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Islamic finance faces legal challenges

Some of the most commonly-used structures may fail to hold up in court, industry experts warn

Some are claiming that greater use of Islamic finance could have averted, or at least minimised, the global financial crisis. However, the sector has potential problems of its own, which may become apparent in 2009 as the real economy in most countries starts to suffer.

The musharakah contract, in which a bank acts as a partner in a business interest, could potentially expose institutions to legal action. The bank is likely to be involved in management decisions, and it could be vulnerable if business is conducted improperly.

“In the case of negligence or misconduct, the Islamic bank will be liable for the capital of musharakah,” said Dr Sabir Muhamed Hassan, governor of the Central Bank of Sudan, speaking in Malaysia last month. “Modern insolvency laws in some countries impose liability on the officers and directors for actions taken on the eve of insolvency.”

The application of insolvency laws will be vital in determining whether more complex Shariah compliant derivatives work. Securitisation is permitted under Islamic guidelines, but the difficulty comes in proving that a particular transaction is a ‘true sale’, in which risk has been completely transferred.

There were also contracts in the past which did not make it clear whether in the event of an issuer’s insolvency its sukuk holders would have a claim to the sukuk assets, or only the income from those assets, which would probably have ceased by that stage. However, guidelines from the Islamic Financial Services Board (IFSB), an international standards board, have since stated that sukuk holders should have a claim on the assets held in the investment vehicle.

“I actually think the next few years will be very difficult for the Islamic finance industry from a litigation perspective,” says Hari Bhambra, a lawyer who has worked on Islamic finance regulations for the UK Financial Services Authority and Dubai Financial Services Authority, and is now a senior partner at consultancy Praesidium. “It’s not quite clear whether some of the elements of the Islamic structure have legal force, so I think they will be tested.”

So far, few Islamic finance contracts have been taken through the courts, but she says that the experience in the UK has not been encouraging. Judges have ruled that customers have

limited rights to pull out of a contract if they are given information about the structure of a product and the reasons why it is Shariah compliant.

Bhambra says: "But in market practice, customers are given a product, it's got a fatwa stamped on it, so it's been approved. There's usually little information about why."

She calls for increased disclosure of fatwa details, particularly since some Islamic finance products with the same name could differ vastly from country to country.

This would also make Shariah scholars more accountable for their decisions. Sheikh Muhammad Taqi Usmani, chairman of the board of scholars at think tank AAOIFI (the Accounting and Auditing Organisation for Islamic Financial Institutions), is widely credited with contributing to a slowdown in sukuk issuance, after he announced in November 2007 that 85% of sukuk in existence were not Shariah compliant because they included repurchase agreements. Investors in and issuers of Islamic products currently run the risk that the scholar who approves their structure could change his mind a few years later, a situation in which they have no legal recourse.

An economic slowdown and the possible end of the Gulf real estate boom are likely to create conditions under which many of these structures will be tested. If any widely used structures are found to fail under the stress, 2009 could be a painful year for Islamic finance.