders – seeking regulatory arbitrage opportunities.

My recommendation in the short-run would be to bring all Islamic finance under the same standards applied to conventional financial practice through a simple conversion operation: reduce all Islamic transactions for regulatory and enforcement purposes to their conventional counterparts. This has been the approach, for instance, partially used in Turkey with relative success. For the longer term, we need to enhance and support efforts by AAOIFI and IFSB towards developing a set of standards for Islamic finance that harmonize their accounting and regulatory methods with best accepted international standards.

Concluding remarks

In conclusion, Islamic finance differs from conventional finance only superficially. However, that superficiality entails degrees of separation through

superfluous trades and leases that make regulation and law enforcement more challenging. There is no reason in theory to assume that Islamic finance would be more or less vulnerable to abuse by criminal financiers, based on its utilization of those methods. On the other hand, fighting criminal financing in the traditional banking sector of the Middle-East is already a significant challenge, due to limited human resources and regulatory infrastructure. The extreme measures that can be (and are occasionally) taken to eliminate criminal financing in that region could also stifle legitimate financial activity – in a region that is in desperate need for enhanced economic efficiency and job creation.

To the extent that Islamic finance utilizes more sophisticated financial structures, the challenge faced by regulators and law enforcement agencies in the region is increased. The goal should be eliminating criminal activities, while fully allowing legitimate financial activity. Towards that end, more coordination with regulators and enforcement agencies, including technical assistance and involvement in development of standards, remains crucial at this time.