

The Black Box Syndrome: A New Challenge for Shariah Supervisory Boards

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The IFSB hosted Interactive Session in Kuala Lumpur last week asked the following question of participants: "Recent developments in the Islamic financial services industry: are they adding value to or Diluting the Industry?"

After explaining that I believed that recent developments included the entry of multinationals, conventional banks from the region, conventional asset managers and legal professionals, I went on to say that my own understanding of the question of dilution may be equated to a reduction of quality or value. As a Shariah scholar (and now also as an executive responsible for all Shariah related matters in a publicly traded company), I look at quality from a Shariah perspective. The question as I see it is whether or not the entry of conventional banks, asset managers and lawyers has led to a reduction in the quality of Shariah compliance within our industry.

I believe that many of the new entrants have added significant value; and there are many examples to support my view. Collaboration between new entrants and Shariah scholars has led to many successes in which the new entrant has found a profitable new market, helped to advance the industry and set new standards for Shariah compliance. Oftentimes, the innovations behind new products, and the Shariah solutions developed for the same, have found applications even beyond those originally intended. Clearly, all of this has been good for the industry. Indeed, the world's most renowned Shariah scholars have been involved in many of these projects, and much scholarship and scholarly discussion has been generated as a result, even when the specifics of each fund or project were protected by non-disclosure agreements. Overall, the benefits to the industry, and not just to those who will invest in these funds, have been very positive and helpful, adding quality to the industry rather than detracting from it.

However, my answer was a qualified one. This is because along with the successes I listed, there is a caveat. I have recently begun to discern what I feel is a disturbing trend which I will label the Black Box Syndrome. This trend could have disastrous results for our industry, and that is why I feel it must be mentioned here. What the black box does is to obfuscate the line between what is authentic Shariah and what is not. Without naming names, there are certain multinationals who offer products that allow returns from investments in what is clearly prohibited, but which, by means of a device or stratagem we will call a black box for simplicity's sake, deliver those returns in a Shariah compliant manner.

We have been quite successful in recent years in pushing the envelope in innovating new and better financial products and processes, and have done so on the basis of sound Shariah principles and scholarship. Most importantly, in doing so, we have had equal regard for the letter and the spirit of the Shariah. However, what makes the Black Box Syndrome so threatening is that it ignores the spirit of the law; in some cases it appears even to flaunt it.

Ours is a rules-based industry, an industry that is predicated upon the authenticity of its adherence to Shariah norms. Without such adherence, Islamic finance would be no different from conventional finance, with no life of its own. Suffice to say that if the industry ignores the teachings of the Shariah, whether via the details or the broader principles, it is in trouble. I have little doubt, although I am not privy to the details of any of these black box schemes, that these adhere to

the "letter of the law," so to speak. I am certain that the structure and the transactional basis of these schemes are compliant, in a literal way, with established Shariah rules. Had this not been the case, my Shariah colleagues would never have approved them. Literalism, however, does not ensure compliance with Shariah principles and precepts. If a so-called Shariah compliant investment yields returns based on a promise linked to the returns on a transaction involving prohibited activities, whether as a primary business or as a function of finance, then that investment cannot truly be called Shariah compliant, no matter how strictly it follows the letter of the law. Without going into details, I will further point out that the linking of pricing to an interest rate benchmark is an entirely different matter.

To expand upon this point, I offer a worst case scenario. By means of a black box, held at arm's length from the Islamic investor by one legal means or another, Islamic money can be invested in junk bonds earning high rates of interest, and those can in turn be used to finance lucrative pornography portals on the internet. Of course, one might think, this is simply absurd. But no, it is technically possible. The black box allows asset managers (private equity and hedge funds especially) to invest in virtually whatever they feel will yield rewards. Since there is a series of legal devices between the Islamic investor and these investments, the returns, which are assumed to be the true concern of the Islamic investor, are technically lawful because they are not directly tainted by the other transaction(s). This, however, is an overly literal view of the situation. Yes, it may be true that the parallel transaction set up for the Islamic investor actually conforms to the letter of the law. But it is also true that the Islamic investor's money has facilitated, however indirectly, the commission of what is clearly wrong and unlawful. Another way to look at this; if the Islamic investor had not placed money in the vehicle or instrument, utilizing a black box device or strategy, the manager would not have made those investments, and those sinful activities would not have been financed. Yes, there is little doubt that others would have no reservations in financing these things. But the fact remains that the Islamic investor has become a part of the problem, even if he was not directly involved.

Taking this to another level, with the black box solution in hand, managers can invest in virtually any business. What, then, would be the need for Islamic indices? Are they for Shariah screening criteria, for Shariah compliant funds or for Shariah compliant home finance? Any financial product or service, then, could become Shariah compliant by means of a black box – bond funds, interest rate funds, funds that invest exclusively in conventional banks and insurance, breweries or even commodity funds investing in pork futures, would all be "open" for investment. Finally, what then is the need of Shariah supervision?

If black boxes are approved – with everyone knowing how they work, and everyone accepts that – then we will have a consensus (ijma'). When we have ijma' on a subject, there is no need for further discussion of the subject; and no need for a Shariah supervisory board to approve it. This is reminiscent of the old Arabic folk tale about the donkey which wanted to have horns and who, in his quest to acquire those wonderful horns, lost his ears.

In recent years I have worked on several projects which required finding authentic solutions to problems that seemed unthinkable. By bringing the right resources, both human and financial, to bear on these projects, major breakthroughs have been achieved. Today, Shariah compliant home finance is available to millions of Muslim families in the US, the UK, the MENA region, Pakistan, Malaysia and elsewhere because Shariah boards worked with financial and legal professionals to find appropriate solutions to all of the issues. Likewise, today Islamic investors may take advantage of the superior returns and risk averse features of hedge funds because Shariah scholars worked diligently beside business and legal professionals to work through all of the associated "short" problems. There are so many similar stories of success. However, the Black Box Syndrome spells doom for all such future stories, as the black box eliminates the efforts that are necessary for Shariah compliance by hiding sinful activities.

I would like to see more faith in what true and diligent Shariah compliance actually means to our industry. We have no need of "black boxes" and of arm's length transactions that miraculously produce results by sacrificing the spirit of the Shariah to the letter of the law.

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