What does a global financial market based on custodial relations look like?

A critical appraisal of Islamic finance as a case study of social capitalism

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Drawing on David Westbrook's (2012) problematique for this conference, let us provisionally define a "social capitalist" financial system based on "custodial regulation" as "the idea that financial institutions and markets are not merely means to ends, but fairly directly serve human and institutional needs." Specifically, finance based on custodial regulation is the "mediation of existing social obligations among parties and across time" so as to "provide money when and where it is needed." This normative vision is dramatically different than the efficiency-based normative vision of conventional finance in which scarce capital is invested where it is most profitable, leading to both creative destruction and market volatility, both of which are understood as necessary handmaidens for economic growth.

Although the financial crisis demonstrates many of the pitfalls of our present financial system, it is certainly possible that Westbrook's (2012) alternative vision is even more harmful. Therefore, before embarking on such a radical project, it is reasonable to ask whether such a project has already been attempted, and if so, to appraise its social consequences.

In this conference presentation (drawn from research in a forthcoming publication),[1] I argue that the existing market in Islamic finance closely resembles Westbrook's (2012) vision of social capitalism based on custodial regulation. However I also argue that the secular social benefits of presently existing Islamic finance appear rather slight, in large part because three social forces push Islamic finance to closely resemble conventional finance. I therefore conclude that on one hand, the dangers of embarking on such a project appear minimal, but on the other hand, the benefits are also likely to be minimal unless there is a regulatory project in place to counteract the three social forces identified in this conference paper.

The organization of the paper is as follows. First, I briefly introduce and survey the existing market in Islamic finance so as to demonstrate that it is a potential case of social capitalism based on custodial regulation. Second, I summarize and critique the social science literature which disagrees with this characterization—a number of scholars have argued that Islamic finance is merely a religious façade for conventional finance and banking. Third, I describe three social forces that push Islamic finance to closely resemble—but I argue not converge with—conventional finance. In the conclusion, I present some preliminary ideas of what the case teaches us for secular financial reform projects such as custodial regulation and social capitalism.

The case for Islamic finance as a case of custodial regulation

What is Islamic Finance?

IBF originated in the early 1970s and postdates the conventional banking sector. The origins and diffusion of IBF are intertwined not with terrorism[2] but with the slow shifting of the world's hegemonic center from a North–South axis to a multipolar East–South arrangement (Imam and Kpodar 2010; Nederveen Pieterse 2011; Pollard and Samers 2007).[3] Therefore, with few exceptions, Islamic financial institutions (hereinafter IFI) **compete in a market dominated by conventional finance**.[4] The global size of the industry is estimated to be between $822 billion (Timewell and DiVanna 2009: 2–3; also see Imam and Kpodar 2010) and $1.3 trillion (Warde 2010: 1).

"What is Islamic finance?" To answer the question is to join a contested discourse regarding how to interpret contemporary finance from the perspective of the Shariah (divine law). As a preliminary definition of IBF:

1) Financiers must attend to the objects being financed. IFIs must not purchase equity in or provide credit to products and activities prohibited by the religion.

2) *Riba* and *gharar* are prohibited. Both are discussed below. As a working translation, *riba* is associated with interest, usury, and financial transactions untied to the nonfinancial economy. *Gharar* is associated with unproductive risk and exploitative information asymmetries.

3) More broadly, Shariah discourages asceticism and encourages the enjoyment of worldly goods from profitable trading, so long as trades are by mutual consent and do not involve products prohibited by the religion (e.g., alcohol or pork). Charity is obligatory. Debt is broadly permissible within the above parameters (Vogel and Hayes 1998: 53–69).

There is considerable definitional anxiety among practitioners of IBF. Bill Maurer (2005: 40) notes an almost ritualistic exegesis in "almost every Islamic banking speech act or text" of what constitutes Islamic finance and how it is or is not distinguished from what this paper will term "conventional" finance. This definitional anxiety is heightened by the perception by many—both within and outside of the field—that IBF is simply conventional finance dressed in Islamic garb. As a consequence, for some the question becomes, "What is Islamic finance, really?"

With little controversy, the defining distinction between conventional finance and the ideal-type of IBF is *riba* and *gharar*. Elsewhere (Pitluck forthcoming), I have argued that the interpretation of these two prohibitions with respect to contemporary finance remains contested because of the social organization of the religion and of the IBF industry. This contestation surrounding how to interpret *riba* and *gharar* in the contemporary economy largely explains the existing ambiguity regarding what is and what is not IBF.

Broadly speaking, across diverse schools of interpretation, virtuous profits are derived by receiving money in exchange for providing a real asset or service. In contrast, one may not make money by exchanging money. As a consequence, the only moral loan is as an act of charity, where a loan is given without interest, and a needy debtor is absolved if he or she cannot repay. One such loan is *qard hasan*, literally a "good loan." Such charitable lending is argued to be superior to charitable giving, since a needy borrower retains his or her dignity, and loans repaid can be given out to others as additional charity. Such loans are understood as charitable because Islam recognizes that the lender of money is sacrificing the time value of lent money, and the lender of property is sacrificing rent (El-Gamal 2006: 57; Maurer 2005; Usmani 2002: 4; Vogel and Hayes 1998: 105–6; Warde 2010: 139).

When one makes money from money (i.e., receives money in exchange for money of the same currency, rather than in exchange for a real asset), this is conceived of as "***riba***," literally meaning "increase," and is forbidden. There is a strong consensus among IBF practitioners that *riba* is a core prohibition in economic activity and a central criteria distinguishing Islamic finance from conventional finance. Nevertheless, since the religion's origins in the Arabian Peninsula, there has been debate regarding what activities are and are not *riba*, as well as why *riba* is prohibited. This debate regarding *riba* has intensified in Islamic economics journals since the mid-1970s, the period coinciding with the birth of the modern IBF industry (Siddiqi 2007; Warde 2010). Although *riba* is often equated with "interest" or "usury," for most IBF scholars this is either an excessively narrow understanding of *riba*, or an eccentrically broad understanding of "interest" or "usury" (El-Gamal 2003, 2006, 2007; Maurer 2001: 9, 2005; Vogel and Hayes 1998: 72–87; Warde 2010).

Gharar is less controversially defined, but interpreting its presence or absence in contemporary finance is often contentious, particularly in insurance products and derivative instruments. *Gharar* is a prohibition against speculative transactions on uncertain or contingent objects, both to prevent gambling on aleatory promises, and to eliminate exploitative information asymmetries (El-Gamal 2001; Vogel and Hayes 1998: 87–93, especially 90). Al-Zarqa defines *gharar* as "the sale of probable items whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling" (quoted in El-Gamal 2001: 5). Although there is great debate among Shariah scholars in how to apply *gharar* to contemporary finance, "[the] majority positions of classical *fiqh* seem antithetical to a great many modern financial transactions, since they presumptively ban all sales of goods not already both owned and in the possession of the seller, not to mention goods that do not yet exist" (Vogel and Hayes 1998: 93). The contested nature of how to interpret *riba* and *gharar* in contemporary finance is therefore a fundamental cause for the continued debate on what is or is not Islamic finance and banking.

In the contemporary IBF field, the least controversial products and financial instruments involve risk capital or credit for the purchase of a productive asset. Both practices can be interpreted as tethering finance to the real economy and are described in detail in the next section.

Also widely "accepted" as IBF is the Shariah-compliant slice of conventional equity markets and the fund management industry, at least as perceived by a "consensus" document produced by the Islamic Development Bank and two influential transnational industry organizations (IDB, IRTI, and IFSB 2007: xi, 41). Stock represents equity in corporations, and is therefore permitted to be purchased and sold, both in primary and secondary markets, as long as the corporation's principal lines of business are Shariah-compliant (for details see Pitluck 2008). Pension funds and the fund management industry are compliant as long as firms invest in Shariah-compliant assets and store liquid capital in the IBF sector. Worldwide, there are approximately 700 Shariah-compliant asset management funds, located primarily in Saudi Arabia, Malaysia, and the Cayman Islands, with approximately half of funds domiciled in Saudi Arabia (Ernst & Young 2010a: 7, 52–3).

Presently there is considerable debate regarding whether Islamic bonds and insurance products are Shariah-compliant (IDB, IRTI, and IFSB 2007: 41). Over the past decade IFIs have raised over $136 billion in corporate and sovereign Islamic bonds (*sukuk*) designed to elude *riba* (IIFM 2010: 6, 14, 19). Symptomatic of the contested legitimacy of *sukuk*, in February 2008 the AAOIFI's Shariah board ruled that the majority of existing *sukuk* issues were not Shariah-compliant, although the board chose to enforce its ruling only for new *sukuk* issues (IIFM 2010; Rethel 2011). Insurance is even more contentious, as it was once viewed as self-evidently containing *gharar*. However, by 2008 there were approximately 158 *takaful* companies spread across the Middle East, North Africa, and Southeast Asia claiming to offer Shariah-compliant life and general insurance, with an additional 36 conventional institutions in Indonesia offering "*takaful* windows" (Ernst & Young 2010b: 37). Nevertheless, the industry itself acknowledges that worldwide, "[t]he *fiqhi* [interpretations of Shariah] differ widely, often challenging even the basic concept of *takaful*" (IDB, IRTI, and IFSB 2007: 36).

Outside of the above areas, contemporary interpretations of *riba* and *gharar* view most modern financial instruments—particularly derivatives—as antithetical to IBF (IDB, IRTI, and IFSB 2007: 41). As a consequence, although complex Islamic financial instruments are built using contemporary techniques of structured finance (El-Gamal 2006), the IBF sector was remarkably stable during the global financial crisis of 2007–8 (Hasan and Dridi 2010). Shariah supervisory boards had generally not permitted IFIs to purchase securitized financial instruments such as mortgage-backed securities, as this would entail the sale of debt. Similarly, they were generally prohibited from trading credit default swaps, because the sale of promises entails *gharar* (Warde 2010: 88–9). As a consequence, IFIs faced less counterparty risk from failing conventional financial institutions. In subsequent years, growth in the IBF sector stalled not from financial contagion, but because of reduced North–South trade and production in the North's real economy.

IBF as a Case of Social Capitalism and Custodial Regulation

Based on the above description, IBF is self-evidently an example of "social capitalism," in which politics and morality are "understood to operate through financial markets, as opposed to in opposition to financial markets." (Westbrook 2012).

Additionally, I argue that IBF is an apt case of "custodial regulation." Both regulatory projects intend to reshape financial markets to serve human and institutional needs. In the case of IBF, that social basis is evolving and contested interpretations of Shariah law, particularly the prohibitions on *riba* and *gharar*. In the case of custodial finance, the social basis is ethical arguments for the extension of fiduciary responsibilities to additional niches in financial markets (e.g., Laby 2004; Richardson 2011). Despite these important differences rooted in different intellectual and ontological traditions, both IBF and Westbrook's (2012) concept of "custodial regulation" seek to better articulate the fiduciary obligations owed by those in power to clients on the short side of asymmetries of power, information, and expertise.

Having defended the position that IBF is a useful case of social capitalism and custodial regulation, we are now obliged to enter a dialogue with a number of social scientists who disagree. A number of scholars have examined IBF and concluded that it is substantively identical to conventional finance. Rather than representing a promising example of social capitalism, a number of these scholars view IBF as a religious façade designed to market conventional financial products to the pious. In the next section, I survey the empirical basis of these authors' arguments and provide a critique.

Readers well-versed in the practices of IBF, and already familiar with or uninterested in social scientists' critique, may safely skip to the next section on page 10.

Social scientists seeking alternatives are disappointed

In recent years, a number of social scientists have examined IBF for its emancipatory potential in restructuring the global financial architecture. With few exceptions the exercise has left them disappointed, leading them to make one of two arguments. First, analysts discover that the paragon forms of financing in IBF—profit and loss sharing—is rarely practiced, and they therefore conclude that IBF fails on its own terms. Second, analysts argue that the most common forms of financing in IBF—sales-based and leasing contracts—are substantively identical to conventional finance, and therefore IBF is merely a façade for conventional banking practices. In this section I outline both arguments and critique the second.

The ideal-type of IBF is rarely practiced

Although IBF is composed of dissonant voices, throughout the world one form of financing—profit and loss sharing—is widely accepted as the paradigmatic form of the IBF sector (Chapra 2007; Chong and Liu 2009; ElGindi, Said, and Salevurakis 2009; Kamla 2009; Khan 2010; Kuran 2004; Mirakhor and Zaikdi 2007: 57; Nienhaus 2007; Zaher and Hassan 2001). "It is an ideal alternative for the interest-based financing with far reaching effects on both production and distribution" (Usmani 2002: 1, also see 41). This preference extends to retail customers. In interviews with Muslim Americans regarding Islamic mortgages, Maurer (2006: 75) finds that they have a "fondness" for profit- and loss-sharing contracts. From the perspective of normative social science, in contrast to conventional interest-based financing, profit- and loss-financing creates

a close coupling of the financial and the "real" economy. Financiers are encouraged to invest in promising projects, to share profits and losses with entrepreneurs and, in so doing, promote development. Money is to be tied to real (material) assets to make them grow; it cannot be used as a commodity in and of itself or used as collateral. (Pollard and Samers 2007: 314)

IBF practitioners attempt to create contemporary "Islamic" variants of conventional banking products and financial instruments by drawing on, modifying, and concatenating historic financial contracts that classical *fiqh* scholars had judged to be permissible. One of these classical contracts is *musharaka*, Arabic for "sharing." In IBF, a *musharaka* contract creates a joint enterprise in which a bank and a firm are partners who share the profits or losses arising from the joint venture. The most commonly practiced profit- and loss-sharing contracts in the IBF industry are *mudaraba* contracts where one party (the bank) invests capital in an entrepreneur's business, thereby becoming a limited liability partner. Both contracts are typically written so that the bank withdraws from the partnership gradually, or upon the fulfillment of specific conditions. If both partners successfully satisfy the contract, at the contract's end the entrepreneur is the sole owner (Usmani 2002: 12–17; Warde 2010: 145–9).

Despite the theological and ideological importance of IFIs entering profit- and loss-sharing arrangements with clients, it is well documented that very little of the IBF sector's capital is invested in such products. As early as 1984, only 14 percent of Pakistan's Islamic banks held assets categorized as *mudaraba* or *musharaka*. In 1986, the Central Bank of Iran reported that *mudaraba* and *musharaka* accounted for 38 percent of assets (Kuran 2004: 9). An examination of assets in the ten largest Islamic banks, between 1994 and 1996, revealed that on average they held only 14 percent of assets in profit- and loss-sharing arrangements (Khan 2010: 809). In an analysis of 81 private Islamic banks between 1994 and 1995, Yousef (2005: 65) found that the percentage of financing made up of profit- and loss-sharing contracts averages 14 percent in the Middle East and North Africa, 30 percent in East Asia, 8 percent in South Asia, and 44 percent in sub-Saharan Africa. Yousef also noted that variation within countries and between countries in the same region is small. To the degree that we equate such activity with the idea of financial institutions forming partnerships with entrepreneurs in the real economy, and therefore as a contrast to financialization in the economy, even the above figures may be overstating the size of profit- and loss-sharing activities in the IBF sector. This is because many IBF institutions categorize portfolio management as *mudaraba* transactions, even though this "investment" is channeled not to businesses in the real economy but into secondary asset markets such as Shariah-compliant stocks (Warde 2010: 149).

In sum, building on the influential work of Kuran (2004), over the past few years social scientists such as Chong and Liu (2009), Kamla (2009), and Khan (2010) have evaluated IBF as an alternative to conventional finance, determined that IBF practitioners perceive profit- and loss-sharing instruments as paradigmatic Islamic transactions, and then documented that the contemporary IBF sector engages in few of these transactions. All depart disappointed.

IBF as practiced is substantively identical to conventional finance

The majority of IBF financing is conducted not on the basis of profit and loss sharing, but as a finance component in a sale or lease. The most common such sale-based instrument is *murabaha* (Khan 2010). Historically, a *murabaha* contract was a spot market negotiation between a buyer and seller over the seller's profit, rather than a negotiation over the price itself. This "cost plus" transaction would allow buyers ignorant of a good's cost to negotiate on equal terms with the seller (Warde 2010: 140).

In the contemporary IBF industry, this contract has been adapted to become a mode of financing. A client requests her bank to purchase an asset on her behalf, and then the client purchases the asset from the bank in installments. The bank is interpreted as improving the asset by giving it a new characteristic—the ability to purchase it using a deferred payment. This improvement of the asset, being of value to the client, permits the bank to charge a higher price (Usmani 2002: 46). This transparent increment above cost is often called "profit" or "service charge," but never "interest." A second sale-based form of financing is *ijara*, which is "virtually identical to conventional leasing: the bank leases an asset to a [client] in exchange for a specified rent." (Warde 2010: 144).

Both *murabaha* and *ijara* involve the purchase or use of an asset (not money), and are therefore understood to avoid *riba*, in the sense of money paid for money lent (Warde 2010; Wilson 2008). *Murabaha* is interpreted as permissible because it *link[s] extension of credit to a unique transfer of goods from a third party to the customer, and in doing so they make a meaningful connection with a credit sale of goods … A conventional loan, by way of contrast, need have no connection with any economic or legal event beyond the customer's undertaking to repay.* (Vogel and Hayes 1998: 143)

Both *murabaha* and *ijara* are argued to resist financialization—the distancing of credit or capital gains from real assets.

Although *murabaha* financing is widely approved by Shariah supervisory boards, its legitimacy has become paper thin because, in practice, these contracts often have only a tenuous connection with the trading of a real asset. The connection may be frayed in two ways. The first is the connection between the bank and the asset. *Murabaha* loans inherently have two risks above and beyond that of a conventional loan: a) the risk to the bank of purchasing an asset that a client might decide not to repurchase, and b) the risk that the asset is damaged prior to the sale to the client. To minimize these two risks, some (but not all) Shariah supervisory boards allow banks to delegate the client as their purchasing agent. The client as agent purchases the asset on behalf of the bank and then immediately (as an agent) sells the asset to himself. As a consequence, the bank plays no entrepreneurial role in selecting or buying the asset, and "owns" the asset for mere seconds before "selling" it. In such common contracts, the connection between the bank and the asset is tenuous (El-Gamal 2006; Usmani 2002; Vogel and Hayes 1998).

Second, the asset's connection to the client can be even more tenuous. Consider a scenario in which a client wants cash and does not want or need an asset, so that the asset is only a ruse to get Islamic financing. For example, a client in need of $10,000 can request the bank to purchase an asset worth $10,000 and then make a deferred sale of the asset to the client for $10,000 plus the profit markup. The client can then immediately obtain the desired cash by selling the asset for $10,000 minus transaction costs (Vogel and Hayes 1998: 142–3, 177).[5] When assets are wholly liquid and fungible, and can be cheaply bought and sold, such as silver, or more controversially, stock in a corporation, the connection between the client and the asset can be quite tenuous—the client never takes physical possession of the asset, and may "own" it for mere seconds before selling it for nearly the same price as the bank had (for mere seconds) "purchased" it. In such a stratagem, *murabaha* becomes "only a device to escape interest and not the ideal instrument for carrying out the real economic objectives of Islam" (Usmani 2002: 41).

Noted critics of IBF, such as Timur Kuran (2004), have called *murabaha* financing an "ancient ruse" (15) and merely a "semantic difference" (10) where debt contracts are Islamicized by using Arabic terms and replacing the word "interest" with terms such as "service charge," "administrative fee," "markup," or "profit." The "semantic difference" between Islamic and conventional finance is also demonstrated by comparing numbers generated by conventional and Islamic products. Maurer (2008: 70) asks, "Why is an Islamic mortgage 'Islamic' if the calculation of the payment structure and schedule is identical to that of a conventional interest-based mortgage?" Both Maurer (2006: 37; 2008) and Khan (2010) use amortization tables of Islamic and conventional mortgages in order to demonstrate them to be materially identical. Such similar calculations are generated because many Islamic banks benchmark their service charges to an international benchmark interest rate (Libor) or to the interest rates charged by competitors (El-Gamal 2006: 74–80).

Taken together, these observations have led many social scientists, IBF practitioners, and prospective and current IBF clients to argue that Islamic finance is merely a façade for conventional finance (Chong and Liu 2009; Kamla 2009; Khan 2010). A variant of this line of thought argues that Islamic finance products are nearly identical to those in conventional finance, except that they are economically inefficient, have high transaction costs, and bear additional economic and legal risks (El-Gamal 2006, 2008; Kuran 2004). Similar debates take place among Islamic economists and IBF practitioners (Maurer 2005, 2006, 2008; Siddiqi 2007; Wilson 2008: 192).

Maurer (2005) briefly reviews these arguments but ultimately rejects the question of whether IBF is distinctive from conventional finance. Instead, he displaces the question by pointing out that the same debate takes place among IBF practitioners at a more sophisticated level of analysis and remains unresolved (also see Maurer 2001).[6] Pollard and Samers (2007) are also wary of taking a position, in part because they worry about the "enduring, largely unconscious Eurocentrism of European and North American knowledge production" (324). They are particularly skeptical of modernist and economistic discourses that conceive of Islamic finance as an inefficient, alternative, or peripheral form of finance that will ultimate replicate or be replaced by conventional finance.

Critique

In the next section, I will propose an argument for why the distinctive IBF sector so closely resembles conventional finance. Before I can do so, however, I must dispose of three arguments in the social science literature that are used to argue that Islamic finance is substantively identical to conventional finance.

First, a number of authors compare the amortization schedules between conventional and Islamic products and find them to be substantively similar or identical (e.g., Khan 2010; Maurer 2006: 37; 2008). Such amortization calculations are self-evidently an important characteristic of these financial products, particularly for clients who have a choice between conventional and Shariah-compliant products. However, this argument confuses the financial products for formulas, when in fact financial products are legal contracts detailing rights and responsibilities of transacting parties to an asset. Financial products require far more of transacting parties than mere agreement to an amortization schedule.

I suggest that a superior exercise would be to compare the language of Islamic and conventional contracts. When this exercise is conducted, it is again easy to be mistaken and interpret IBF as a façade, for much of the language can be identical. For example, Islamic home mortgages in the United States can have pages of language identical to a conventional home mortgage; both contracts contain terms inimical to Islamic finance such as "loan," "interest," "lender," and "borrower" (Maurer 2006: 48, 50).[7] However, in contrast to conventional mortgages, Islamic mortgages include *additional* contractual language mandating specific actions, including a redefinition of terms such as "interest" in the accompanying mortgage document (Maurer 2006). This point is generalizable: Islamic financial products are typically more complicated than conventional financial products insofar as they constitute multiple contracts in order to create multiple sales, create special purpose vehicles, and other legal exotica (El-Gamal 2006). If financial products are understood as legal contracts, Islamic financial products cannot be confused for conventional financial products.

Second, the façade argument ignores the intentions and epistemologies of participants (Maurer 2006; Swedberg 2007). For example, clients and prospective customers currently desire to have Islamic products closely resemble the cost structure of conventional products, and yet be distinctively Islamic (Elfakhani, Zbib, and Ahmed 2007). As an American Islamic mortgage company explains in its promotional brochure, "We do not change the math. We change the way we do business" (Maurer 2006: 52; 2008: 70). In interviews with Muslim Americans, Maurer (2006: 74–84) found that they valued mortgages (and banks) approved by prominent scholars, and valued Islamic banks that treated them formally and bureaucratically, in a fashion similar to the conventional banking system, while at the same time offering a product that felt "processual, social, and collaborative" (75). Rather than perceiving Islamic mortgages as problematically similar to conventional mortgages, there is evidence that customers simultaneously desire such similarities while also craving an "Islamic difference."

The façade argument also ignores the intentions of IBF scholars who write into Islamic financial products' contracts required behaviors that are wholly absent in conventional finance. For example, recall that a key characteristic distinguishing *murabaha* contracts from interest-based lending is that the former must fund a real asset (El-Gamal 2006; Usmani 2002; Vogel and Hayes 1998). IBF scholars such as Usmani (2002: 65) therefore write into these contracts that the bank must take "all necessary steps" "to make sure that the client really intends to purchase a commodity."[8] He provides three examples of such steps:

1. Instead of providing funds to the client to purchase the commodity, the bank should provide funds directly to the supplier;

2. If the client must be entrusted with the funds, the bank should require evidence that the commodity was purchased by examining invoices and similar documents;

3. Where funds are entrusted but invoices are not available, "the financing institution should arrange for physical inspection of the purchased commodity." (Usmani 2002: 65)

My point is simply that intentions such as these, documented in Islamic financial products, are substantively different than in conventional products. Certainly many details found in contracts—Islamic or conventional—may in practice be poorly implemented, avoided, or even unknown to signatories. How contracts are enacted is an empirical question that partly reflects the balance of power between IFIs and their Shariah supervisory boards, as well as the enforcement of contract law in the country. Unfortunately, the poor corporate governance and opacity of IFIs with respect to Shariah-compliance, discussed in the previous section, inhibits an empirical assessment of whether IFIs are or are not fulfilling their contractual obligations to be Shariah-compliant.

In summary, although the formulas and fee structures in Islamic and conventional financial products may be by design quite similar, the physical embodiment of financial instruments in words, the intentions behind those words, and some of the financial practices required of the transacting parties are substantively different. For social scientists advocating for regulatory reform—such as custodial regulation—the efforts that IFIs and Shariah supervisory boards make to ensure that each client requesting credit "really intends to purchase a commodity" provides a demonstration of the thorny conceptual and pragmatic challenges required for any social movement to tie all financial activity to the so-called "real economy."

Why does Islamic Finance so closely resemble conventional finance?

On one hand, this paper has argued that Islamic finance and banking (IBF) is an apt case of custodial regulation to reshape financial markets to conform with social capitalism. On the other hand, this paper has also entered into a dialogue with critics of IBF, and although it disagrees with these critics that IBF is merely a religious façade to peddle financial products to the pious, nevertheless this paper does readily concede that the secular social and economic distinctions between IBF and conventional finance are often vanishingly subtle. This is not necessarily problematic for observant Muslims. Just as one may feel that one is performing one's religious duty by eating *halal* meat regardless of whether or not that meat is aesthetically or nutritionally different than non-*halal* meat, one may purchase Islamic financial assets without excessive concern with whether IBF is distinct from (or nearly identical to) conventional finance.

However the similarities of IBF and conventional finance is potentially worrisome for scholars viewing IBF as a case of custodial regulation. On one hand, such convergent forms suggest that custodial regulation is unlikely to be harmful—or at least no more harmful than conventional finance. On the other hand, such convergence also suggests that there may be few, if any, social benefits from reshaping the financial system. This is particularly surprising given the radical endeavor of IBF to prohibit *riba* and *gharar* from the financial system.

We have therefore found ourselves in a paradoxical argument. On one hand, IBF 's prohibitions of *riba* and *gharar* are radically different than existing prohibitions of financial regulation centered on information disclosure and premised on *caveat emptor*. On the other hand, Islamic banking and financial instruments are found to be so strikingly similar to those in the conventional sector that a number of scholars have argued that the two are in fact identical.

Why is IBF—although distinctive—nevertheless similar in many respects to conventional finance? Drawing on DiMaggio and Powell's (1983) typology of isomorphic change, I analytically identify three social mechanisms promoting similarities between Islamic and conventional finance.[9]

The first mechanism is **coercive isomorphism** resulting from formal and informal pressures by other organizations, as well as broader cultural expectations (DiMaggio and Powell 1983). In our case, the strongest structurating force is a secular legal system that has coevolved with an interest-based financial services industry. Each country's extant regulatory structure and legal precedents pose unique challenges for the IBF sector. The applied literature is filled with complex regulatory issues, but a simple illustration will suffice.

In many countries, regulators require banks to assure full repayment of account holders' deposits; in contrast to profit- and loss-sharing banking, losses are not legally permitted. When the Islamic Bank of Britain sought a banking license, it desired to offer a profit- and loss-sharing account (*mudaraba*) where the customer receives profits and losses based on a risk-sharing formula, rather than a risk-free interest rate, as required by local interpretations of Shariah (Plews 2005). However the Financial Services Agency (FSA) requires that all UK deposit holders be assured full repayment unless the bank is insolvent. The compromise that the Islamic Bank of Britain and the FSA reached was that if the bank's risk-sharing formula suggested that customers suffer losses, the bank would nevertheless be required to offer full repayment of the capital (in accordance with FSA regulations); however, customers may elect to accept less than full repayment and instead accept the amount determined by the risk-sharing formula (in accordance with local interpretations of Shariah) (Fiennes 2005; Plews 2005). In this putatively successful resolution, the Islamic Bank of Britain offers profit- and loss-sharing deposit accounts to depositors that legally cannot lose money without the *ex post* consent of depositors.[10] Self-evidently, coercive isomorphism is a powerful factor in pushing IBF to very closely resemble conventional products.

To date, only a few countries have sought to circumvent their national legal system's coercive isomorphism by enacting Islamic banking laws: for example, Indonesia, Iran, Malaysia, Pakistan, Sudan, Turkey, the United Arab Emirates, and Yemen (El-Hawary, Grais, and Iqbal 2004: 26). However, it is an empirical question whether such legislation merely reproduces the conventional banking laws with minor alterations or whether it addresses larger epistemological differences between the Islamic and conventional financial systems (cf., Rethel 2011).

The second social force encouraging Islamic and conventional finance to resemble one another is **competitive isomorphism**. As organizations compete with one another (and seek to minimize competition by forming market niches), the organizations within a market niche progressively resemble one another, either by learning from successful competitors and their products, or because dissimilar organizations or products do not survive market competition (DiMaggio and Powell 1983; Fligstein 1996; Hannan and Freeman 1977). A frequent argument in the literature is that the IBF sector is a small niche in a competitive industry. In order to compete for clients and meet the demands of shareholders, the fees charged to IBF clients will rapidly converge on the interest-based fees charged to clients in the conventional sector. Yousef (2005) has made a similar point by arguing that it is unrealistic to expect the IBF sector to be primarily constituted by profit- and loss-sharing contracts when this form of financing is so costly in the conventional sector (also see Kuran 2004).

A third form of isomorphic change is **mimetic processes**. As a consequence of uncertainty (and risk aversion), organizations may model themselves and their products on preexisting organizations and products (DiMaggio and Powell 1983). As a relatively new industry with rapid product innovation, there is a great deal of uncertainty regarding what clients want. For example, Maurer (2006) investigates how Muslim Americans interpret two kinds of Islamic mortgage products and finds that these interpretations are quite different than each firm's understanding of their clients as well as their own marketing. Moreover, clients' knowledge of financial markets is shaped by their experience with the conventional banking sector, and this in turn shapes their expectations for niche markets, including the IBF sector.

An additional source of uncertainty is whether new IBF products can meet the requirements of two demanding constituencies with very different criteria: the Shariah supervisory board and market regulators. Each financial product must be crafted so that it can satisfy Shariah boards (e.g., by demonstrating that a transaction is not an interest-bearing loan). However, the same product must also satisfy regulators (e.g., by demonstrating that there is no legal difference between this product and standard interest-bearing lending) (El-Gamal 2008: 198). In all financial innovation there is a risk that the product or financial instrument will not be able to pass both constituencies. This uncertainty—combined with the uncertainty regarding what clients desire—is a powerful mimetic process, pushing Islamic financial products to resemble conventional financial products.

Conclusion and Policy Implications

Westbrook's (2012) problematique for this conference proposes a vision of the economy as "social capitalism" coupled with financial market regulation based on the concept of "custodial regulation." What lessons can we draw from Islamic Banking and Finance (IBF) for secular financial reform projects such as that of this conference's?

First, IBF demonstrates that a social movement seeking to restructure global financial markets can be successful without imposing a uniform reform program. IBF is a market in formation with factious voices claiming certain economic activity as "Shariah-compliant" or "Islamic" while other voices claim the same economic activity to be outside of, if not contrary to Islam. Yet the global size of the industry has grown to be between \$822 billion and \$1.3 trillion, and continues to grow significantly faster than many conventional financial markets. Intellectual disagreement among scholars regarding how to define "social capitalism" or how to enact custodial regulation need not prevent the launch of successful markets.

Second, in spite of IBF's radical vision of an alternative financial system grounded in the needs of the productive economy, and IBF's longstanding and persistent efforts to absolutely prohibit *riba* and *gharar* (two characteristics of conventional markets that many consider natural if not essential), nevertheless IBF is surprisingly similar to conventional financial markets. A number of scholars have interpreted this to mean that IBF is merely a marketing ploy to dress conventional financial products in Islamic garments. This paper disagrees and argues that there are substantive differences between IBF and conventional financial markets: IBF imposes distinctive interpretations of economic behavior, distinctive work practices, and differing rights and obligations. As physical entities, the contracts of Islamic financial instruments are also distinctive from their conventional counterparts. Nevertheless the critics are certainly correct—Islamic financial instruments and products very closely resemble those in the conventional sector.

This peculiar isomorphism elicits two hypotheses. First, the dangers on embarking on a radical financial reform program such as social capitalism and custodial regulation appear minimal when it is offered as a market niche in competition with conventional financial markets. In even a radical reform program such as IBF, the resulting financial instruments and services closely resemble those in the conventional market. This is not to deny the truism that poor regulation can destroy the incentives to trade in a market. Rather, it is to emphasize that firm-level financial innovation—no matter how radical—is likely to closely resemble preexisting financial instruments and markets. The second hypothesis is that such radical reform projects to promote social capitalism and custodial regulation, when in competition with the conventional market, are also unlikely to yield dramatic social benefits. While IBF products may be superior to their conventional counterparts from the perspective of observant Muslims, my preliminary research in Malaysia suggests that IBF provides few secular social benefits that are not already provided by conventional finance. Therefore advocates of social capitalism and custodial regulation may find that even if their radical project bears fruit, this fruit may very closely resemble the conventional counterparts they had critiqued.

Third, I argued that this isomorphism between IBF and the conventional financial system is caused by three social mechanisms. (Readers scanning this paper may find the definitions of these three social mechanisms in the previous section). This paper's case study suggests that to yield salient social benefits, regulatory reform projects such as this conference's require an additional regulatory project in place to counteract these three social forces.

In the discussion following this paper, I am extremely curious to hear from conference participants regarding their ideas, case studies, and experiences, with regard to financial regulation to counteract these three social mechanisms. I suspect that other cases of social capitalism can learn from one another. Below are some preliminary ideas to get the ball rolling.

a. **Coercive isomorphism**: This social force is the most amenable to correction by regulation, and is the central topic when financial regulators convene to discuss IBF. However regulatory discussions tend to be centered on creating a 'level playing field' where IBF can compete on an equal footing with the conventional financial sector. The paradigmatic example of this is tax policy, which in most jurisdictions is inadvertently punitive for IBF due to double taxation. However such political economic issues are merely the tip of the iceberg.

   To reduce coercive isomorphism, regulators in coordination with legislators must rethink the financial system in social capitalist terms. For example, the previous section described the case study of UK savings accounts at the Islamic Bank of Britain. To prevent such coercive isomorphism, UK regulators and legislators would have needed to dialogue with ideas unique to IBF (such as *riba* and *gharar*) in order to create new regulatory categories such as profit-and-loss sharing savings accounts.

   For secular social reform projects such as social capitalism, the case of IBF demonstrates that it is necessary not merely to build a parallel, social capitalist market, but to also create new legal and regulatory categories applicable to that market. Whether this is based on fiduciary lines—as suggested by Westbrook (2012)—or along other normative lines—as suggested by IBF scholars—is an independent normative question.

b. **Competitive isomorphism**: An implicit theme in this paper is that IBF's competition with the conventional financial market has yielded both benefits and costs. The benefits include rapid growth and rapid firm-level financial innovation which has rapidly diffused throughout national jurisdictions. But the principal cost is competitive isomorphism—where IBF products and instruments closely resemble those existing in the conventional sector.

   One solution is to apply the well-known tools of industrial policy (Chang 1994) to insulate the young social capitalist market from competition with the conventional sector. Over time, as the social capitalist market matures, the political economic problem is how best to withdraw the market protection and subsidies.

   A politically simpler solution is to promote mutualization of social capitalist financial firms so that they become cooperatively owned by their key stake holders (e.g., by becoming a credit union or building society). In the IBF sector, Mahmoud El-Gamal (2007) has advocated that firms pursue mutualization, both to insulate them from competition, but also to resolve numerous corporate governance problems plaguing the IBF sector.

c. **Mimetic processes**: If coercive isomorphism is the social force most amenable to change by legislators and regulators, mimetic processes are likely to be the least amenable. Policy makers have essentially two strategies to reduce the isomorphic influence of mimetic processes. First, regulators can use all the tools in their arsenal to reduce regulatory uncertainty. Financial firms respond to regulatory uncertainty with mimetic processes—imitation of other firms and trivially incremental financial innovation. Second, policy makers can reduce mimetic processes by expending government resources to educate consumers of what makes social capitalist products and services distinctive from those in the conventional sector. Such education is a public good undersupplied by the private social capitalist sector. Individual Islamic banks, conventional credit unions, and microcredit institutions certainly have an incentive to educate potential customers regarding what makes social capitalism distinctive from their conventional counterparts; however government can both amplify this message, and also provide information that may be perceived by the public as more accurate and neutral, given the self-evident conflict of interest involved in firms marketing their own distinctiveness. By reducing regulatory uncertainty and increasing the sophistication of market demand, government can potentially inhibit mimetic processes so that social capitalism need not converge in form with the conventional sector.

In conclusion, I hope to have convinced conference participants that the Islamic banking and finance sector is a useful case study of social capitalism and custodial regulation that yields insights for secular financial reform. This research—particularly the paper's preliminary conclusions—is very much a work in progress. I welcome all comments to modify or improve these arguments, both via the conference and email.

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[2] In the three years following the terrorist actions of September 11, 2001, most (67 percent) articles in the mainstream media regarding IBF mentioned a link with terrorism (Ali and Syed 2010: 34), particularly through IBFs' charitable contributions. Subsequent investigations have found this characterization of the industry to be unwarranted (de Goede 2008: 227–9).

[3] IBF originated in the early 1970s, fueled by the quadrupling of oil prices in 1973–4. Its principal intellectual and institutional support arose from debates within the Organization of the Islamic Conference (OIC) to reform the monetary and financial system to conform with Islamic ethics, as well as in larger debates within the United Nations for a New International Economic Order (Warde 2010: 70–113).

[4] Only Iran has a wholly Islamic financial system. Pakistan attempted one in 1985 before transitioning into a dual financial system over the past decade, and pre-secession Sudan attempted one between 1983 and 1986, and in the northern provinces since 1991 (Said 2005; Warde 2010: 114–25).

[5] When banks knowingly use such fungible assets to provide cash to clients, this is known as a "bank *tawarroq*" and is widely practiced in the Gulf States. It is considered by some IBF scholars as a permissible but not advisable economic transaction (Warde 2010: 143–4).

[6] "To put it another way, the metalevel debate between [social scientists] has already been anticipated (and exhausted) in metalevel debates" among IBF practitioners (Maurer 2005: 71).

[7] This identical language is due to the role of agencies like Fannie Mae and Freddie Mac that standardize mortgage forms and paperwork (Maurer 2006), a nice example of coercive isomorphism discussed in the main text.

[8] I have chosen to detail Usmani at length because his intentions are institutionalized in Shariah supervisory boards throughout the world. He holds the chair on the Shariah Council of three influential standard-setting international bodies: the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Rating Agency (IIRA), and the Central Bank of Bahrain. Additionally, he is the chair of ten Shariah supervisory boards in Pakistan, the United Arab Emirates, and Switzerland (Usmani 2011).

[9] DiMaggio and Powell (1983) also discuss a fourth form of structuration, normative isomorphism, in which forms resemble one another because of the professionalization process. I do not observe this in the IBF industry, perhaps because the professionalization process of IBF scholars is at an early stage of development (Chapra 2007; Ghoul 2008; Kahf 2005).

[10] In practice, IFIs competing with conventional banks cannot allow even small losses without a run on the bank, and therefore IFIs typically implement so-called "profit smoothing," so that depositors' returns closely track competitors' interest-based accounts rather than periodically experiencing losses. This introduces numerous corporate governance and conflict of interest issues (see Nienhaus 2007: 130–2, 141; Safieddine 2009).