Understanding Reverse Shari'a Arbitrage

Haider Ala Hamoudi
Associate Professor of Law
University of Pittsburgh School of Law

Common Concern

- Many scholars, of widely varying persuasions (Sh. T. Usmani, M. Asutay, M. El Gamal), have pointed out that Islamic finance does not do enough to achieve social betterment and social justice. It relies too much on transactions that "mimic" conventional finance, rather than those that involve risk sharing or profit and loss sharing.

Result

- If this concern were shared by the market, we would expect decreasing interest in Islamic finance over time, and less competitive rates.
- No loss of interest in Islamic Finance, seems to grow undeterred.
- No seeming material reason to depart from current techniques as a result.

Dilemma

- Why?
- Focus in this paper on dual market actors in particular (i.e. those who access both conventional and Islamic finance and credit markets regularly)

Examples of Dual Market Actors

- Irish Electricity Supply Board considering issuing *sukuk* in Malaysia.
- Dubai World Financial Restructuring 2009 (refinancings divided as between conventional and Islamic products).
- Iraq's State Company for Oil Projects (SCOP) considering Islamic finance as additional means to finance badly needed infrastructure investment.

Dominant Explanation

- Technical compliance with *shari’a* being achieved, as interim stop gap.
- Plainly not sufficient explanation for dual market actors

El Gamal's *Shari'a* Arbitrage

- Severe in its descriptions.
- Arguably relevant for home financings and other smaller transactions.
- Simply does not work for sophisticated market actors.
- Most importantly, rates seem to be *more competitive* than conventional finance in many cases. Completely inconsistent with arbitrage.

Limits of *Shari'a Arbitrage*

- Factors causing increased rates for Islamic finance are obvious:
  - Structuring Costs (Investment Banks, Law Firms)
  - Approval Costs (Shari'a Review Boards)
  - Coordination Costs
- Factors causing preferential rates could include commonly discussed elements:
  - Access to previously untapped credit markets
  - Perhaps, though limited (*e.g.* JAFZA *sukuk* on Irish exchange)

Other Factors Need to Be Considered

- Reductions in Political Risk for Public Debtors
  - Foreign Creditor Objections
  - Objections to Debt/Credit
  - Demonstrations of Islamicity on the Part of Regimes

Other Factors, Cont'd

- For Creditors of Foreign Debtors, Concomitant Benefits
  - Reduction in Political Risk Brings Lessened Risks
    - Default Risks
    - Dispute Risks

Reverse *Shari'a* Arbitrage

- Thus, while there may be *costs* to Islamic financings, there are self-evidently *savings as well.*
- We may refer to these savings as "reverse *shari'a* arbitrage."

Reverse *Shari'a* Arbitrage and Arab Spring

- Islamist led regimes in Egypt and Tunisia (and separately from Arab Spring, Iraq).
- Secularist challenges and warnings.
- Responses Thereto by Regimes to Integrate Into Global Communities.
  – Reassurance
  – Balanced Against Internal Conservative Opposition

Conditions Ideal for Maximum Exploitation of

- Burnish Islamist Credentials
- Nonthreatening (if not mandated)
- Political Risks of Credit Obvious
- Suspicion of Foreign Creditors Obvious

Prognostication

- As Arab Spring states stabilize, it will lead to increased use of Islamic finance facilities, along traditional “mimicry” lines, to take advantage of opportunities afforded by reverse *shari’a* arbitrage.
- Demand for more PLS/risk sharing will be thrust further into background.